Election 2021: No Fairy Dust Edition Part 2…

This three part series looks at the election issues of government deficits, debt, taxes and housing. **Part 1** covers deficits, debts past and present. **Part 2** covers current and proposed tax changes. **Part 3** focuses on housing – one of the main rationales for tax changes in Part 2.

McLean's Magazine provides a handy summary of the various party's election platforms. The guide provides direct links to the platform issue. I've relied on the party platform publication for any data in my commentary (7). In my commentary 'the names have been changed to protect the innocent'. I've left out party ID's for various ideas on offer. I'm looking at the ideas not the parties. Readers will make their own conclusions and vote. Please do vote!

(1) https://www.macleans.ca/rankings/2021-federal-election-platform-guide/

Canadian Election Opinion Poll updates: (8) https://338canada.com/

The Solution to everything is…tax.

In the months prior to the Sept/2021 election, politicians floated various tax hikes. None have discussed cutting spending. Some liked the idea of a wealth tax. Some discussed a 'one-time' 3% tax on wealth exceeding $10 million and 5% on amounts exceeding $20 million. (One-time taxes have a way of becoming permanent. Once Govt's get the money they don't let go. More accurately, once voters start receiving benefits paid for by 'someone else' they become 'rights' and are politically hard to give up.) Others didn't bother framing a wealth tax as one time, including a permanent 1% annual wealth tax in their platform to *'make sure the rich pay their fair share.'* We look at that 'fair share' idea later on this week.

One party dropped the Wealth Tax while bringing in a minimum 15% tax on individuals earning over $216,000 per year (Canada already has a minimum tax). Their platform backgrounder rationale is that high earners are using 'various deductions' to pay less than 15% through tax avoidance. The current Federal tax rate on income exceeding $216K is 33%.

Adding in BC's Provincial current income tax of 20% on regular income exceeding $220K, the combined rate is 53%. We detail this later. How one uses 'various deductions' mentioned to get income below 15% (being the marginal rate on $49,000 of income) is a mystery to me. Sign me up!

If 100% of income exceeding $220,000 was achieved from Canadian dividends fully eligible for the Canadian Dividend Tax Credit (CDTC), the combined Fed/Prov tax rate applied would be 36.54% here in BC. That's lower than top 53% marginal rate. But…

Canadian dividends eligible for the CDTC are paid out of after-tax earnings from the corporation paying the dividend. The Federal tax rate on active income for large Federally registered corporations (like the Canadian banks) is 15% before changes proposed in the platform.

(2) https://www.taxtips.ca/taxrates/bc.htm

Adding 36.4% BC tax rate on dividends received by the high earner individual to the 15% tax rate paid by the corporation paying the dividend arrives at 51.4% for a whopping 1.6% difference in total tax take between pure interest / employment income and dividends to the various levels of Govt. in Canada. We haven't spent the money yet.

Hike Corporate Tax Rates on Bank Profits exceeding $1 billion

That same platform provides a 3% tax hike on Bank & Insurance Co. profits exceeding $1 billion. The increase takes the tax rate from 15% to 18% on profits $1B+. The Royal Bank of Canada's projected 2021 profit is $15.3 billion. 94% of their profit would fall under the corporate tax rate 3% hike. Taking the top 6 banks and the top 2 largest Life insurance cos. 87% of their profits fall into this scheme. The 3% hike represents a 20% increase in tax.

But wait. There's more. There's a '*Canada Recovery Dividend*' (tax).

The rationale for the *'Canada Recovery Dividend'* is in that same party's backgrounder titled *'Asking Financial Institutions to Help Canada Build Back Better'*.

"Over the past ten years, Canadian banks and insurance companies have performed solidly. Thanks to the stability of our financial markets and the strength of the Canadian economy, Canada's largest banks and insurance companies are among the most profitable in the world.

During COVID-19, Canada's financial services sector recovered faster and stronger than many other industries, due in part to the unprecedented federal support that ensured Canadians and Canadian businesses were able to weather the crisis.

The public funds that supported millions of individuals and businesses – preventing bankruptcies and credit loss – through programs like the Canada Emergency Wage Subsidy (CEWS), the Canada Emergency Rent Subsidy (CERS) and Lockdown Support, and the Canada Recovery Benefit (CRB), were an economic lifeline for our country, and insulated our financial sector from the worst of the pandemic.

Over the same period, the operating income of Canada's largest six banks has increased by more than 17% since the beginning of the COVID-19 crisis. In light of this record, a (deleted*) government will ask our largest banks and insurance companies to do a little more to support Canadians in their goal of becoming homeowners, and to share in the dividends of this pandemic profitability."*

So…to summarize:

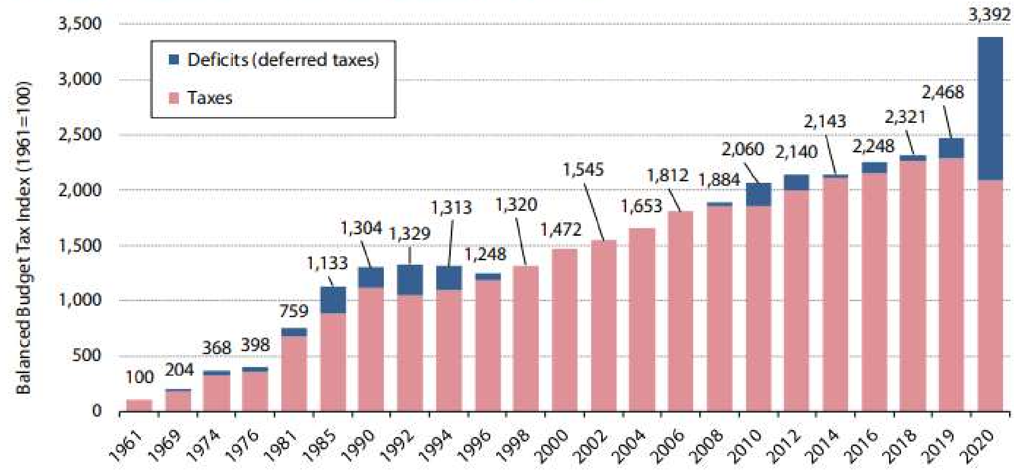
- The banks make gobs of money.
- The banks made gobs more money in 2021 than in the past.
- The reason the banks made gobs more money post COVID-19 was due to *'unprecedented federal support'*. I guess this means the clever application of government expenditures by the sending of checks out to individual Canadians and businesses small and large whether they needed them or not. Clearly the banks didn't.
- 'The Banks' are entities that unfairly benefitted from Govt largess.
  - Additional notes in the that platform prevent the Banks for passing these additional tax costs on to their consumers (good luck with that).
- The details of the *Canada Recovery Dividend* (tax) are lacking. No numbers provided. I've assumed they'll add 2% to the 3% base rate for a total hike of 5%.
- A rationale for this *Canada Recovery Tax* (I reject the '*Dividend*' label) – the distribution of which is unclear - is to *'help Canadians buy a house'*. That platform includes granting $30,000 to potential house buyers.

We look at the effect of government policy on the housing markets next week.

As singling out The Banks while not allowing other industries to *'contribute to Canada's recovery'* is just so unfair, common Canadian decency would dictate applying the 3% tax hike to all corporations from 15% to 18%. I suspect this is really what it's all about. Call me cynical. In 2008 the effective corporate tax rate was 19.3%. In 2010 18%. In 2012 the rate was cut to 15%. Lest some argue the current deficits are the result of the 2012 corporate tax cuts (nothing to do with spending - oh no) I reattach last week's chart from the Fraser Institute September 2021 update of their ***Consumer Tax Index*** chart on CDN Fed Govt Deficits by year.

https://www.fraserinstitute.org/sites/default/files/canadian-consumer-tax-index-2021.pdf

Figure 2: The Balanced Budget Tax Index, 1961-2020



Sources: The Fraser Institute's Canadian Tax Simulator, 2021; Canada, Department of Finance, 2020, 2021; RBC Economics, 2021; calculations by authors.

The three years following the 2012 corporate tax rate cut to 15% saw deficits <u>go down</u> as a %'g of taxes received while revenue went up. There were other factors at play but it's hard to say the corporate tax cuts caused deficits.

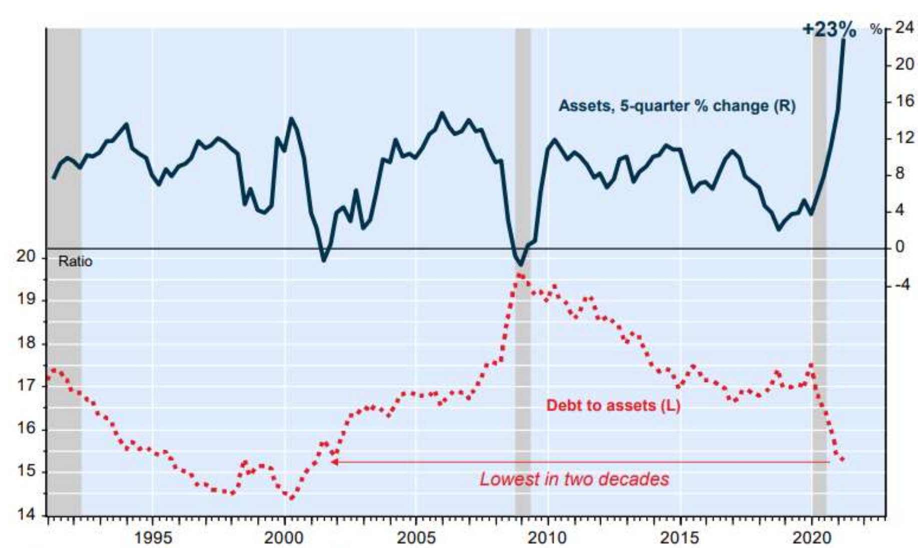
Let's break down the proposed financial services tax hikes.

Royal Bank is Canada's most profitable bank, 94% of which would be taxed.

Were the financial service sector profits unusual?

This week's Hot Chart focuses on the average Canadian household balance sheets.

Canada: Unprecedented positive wealth effect during the pandemic
Households assets and Debt to total assets ratio



NBF Economics and Strategy (data from Statistics Canada)

Canada Watch

By Matthieu Arseneau & Daren King

Last Friday, all eyes were on the employment report in Canada. For this reason, the data on household balance sheet that came out simultaneously went unnoticed. That's too bad because the report was interesting. The element that caught our attention in the release was the evolution of household assets. In Q2, households' assets rose by 3.6%, a fifth consecutive increase, driven by sizable gains in residential (+5.7%) and equity/investment fund share (+7.6%). As today's Hot Chart shows, household assets are up a whopping 23% from the low of 2020Q1 when financial markets were in disarray at the beginning of the pandemic. This 4 standard deviations jump is by far the quickest turnaround since data recording began. This development allowed another important metric for household financial health, the deb-to-assets ratio to drop to its lowest level in two decades. This unprecedented development should continue to bolster the economic recovery in the coming quarters.

(see the PDF links section for the full report and graphics)

The NBF chart tells us Canadians (IE the Bank's customers) made an *'unprecedented'* 23% gain in wealth coming out of the COVID-19 pandemic. Canadian debt vs. assets are at the lowest ratio in 20 years. No surprise the banks who serve them made *'unprecedented'* gains in profits. Will someone please tell our elected officials that's kind of how things work? Maybe it was government largess that was unprecedented? Using the logic that The Banks made unseemly profits, all Canadians made too much money, are worth too much, all due to unprecedented Government intervention and must be parted from *'a little more'* of it.

Were Royal's 2020's profits unusual?

- Royal Bank 2021 vs 2020 profits +36%. Nice! An eye-brow popper for sure.
- But…Royal Bank's profits 2020 were lower than 2017-18 and only +9.3% higher than 2016. 1.8% growth per year is hardly stellar.
- Royal Banks earnings stalled from 2016 to 2020.
-

Were the Royal's profit increases the result of Government policies?

Although the party backgrounder uses the term 'partially', the implication is 'mostly'. How much time again did elected officials and their minions spend in the Royal's head office risk management department? The current government's tenure began in October/2015. If Government is the reason Royal made too much money in 2021, one must also place the blame for the flat 2016-2020 results at their feet. I reject both these notions.

Who is the Royal Bank? Who owns it? Who pays these taxes?

Government regulations prevent any entity controlling more than 20% of any Canadian Schedule 1 federally chartered bank. In practice ownership distribution is more widely spread. Of the top 10% of shareholders of Royal Bank common stock, 8.5% is held by Royal Bank mutual funds and their wealth management divisions. Royal Bank shares are one of the country's most widely held securities. The Royal Bank is owned by Canadians, as in ALL OF US.

What does a Bank Tax mean for a middle-class investor…in dollars?

We held a portfolio review with a longstanding client recently. She is of modest means and fully retired. She sold a small business a few years ago and now lives off her saved $300,000 investment portfolio income, CPP and OAS. Her annual income totals roughly $40,000. She is barely in the middle-class income band. She has drawn $18,000 per year from her investments. She carefully monitors this income draw. Her investment income represents 45% of her total annual income. It is important to her lifestyle. As her investment returns have exceeded her income, the portfolio purchasing power has slowly kept ahead of her expenses and inflation. Last time I checked no one from any political party was involved in her investment decision-making. Like many conservative Canadians, she is invested in bank and insurance company common shares. Her allocation is 27% of her total portfolio. She started at 14%. She is very pleased with her bank share returns.

Her combined financial services sector holdings are generating internal profits inside her portfolio (profit per share X shares held) of $6,525. The portion of this profit taxable under the Bank Tax plan is $5,327. The potential additional taxes on this profit are -$290.30 per year. To clarify, the tax reduces the portfolio profit. She doesn't see the immediate effect, but it will ultimately reduce her future dividend income by at least that amount and/or will impact the share prices of her holdings. Cash dividends typically are 35-40% of corporate earnings. The actual cash income effect to our client's portfolio could be larger than the increased tax. At minimum a reduction of future dividend hikes is likely. These costs are invisible at the outset, only showing up over time. Sneaky.

Our client's income is static. I calculated her tax bill in 2016 at $5,843 to net $34,157. She was pleased to note the current Govt has reduced her income taxes such that for 2020 her income tax was $5,486 to net $34,514. She is aware of the $357 income tax saving as it represents roughly one week of her investment portfolio earnings per year. The Bank Tax will effectively claw-back 81% of these tax cuts. She won't directly experience the cash impact, but it will be there. The bottom line is a barely middleclass Canadian is going to pay for these tax hikes. If applied this coming year, the $290 annual increase in tax to her portfolio equates to a 5.3% increase of tax on her 2020 total taxes paid. She's been retired for seven years. $290 X the next seven years = $2,030. Note that if the bank profits grow, she'll pay (lose) more. Mind you it's on a growing base.

I worked out the potential Bank Tax hike cost to our book of clients. I estimate this cost to be approximately $114,000 per year. To make your own estimate, total the dollar value of your bank holdings. Divide that total by 11 (avg P/E for the banks), to arrive at your portfolio financial service profit. Multiply that portfolio profit value by 87% to determine the likely portion of your portfolio's bank profits falling under the Bank Tax then multiply that result by 5%. (3% base rate + 2% Recovery Dividend-tax). It won't be 100% accurate but it will give you an idea. That money is coming out of your portfolio. More than one political platform says or implies that there are all kinds of tax revenue to be had (from someone else) if governments would simply stop letting 'the wealthy' off the hook. No there isn't and no they aren't.

I'm not saying taxes are bad.

Taxes pay for all kinds of services and infrastructure we rely on. Business can't succeed without a healthy safe environment. My late father once had a debate with a first-generation immigrant construction contractor who was outraged lower-income families qualified for post-secondary education grants. He'd worked hard, saved hard, and achieved success without any help. Never on Welfare. He proudly put his kids through college without grants. He believed poor folks were poor for a reason and didn't deserve help. My father replied: *"The question isn't whether they deserve it or not. The question is what kind of society do you want to live in? Education lifts all boats"* (Dad was the son of a University President!)

I'm okay with taxes. Make sure you understand and are okay with <u>your share</u>. No Fairy Dust.

All of these tax ideas are intended (hoped) to pay for looming massive deficits.

Some politicians proclaim *Tax the Rich Top 10% Fat Cats More* will fund additional spending. The spending might be a good idea but what about paying for it? The top 10% are currently covering 40% of the revenue.

https://www.fraserinstitute.org/sites/default/files/measuring-the-distribution-of-taxes-in-canada.pdf

Last week I complained Canada's politicians are acting like drunken sailors buying each other rounds at an increasing pace before the bar shuts down. *Tax The Rich* proposals in short:

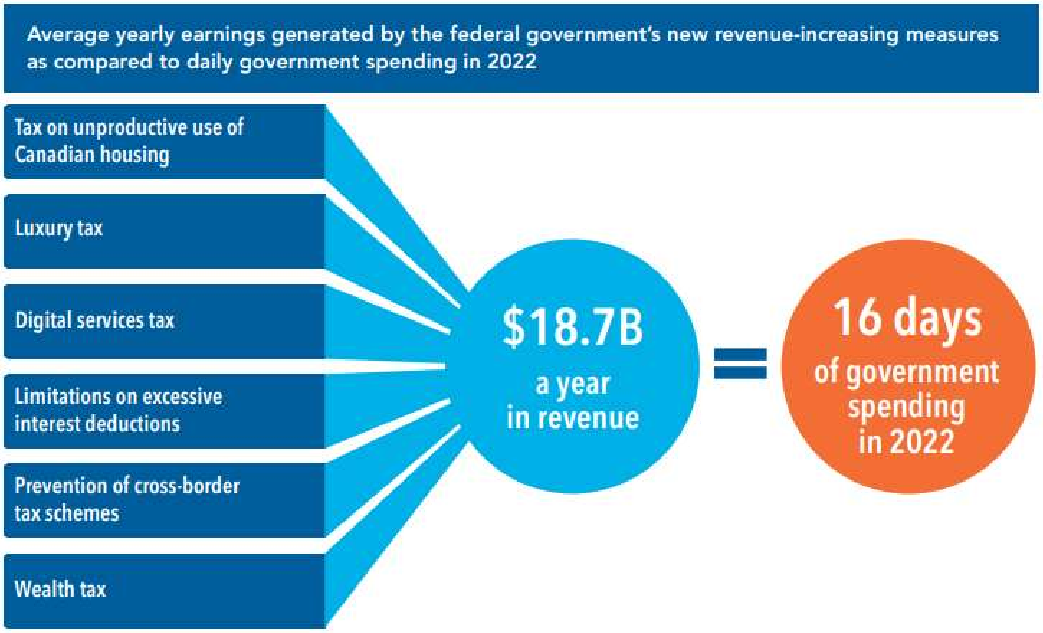
"Let's beat up the 1 out of 10 sailors in the bar who, having saved more of his pay prior to shore leave, has been the source of 40% of those 'free' rounds. We'll grab his wallet. After all, clearly he's been able to afford it".

The proposed 15% 'alternative minimum tax', using the party's own numbers, was projected to generate $1.7 billion <u>over 5 years</u>. Later, to ensure compliance on these many ideas, they will allocate $1 billion <u>per year</u> to CRA to help catch those Rascally Rich Folks. Am I missing something?

What about a Wealth Tax? Would it work?

More than one party liked the Wealth Tax idea. One got cold feet, another made a 1% annual tax on wealth exceeding $20 million a major platform plank. Would a Wealth Tax cover the deficit (let alone debt) projected by Canada's Parliamentary Budget Office? MEI of Montreal ran numbers in their August/2021 report *'Wealth Tax: A Predictable Failure'*. Adding up a series of proposed new taxes appearing in various platforms including: 'Unproductive housing' tax, Luxury Tax, Digital Services Tax, limitation on excessive interest deductions, prevention of cross border tax schemes and a Wealth Tax. Assuming no behavioural change on the part of the taxed, MEI projected total take from all these programs to be $18.7B per year in revenue (high net worth individuals, like the rest of Canadians, would likely take remedial action). Assuming static taxpayer behaviour, what combined effect would these taxes have on Govt expenditures? Here's the chart.

Figure 1



Sources: Author's calculations. Government of Canada, *Budget 2021 - A Recovery Plan for Jobs, Growth, and Resilience*, April 19, 2021, pp. 304-306, 328; Office of the Parliamentary Budget Officer, "Revenue Estimates Of M-68: Onetime Tax on Extreme Wealth," July 15, 2021, p. 4.

The study is available as download here

https://www.iedm.org/wp-content/uploads/2021/08/lepoint052021_en.pdf

Assuming deficits are a dilemma there isn't enough money to be had pursing *Tax The Rich* solutions to solve the deficit. I'm. I leave *"Should anyone be rich?"* for Philosophy 101.

A Wealth Tax implies an Inheritance Tax:

One proposed Wealth Tax threshold is $20 million Canadian per individual. An individual holding $20 million in wealth with three children could distribute their assets between those three, getting well under the $20 million mark. The regulatory response would be to impose an Inheritance Tax to ensure compliance with the Wealth Tax to grab a piece of any distribution pre-estate to avoid the tax. Gift taxes, attribution rules, the whole bit. The United States has an inheritance tax at $5 million+ per individual but does not have an annual wealth tax. Various complex annual distribution strategies and family trusts are used to avoid the US inheritance tax, a boon to the US tax-preparation industry. A Canadian Wealth Tax is likely to scare off at least some of those bad people worth more than $20 million. The sailors with the wallets find other bars.

Have the Fat Cats gotten off scot-free? Historical tax rates.

Scot-free is appropo as explained here:

https://www.onestopenglish.com/your-english/phrase-of-the-week-to-get-off-scot-free/145661.article

The history of Canadian tax rates are posted at Delloite Touch:

https://www2.deloitte.com/ca/en/pages/tax/articles/canadian-tax-rates-archive.html

The current Govt was first elected in Oct/2015. We compare 2015 to 2020 tax rates. Changes highlighted

2015 tax rates: middle class and upper income bands:

- Federal
  - $44,701-$89,401: 22%
  - Over $138,586: 29.00%
- BC :
  - Over $37,869 up to $75,740: 7.70%
  - Over $75,740 up to $86,958 10.50%
  - Over $151,050: 16.80%

2020 tax rates: middle class and upper income bands:

- Federal
  - $48,535-$97,069: **20.5%**
  - Over $214,368: **33.00%**
- BC :
  - Over $41,725 up to $83,451: 7.70%
  - Over $157,748 16.80%

Over the past 5 years, the Fed's added 4% tax via two additional top marginal income bands while reducing the $44-$90k rate by 1.5%. A couple whose individual incomes were in the $44-$89K range saw a drop in tax. A couple with a single breadwinner in the $160K range (same total income) saw their income tax unchanged. Individuals over $214K pay an additional 4% = 13.8% higher taxes.

So yes the middle class paid 1.5% less and 'the rich' paid 4% more(2.6X). Despite historically low interest rates to begin with, a decline in borrowing rates over the period (refer to the debt service chart above) and a strong economy, budget deficits ballooned prior to the COVID-19 Pandemic. John Maynard Keynes where art thou?

'Tax the Rich' may play well in certain circles but it didn't solve budget deficits over the past 5 years. My guess is the new solution *'Tax The Rich More'* won't reduce budget deficits over the next 5 years either. An expanding economy can help, but the elephant in the room is a lack of fiscal discipline. We'll do it our selves or it will be forced upon us.

What about *'The Rich should pay their fair share'*?

The slogan implies The Rich don't pay their fair share now.

First off – Who's Rich in Canada?

The top combined Federal and BC Provincial 53.5% tax rate is applied on income exceeding $222,420. Presumably that income and above qualifes as 'Rich'. $222,420 Canadian at current FOREX rates = $177,046 US income. The marginal combined Federal and State income tax rate in Washington state on $177,046 income is 33%. A Washington resident paying tax on $1,000,000 US annual income is taxed at 37% and no I'm not saying we should ape Washington. It seems 'Rich' in Canada is a much more modest affair. Maybe we're okay with that, but let's keep it straight.

The Fraser Institute looked at this issue at length in their 2017 study *'Towards a Better Understanding of Income Inequality in Canada'* (14)

https://www.fraserinstitute.org/studies/towards-a-better-understanding-of-income-inequality-in-canada

This section of the 2017 report deals with who pays what in Canada (15)

https://www.fraserinstitute.org/sites/default/files/measuring-the-distribution-of-taxes-in-canada.pdf

Income taxes aren't the entire story.

When considering wealth and income, every dollar earned by a taxpayer is eventually spent. If they save today they or their heirs will spend it later, but spent it will be. We must reduce gross income by both income taxes and sales taxes to arrive at the effect on net purchasing power of tax policy on a given income band. Politicins like to talk in percentages. How about some real numbers?

Let's compare two individual BC taxpayers. A middle-class individual with taxable earnings of $60,000 per year to one paying tax on $600,000. BC's GST/PST combines to 12%.

$60,000 Income:

- Combined Fed+BC income tax: -$10,479 / 17.47%
- After-income tax residual: $49,521
- BC Prov. 12% GST/PST cost: -$5,305 (the 12% reduces purchasing power)
- Total income+sales taxes paid: **-$15,784**
- After-tax purchasing power: $44,215.
- Effective Govt tax burden 26.3%. $100 = $73.69 for the benefit of the tax payer

$600,000 Income:

- Combined Fed+BC income tax: -$277,645
  - This figure is up <u>$20,643 per year</u> from 2015.
- After-income tax residual: $322,355
- BC Prov. 12% GST/PST cost: -$34,538
- Total income+sales taxes paid: -**$312,183**
- After tax purchasing power: $287,817
- Effective Govt tax burden 52.03%. $100 = $47.97 for the benefit of the tax payer

The high earner starts with 10X the income and ends up with 7X the income. The middle class tax payer pays $15.7K. The high earner pays $312K. Yes Mrs. High Earner ends up with more money. If the objective is income equality ,the tax code should punish success and reward mediocrity. When I look at these numbers I want to say a big THANK YOU to the Mrs. High Earner tax payer. I'm not sure what *Fair Share* is but maybe today's 'over half' is already getting there…maybe?

Focus on that $34,538 in sales taxes. If Mrs. High Earner tires of hostility, what's to stop her from moving somewhere else? She has enough wealth to own a home in Burnaby (maybe) and a home in a less wealth-hostile environment where costs are lower. If she wants to maintain her Canadian tax status she could spend mid-Oct-to-mid-March outside of Canada. She could bias her expenses into that lower cost environment before she comes home. Don't chase that $34,500 in sales taxes per year off! If we REALLY cheeze her off, she'll spend 7 months a year in that lower cost, lower tax jurisdiction, renege her Canadian residency (but not citizenship) and escape paying any Canadian taxes. She can always come back to visit. Blaine isn't far from White Rock. If she owns a business, she'd be likely to move that business with her. The jobs follow. I've seen clients do this.

Taxes are a cost. Rising costs require higher earnings before tax. It's why Unions exist. Investors require a higher return to achieve the same after-tax end result. Just as declining costs increase the present value of a future income stream, rising costs have the opposite effect. If returns must be higher, the hurdle to success rises. Less profitable opportunites are squeezed from consideration meaning less opportunity will be acted upon. All else being equal, higher taxes mean less economic activity. Prices paid for an investment opportunity must be reduced by increasing tax costs accordingly. The effects are lagged, easily confused, comingled and explained away by other events.

Taxes aren't bad. Like my Dad asked *"What kind of society we want to live in?".* <u>We</u> also must pay for it. There is no Fairy Dust. I see our clients progressing from middle class work-a-day lives to some form of security. Some started on Welfare and ended financially secure. Some clients even became 'rich'. They all pay a lot more tax today than they did when they started out. They're (mostly) okay with it. Please don't make up stories about them. No one sprinkled them with Fairy Dust. They flew on their own.

But this is all to help young people buy houses. Surely that's a good thing?

Tune in next week.

Steve & Anna Hilberry

Have a Great Weekend!

FOR THE RECORD Sept 13, 2021

DOW INDUSTRIALS:	34,869
S&P 500:	4,468
S&P/TSX COMP:	20,666
WTI:	$70.60
LOONIE IN $USD:	$0.7905 $US

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