# E.Q Trendwatch™

## *Conscripting wealth*

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*"In Canadian political history, the summer of 1917 is best known, not for the income tax, but for the conscription debate. Robert Borden's government had avoided introducing compulsory military service for the first three years of World War I but finally felt it necessary that summer to enact it, which it did just days before announcing the "War Income Tax" (the income tax's name until after the Second Great War). The timing is not coincidental. A phrase in the air that summer was "the conscription of wealth." With young Canadians about to be forced to risk life and limb in military service most people felt it only fair that those with high incomes be required to contribute to the war effort, too, not just asked to do so voluntarily in various bond drives."*

— The History and Development of Canada's Personal Income Tax, Fraser Institute 2017

**In this edition:** The IMF estimated this month that the Covid-19 pandemic will cost $28 trillion globally, while a study out of Harvard University estimates the cost will be about four times the economic output lost in the 2008-09 Great Recession. Canada's federal budget deficit for fiscal year 2020-21 was projected at $343.2 billion in July, ten times the $34.4 billion deficit projected before the pandemic and the net federal debt (to fund deficits) is on course to hit $1.2 trillion by March 2021, a near double from $684 billion in March 2019. Thinking people everywhere are wondering how we will repay the debt while still affording emergency support, critical spending and investment. While no one loves paying taxes, few understand their history and how current rates and collection statistics compare to historical and global precedents. Today, Canada's government services for taxes paid are more generous than average, while our corporate subsidies are large, and pursuit of tax evaders weak. Policies reflect a society's values, and values evolve during times of crisis.

The International Monetary Fund (IMF) estimated this month that the Covid-19 pandemic will cost $28 trillion globally, while a study out of Harvard University estimates the cost will be about four times the economic output lost in the 2008-09 Great Recession (see *The COVID-19 Pandemic and the $16 trillion virus)*. This amounts to a loss of just under $200,000 per American family of four—half in lost income from the COVID-19–induced recession, and half from the economic cost of shorter, less healthy lives. The authors offer some context:

> *"Output losses of this magnitude are immense. The lost output in the Great Recession was only one-quarter as large. The economic loss is more than twice the total monetary outlay for all the wars the US has fought since September 11, 2001, including those in Afghanistan, Iraq, and Syria.[6] By another metric, this cost is approximately the estimate of damages (such as from decreased agricultural productivity and more frequent severe weather events) from 50 years of climate change.[7]*

**Canada's federal deficit (spending greater than revenue) for fiscal year 2020-21 was projected at $343.2 billion in July, <u>ten times the $34.4 billion deficit projected before the pandemic</u>.** Net federal debt (to finance deficits) is on course to hit $1.2 trillion by March 2021, a near double from $684 billion in March 2019.

Despite our leaping debt, demand for Canadian government bonds pushed long term rates below 1% and the cost to service the federal debt in 2020 is projected to be $4 billion lower than forecast last December. Still, interest rates can't stay sub-one percent forever and debt weight reduces fiscal options.

All over the world, thinking people are wondering how we can repay all the debt while still affording the massive spending and investment needed. Less waste and greater efficiency are key parts of the solution, but undoubtedly, more tax revenue is needed. While the topic can trigger ire and loathing, historical context is illuminating in terms of where we are and what policy steps are likely to flow from here.

**Three thousand years of recorded human history attests that taxation has been present throughout.** Historically, taxes have been implemented as ways to pay for wars and protection. At extremes, they have catalyzed revolts and exodus to new lands like North America. ( See *A Short History of Taxation* for more).

**In our March 2019 letter *Saving Capital,* we reviewed how starting in 1914 the Canadian government called on savers to help fund the nation's first world war effort by buying 'victory bonds' paying interest of 5.5%.** At that point, Canada did not yet have income tax. To help supply goods to the soldiers, rationing was introduced for everyday items and a luxury tax was imposed on tobacco, alcohol, tea and coffee. In 1915, a 'Dominion' tax was added to transportation tickets, telegrams, money orders, cheques and patent medicines.

In 1916, the new *Business Profits War Tax Act* required all Canadian corporations having $50,000+ in capital to file an annual tax return for the first time. By 1917, however, resources were running low. Prime Minister Robert Borden announced that he would introduce the *Military Service Act* allowing the government to conscript men aged 20 to 45 across the country if the Prime Minister deemed it necessary. Highly divisive, the act ordered up 404,385 men for military service, from which 385,510 sought exemption. Compulsory service for young Canadians brought calls for greater contribution from older and wealthier citizens. 'Conscripting wealth' for the war became a national preoccupation.

On July 25, 1917, a six-page *Income War Tax Act* introduced personal and small business tax collection the following spring. Individuals exempted from the tax included the Governor General, foreign consuls, those who were on active service overseas as well as small businesses, married Canadians with an annual income below $3000, and single people with an income below $1500. While the *Income War Tax Act* had no time limit, the Minister of Finance said it should be reviewed a year or two after the war was over.

GRIN AND BEAR IT

The base tax rate was 4% with an additional 2% on income between $6,000 and $10,000, and a further 25% on income over $100,000. Enforcement was strict and eligible taxpayers that did not submit a tax return were fined $100 per day with a maximum penalty of $10,000—a formidable sum relative to incomes at the time. The 1917 cartoon on right, captures the public sentiment.

When the war ended in 1918, related expenses such as veterans' pensions and interest on the national debt did not. The government added a federal sales tax in 1920.

**As Canada entered World War II in 1939, Prime Minister William Lyon Mackenzie King pledged to not institute conscription**, but by April 1942, the *National Resource Mobilization Act* did just that.

As spending escalated, in 1943 the government began withholding tax at source. By the war's end in 1945, income tax was considered permanent and The *Income War Tax Act* was replaced with the *Income Tax Act* of 1948.

**The U.S. had begun taxing capital gains on property in 1860 to finance its war against the southern confederacy, and Britain in the 1960s, mainly to finance social security programs**. In 1972, Canada introduced capital gains tax with a 50% inclusion rate following the Carter Commission recommendation of 1966 that this would create a more equitable tax on income, because *"wages, salaries, business profits, gifts and capital gains all increase the economic power of the recipients and should be treated on exactly the same basis for tax purposes…or said differently a buck is a buck, is a buck.*"

**Canada's capital gains tax was devised as a way to help pay for the Canada Pension Plan (1965) and universal health care (1966) while replacing revenue lost from the 1972 to 1985 phase out of death taxes which the federal government had first imposed in 1941.** The long-recognized purpose of death taxes was as a brake on the wealth accumulation in affluent families and to recoup revenue from tax avoidance strategies commonly used throughout their lifetimes. When capital gains were taxed directly, there was less justification seen for death taxes. There remains no federal death tax in Canada to this day.

**To encourage home ownership, personal residences were tax exempted from the outset and have remained so.** In 1985, a generally available $100,000 lifetime capital gains exemption (LCGE) for property beyond the personal residence was added as part of changes *"to broaden the tax base, increase fairness…"* (Department of Finance, 1985). See Capital gains taxation in Canada 1972 to 2017: evolution in a federal setting.

The LCGE was intended to increase annually over six years, but in 1987 deficits prompted the federal government to freeze the cumulative limit at $100,000, with the exception of farmers, fishers and small businesses which reached the planned maximum of CAD $500,000 in 1990. After increases in 2007 and 2014, in 2015 the LCGE for small business shares (SBC), was indexed to inflation and set at $1,000,000 for farmers and fishers (but cannot be lower than the SBC amount in any given year).

**The justification provided for preferential capital gain treatment has been to encourage investment and allow property owners to save more for retirement (Department of Finance, 2015).** Apparently, it works: subsequent studies have shown that this group tends to earn and save more than average workers. Government figures from 1997 indicate that 45% of total capital gain tax breaks went to individuals earning more than $250,000 annually—less than one per cent of the population. Although much contested, a reduction of the tax breaks given to capital owners versus workers is likely in the years ahead.

In the late 1980s, a frenzy of real estate speculation in Canada inspired an increase in the inclusion rate for non-exempt capital gains from fifty percent to two-thirds (for 1988 and 1989), and then three quarters in 1990 just as the property bubble popped. In 2000, the inclusion rate for capital gains was dialed back to two-thirds (February 27, 2000 and October 17, 2000) and then fifty percent again as that stock market bubble burst.

**Sixty-eight percent of Canadians are homeowners**. The vast majority don't own capital property outside of their personal residence and tax-sheltered retirement accounts, so capital gains tax and exemptions beyond the personal residence are of little personal impact.

In the last decade, however, rising home prices have encouraged 'flippers' who inhabit properties just long enough to claim it as their principle residence and then sell for a tax-exempt profit. Beyond the original intention of the principle residence exemption, in 2016, the government began tracking this activity by requiring Canadians to report home sales on their tax returns. Although widely unpopular, it is likely that the principle residence exemption may be reduced in the years ahead and require a multi-year habitation period in order to qualify. Accountant and author Tim Cestnick put it this way, on Sept 11, 2020:

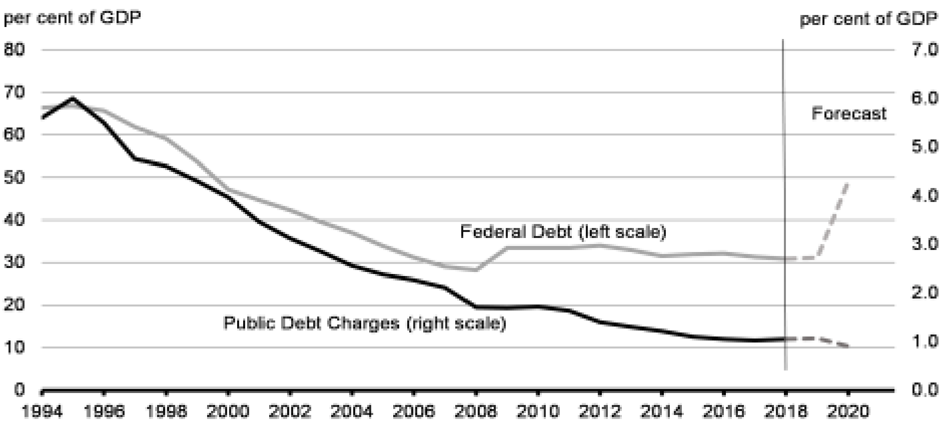
> *"If there's one thing the current government has shown, it's a propensity to tax those who have financial means – real or perceived. And there is, perhaps, no store of value greater than the homes of Canadians. Given the misuse or abuse of the principal residence exemption in the past and the current COVID-19 environment that has seen government deficits reach historic levels, I fully expect the current government to find ways to recover the funds that have been handed out to so many Canadians – many in need, some not so much. Taxes are going up."*

As budget deficits and debt soar, the three quarters of Canada's wealth held in real estate is an obvious target.

**As shown below, a federal budget deficit appeared in 1958 (net income below zero) and persisted through all administrations to 1997.** In 1994, as interest rates rose and the loonie dove, international credit agencies began comparing Canada's fiscal management to Mexico. In response, the 1995 federal budget slashed transfers to provinces, unemployment insurance, defence and international aid. Provincial debt has increased since.


A global commodity boom buoyed Canadian investment, jobs, exports and a budget surplus for a decade into 2008 before that boom went bust. Budget deficits have resumed since.

**As shown below since 1994, after falling between 1994 and 2008, Canada's federal government debt as a percentage of GDP (left scale) has risen since 2008 and is conservatively forecast to reach 49% of Gross Domestic Product in 2020 (dotted line)—the highest level since the 1990s.**

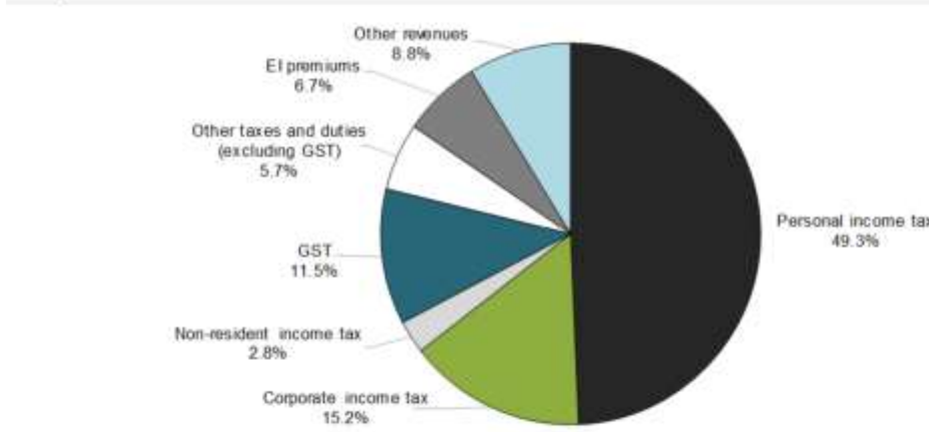



**In 1918, personal income receipts made up 2.6% of the government's total revenue and by 2018-19 it was 49.3% (chart below).**

In 1938, 2.3% of Canadians filed income tax returns, today 75% do. From six pages in 1917, the Canadian Income Tax Act grew to 1,412 pages by 2019.

When people think of taxes, they tend to think of the rate associated with the highest marginal tax bracket (54% federal and provincial taxes combined in Nova Scotia), but the actual or 'effective' tax rate of a person or family, is calculated by dividing their total tax paid by their total income.

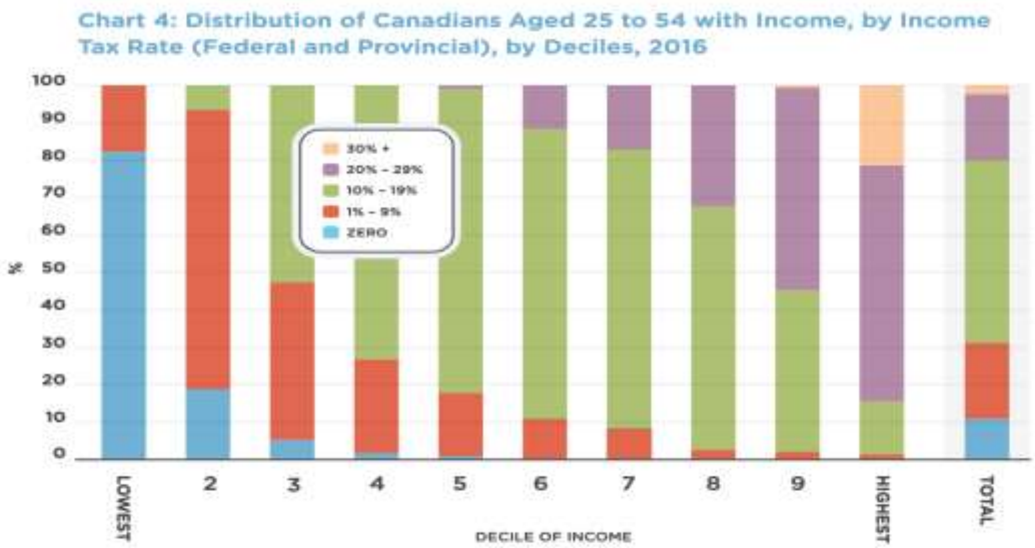
**Composition of Revenues for 2018–19**




Note: Numbers may not add to 100% due to rounding.

Source: *Public Accounts of Canada.*

**As shown in the far-right bar below, 80% of working Canadians (blue, red, green and purple bands) pay less than 20% of their income to taxes and just 2% pay more than 30% (yellow band).** See: Busting Myths about overtaxed Canadians. The latest StatsCan data (available on the web here) shows that the bottom 50% of Canadian tax filers pay zero federal or provincial income tax. The top 1% had a median annual income of $323,000 in 2017 (StatsCan data here) and paid a median total federal and provincial income tax of $110,000 or 34% of their total income.




The most affluent tax filers generally have tax rates much lower than many presume because they typically earn income from tax-preferred sources (business ownership, capital gains and dividend income) and can avail themselves of planning and tax mitigation strategies.

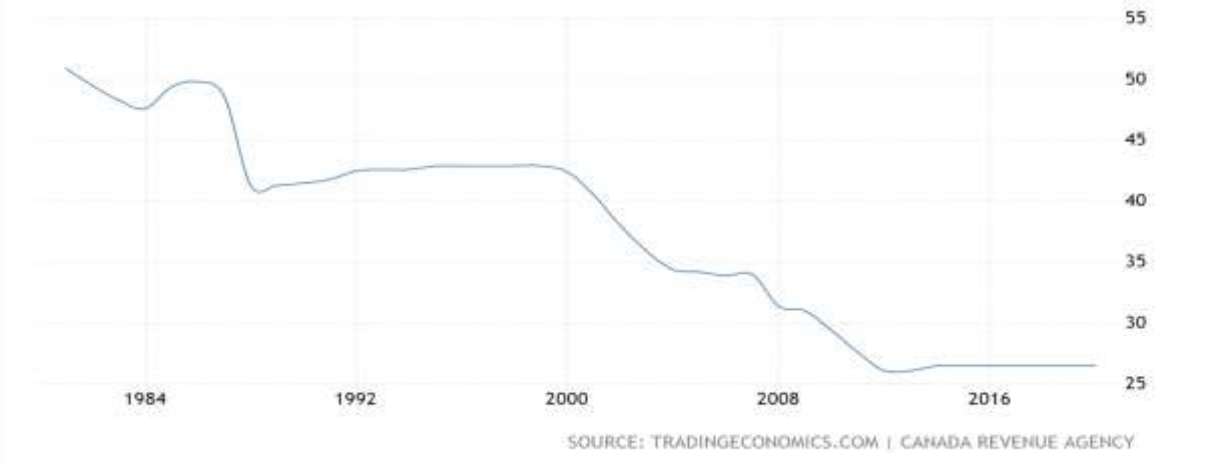
As an example, an Ontario resident who earned $100,000 in employment income paid $27,133 (27.13%) in all income tax, EI and CPP contributions last year. In order to pay 50% in total tax, one needed to earn $1m in employment income in 2019. However, if the same person, for example, received $500,000 in employment income and $500,000 in dividend income, their total tax rate was 36%.

In 2017, the average Canadian paid 22.8% of their gross wages in total tax, and less than the 25% average paid in the 37 Organization for Economic Co-operation and Development (OECD) countries. National averages ranged from 15% in Chile, South Korea and Mexico to more than 35% in Belgium, Denmark and Germany (source: OECD).

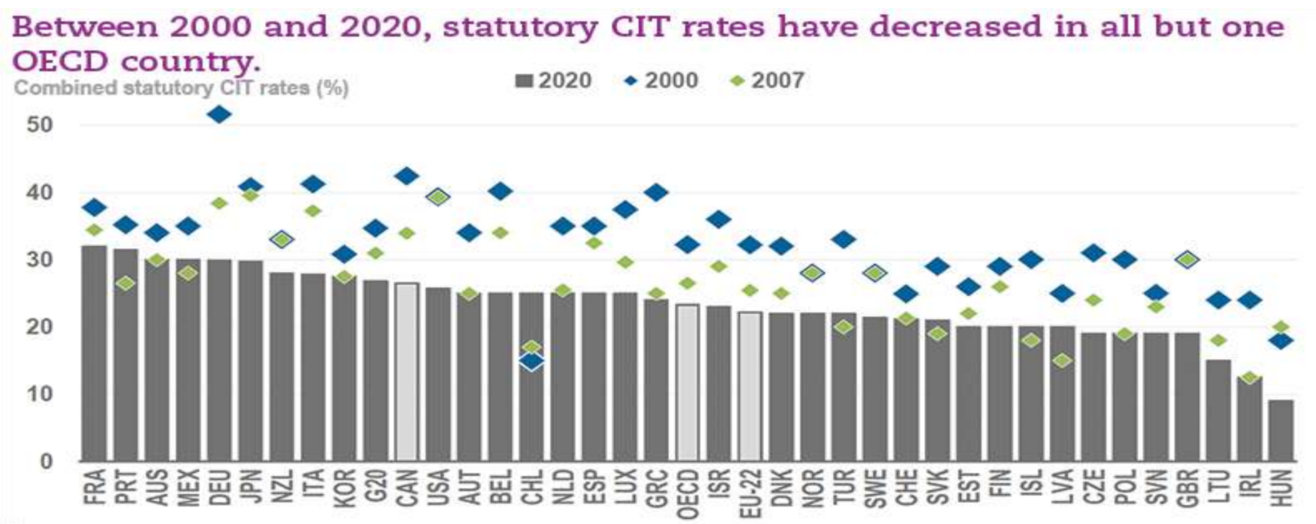
American marginal tax brackets are not much different than Canadian—the top federal marginal tax bracket in the US is 37%, versus 33% in Canada. Canadians, however, receive significantly more from their government, including universal health care, higher quality public education, unemployment insurance, paid parental and sick leave, Canada Pension Plan, Old Age Security and other services that consistently rank Canada in the top 10 best countries in the world to live. Canadians have a three year longer life expectancy than Americans.

**Corporate income tax rates**

In addition to the LCGE for small business owners, the Canadian federal small business income tax rate was reduced in 2019 to just 9% on the first $500,000 of active net income (for companies with taxable capital of less than $15 million), **and the general corporate income tax rate (shown below) has been halved from 50% in 1982 to 26% in 2020.**




**In fact, as shown here, all OECD countries, but Chile, significantly cut their corporate tax rates following 2000 and 2007 in order to attract corporations as stock and property bubbles burst and economies tanked.**




**Falling corporate tax receipts and ever-more generous subsidies to the sector have helped to balloon government deficits and debt the world over**. As shown in the pie chart on page 5, <u>just 15% of Canada's tax revenue now comes from corporations, compared with 49% from individuals.</u> For years, large corporations have argued that, as job creators, they earn low tax rates and government support. In reality though, offshoring and automation have steadily reduced domestic jobs, while inflating business profits.

Many of the world's largest corporations have positioned their head offices in low or no tax zones rather than the countries where their customers live. This has helped them to stockpile wealth beyond tax systems even as they benefit from government funded infrastructure and services. U.S. Fortune 500 companies had an estimated $2.6 trillion in offshore tax sheltered havens in 2017.

In response, proposals are now spreading globally to tax companies where their income is earned, based on the geographic distribution of their customers and employees. Canada has been effectively using a similar method for decades to tax interprovincial commerce. (See*: Canada can help fix broken international tax system.)* It is likely that these actions will be implemented as cash-strapped governments seek revenue.

After lowering the corporate tax rate from 35% to 21% in 2017, President Trump has promised to cut taxes further if re-elected next week. If Democrat Joe Biden is elected, he has pledged to increase the general corporate tax to 28% and introduce a minimum tax on corporations with book profits of $100 million or more.

Anticipated corporate tax increases are expected to decrease the after-tax earnings of S&P 500 companies by 9.8% in 2021, according to an analysis conducted by Zion Research Group; an impact that euphoric stock prices are not currently acknowledging. (See: *Investors, it's too soon for an election night party).*

**Without effective collection and enforcement, all tax rates are moot.** Estimates of private wealth hidden from resident governments globally range from $8 to $36 trillion and International tax avoidance is estimated to cost governments around the world some $800 billion in lost revenue each year. In 2018, The Canada Revenue Agency estimated some $240 billion in private Canadian wealth was parked in tax free zones, costing the Canadian treasury an estimated $20 billion in lost revenue annually.

Canada has also been well documented as a global haven for tax evasion and financial crimes. A recent international report on money laundering and terrorist financing ranked Canada as worse than Colombia. Chris Mathers, a former RCMP officer who worked undercover to investigate financial crimes has warned that Canada's lax tax enforcement is a global beacon:

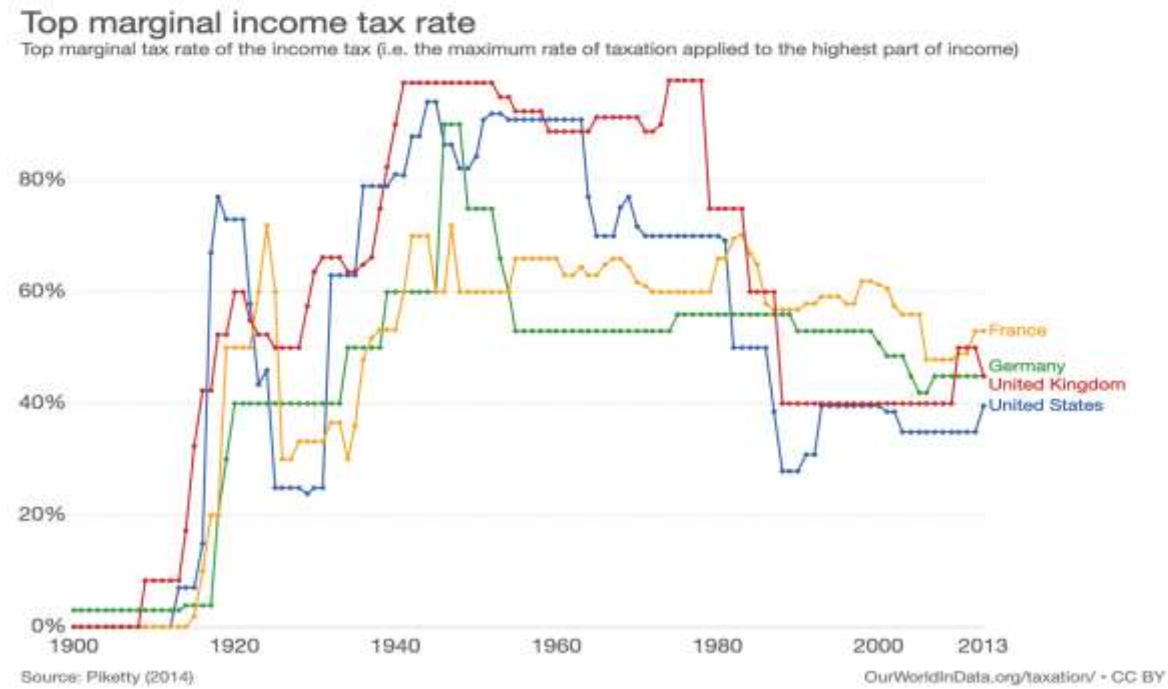
> *If you launder money in Canada and get caught, FINTRAC suspends your golf membership. No one goes to jail in Canada for even the most significant financial crimes. Things you'd do 20 years for in the U.S., you might get a fine [for] in Canada, and that's not lost on criminals.*

In *the Wealth of Nations* (1776), economist and philosopher Adam Smith wrote that the first maxim of a viable tax system is that subjects *"contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities."* In 1927, Oliver Wendell Holmes Jr., said that *"Taxes are the price we pay for a civilized society."* Before tax-funded armies, law enforcement, infrastructure, health care and social services, it was up to individuals to self-fund everything in accordance with their personal ability.

US President Donald Trump has bragged that he has not paid federal income tax for decades because he is smart. Meanwhile, during the first three years of his term (before COVID-19 hit) the US Federal deficit leapt on his administration's tax cuts and spending to add 16% to the national debt and push the US debt to GDP ratio to 103%--the highest since WW2. In 2020, the US federal debt to GDP ratio has eclipsed 137%--well above the 121% previous war time peak of June 1946.

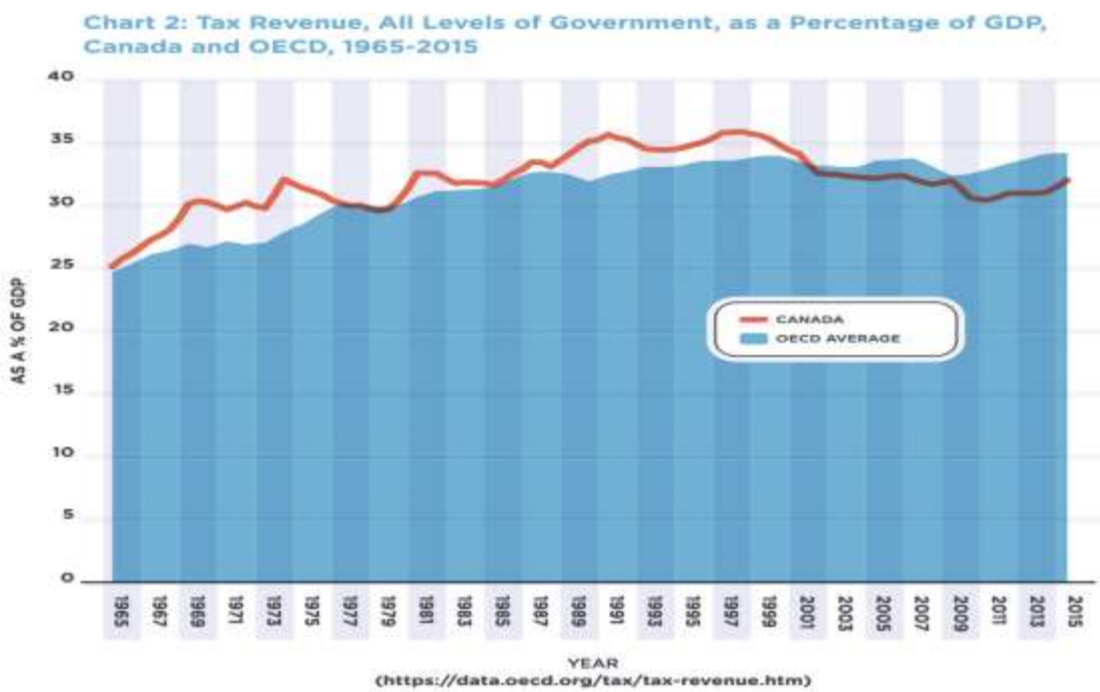
**During the Depression of the 1930s, after the real estate and stock market bubbles of the 'easy money' 1920s had burst, the top marginal tax rates for individuals in developed countries increased from 20% in**

**1920 to 90% by 1940 (shown on right) and stayed above 60% for decades.**




In Canada, the top marginal personal tax rate stayed at 80% until 1972 and 60% until 1981. It's 33% today.

Over the last 20 years, total **Canadian tax revenues as a percent of GDP have fallen from 36% in 1997 to 32% in 2015 (red line below) and below the average for OECD countries as a group (in blue).**

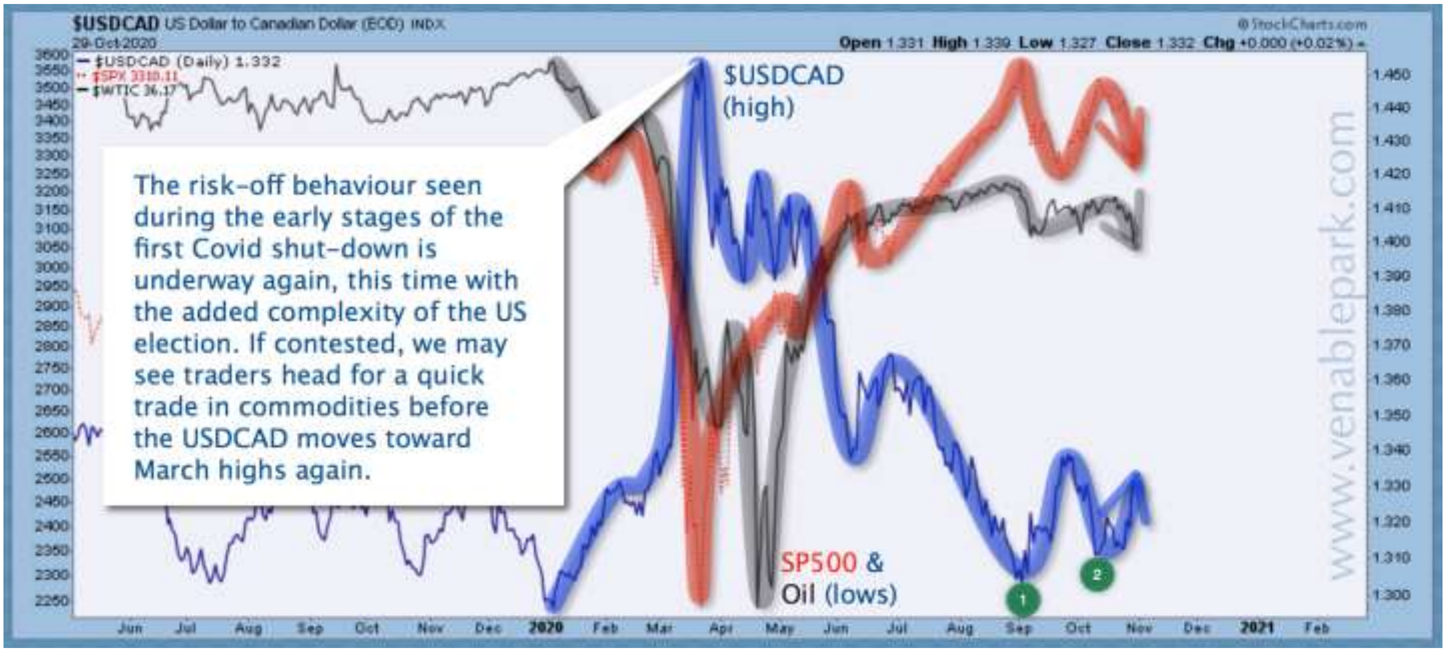



The fight to recover from the COVID-19 pandemic and reinvent a sustainable economy for the 21st century are war-scale expenditures.

Both historically and internationally, Canada's effective tax rates today are moderate while our evasion prosecutions are weak, and government services and corporate subsidies more generous than average. Something has to give.

It's been wisely noted that the trade-offs each society makes depend on its values and values change over time—particularly during times of crisis. To maintain our current standard of living will require higher operational efficiency and more equitable tax collection. The less serious we are in these efforts, the more individual taxes are likely to increase and social cohesion decline.

**The US dollar ended October flat against the Loonie (blue line), as the S&P 500 (in red) was little changed and oil down about 10% (WTIC in black). With monetary and fiscal efforts fully in and no new stimulus until after the US election is settled,** the 'risk trade' is flopping around like a fish out of water. The next leg of greenback up and risk 'off' is likely once the election is resolved and minds refocus on the challenges at hand.



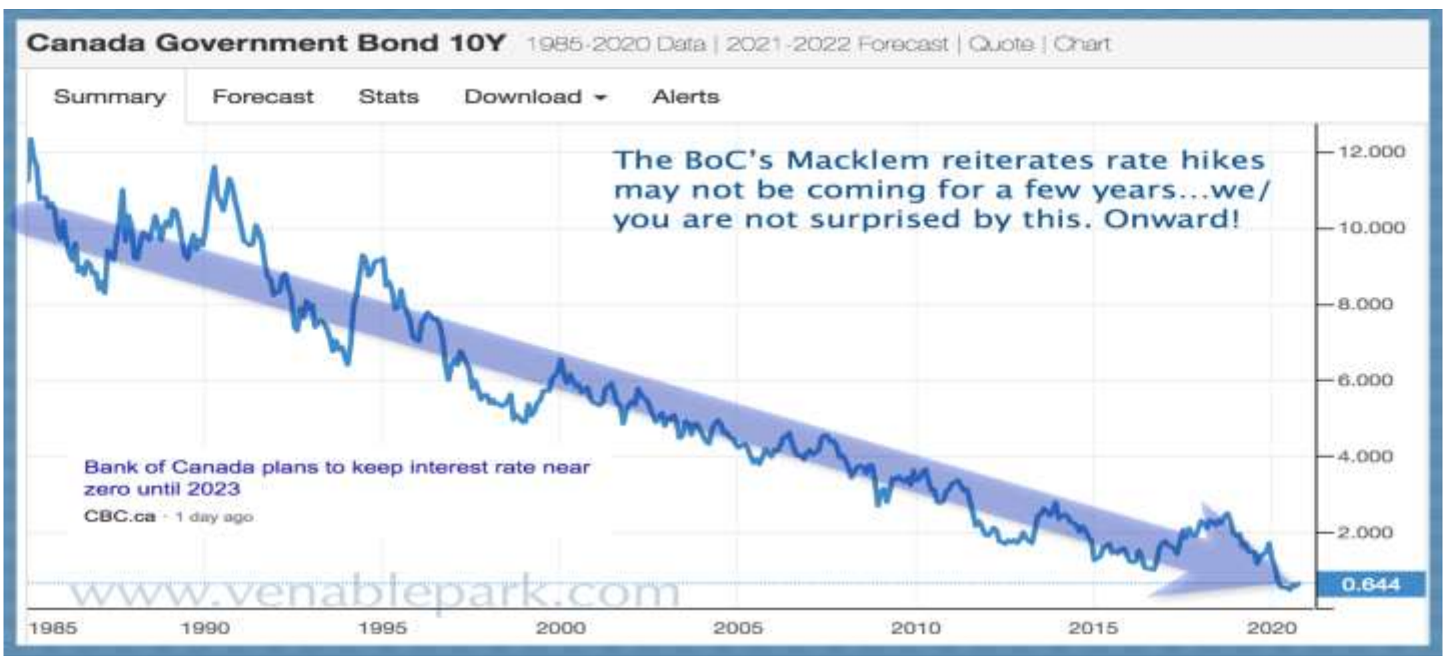

**Oil (WTIC below since 2017 priced in U$) has flatlined since June and remains negative 36% year to date.** With consumption well below 2019 levels and countries announcing more aggressive targets for renewable energy and EVs each month, black gold is floundering. A fresh leg of greenback strength will be oil's next test.

**Prices for the lowest quality corporate 'junk' bonds (JNK) dropped relative to the highest-grade issues (LQD) since 2018 (price different below in blue line)** and, as typical in bear markets, moved sharply lower with stocks into March. After borrowing more to plug income holes into October, balance sheets are the weakest they have been since 2008 and bankruptcies are accelerating. As corporate bond prices fall further, higher yields and capital gain prospects will make survivors in the sector worth buying once more.


**US Treasury 10-year versus 3-month yields (in blue since 2000) have widened from a negative spread (short rates higher than long) in 2019 to positive sloping (short below long) year-to-date.** Equity prices (S&P in red) typically fall as this yield spread rises and do not bottom until the two lines have inverted. A break through the .88-.90 spread area (see red circles) marked the intensifying of the 2001 and 2008 bear market for stocks.

**The US 10-year treasury yield, here since 2015, increased on stimulus announcements in April and July but stagnated this month and remains far below levels seen in 2018 as the government bond market continues a non-confidence vote on bullish growth and inflation expectations for the foreseeable future.**

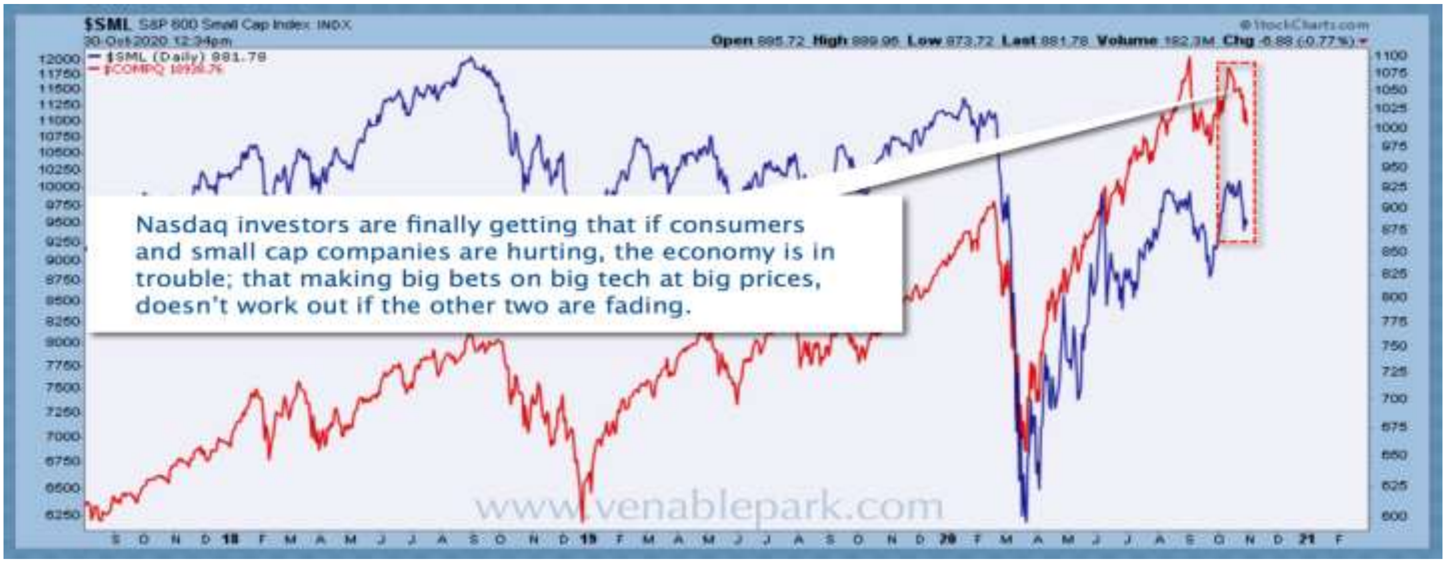

**Canada's 10-Year government bond yield (here since 1985) closed October little changed at .65 as the Bank of Canada admitted that their policy tools will be stuck near the zero bound for years as households and businesses dig their way out of record debt amid a difficult economic transition to new business models.**



**Canada's TSX below since 2005, lacked lift in October and closed the month just 4% higher than its 2008 cycle peak, more than 12 years ago.** Overweight financial and oil shares continue to lead the beleaguered index down; even gold miners and Shopify lost value this month. The 8-9k area remains a downside target.


**After the largest tech stocks dragged the S&P 500 index to a marginal new high in August, it has lost ground since and closed October back below its February high.** A close below the 3200 level will confirm a double top formation and warn that the next leg of the bear market is underway. A retest of the March lows is likely.

**The index (SML below in blue) of 600 small-cap US companies (considered most economically sensitive) relapsed in October to close 15% below its January peak and beckons the tech-heavy NASDAQ down (in red).** Tech revenues are not impervious as cash-strapped businesses cut spending. Having been priced for delirium, tech shares are due for another 50%+ repricing cycle.




Short days and long nights are here, keep finding the light!

> *"What can be said about the desirable levels of progressivity in a personal income tax rate structure? Economists cannot claim to know what is fair. What is fair depends on the country or province, its culture, its other taxes and expenditure programs, and on societal values that change overtime. Income disparities that are acceptable in a time of opportunity and rapid growth may become unacceptable in a time of limited opportunity and little change*."
> —Income Tax: Avg and Marginal Rates in the Post-War Period (1995)

> *"This is an historic opportunity for the world to finally achieve substantial progressive reform of the international tax system, to ensure that multinational enterprises are taxed fairly and that all countries receive their fair share of the revenues. At stake are not only billions of dollars annually for Canada and hundreds of billions worldwide, but also the fundamental faith of the public in the fairness of our overall tax system."* –How to fund Canada's recovery? How about finally stopping tax avoiders (2020)

> *"It is not the strongest or most intelligent that will survive, but those who can manage change*."
> --Charles Darwin (1809-1882)

> *"If we want to see a more peaceful world, we have to learn to collaborate. Young people shouldn't follow previous patterns of behaviour. New conditions, like our interdependent, globalized world, require new ideas. Dividing people into 'us' and 'them' is out of date."*—Dali Lama, October 20, 2020

> *Don't forget to visit our blog* www.jugglingdynamite.com *for daily charts and commentary.*