Dahms Wealth Management Group Newsletter

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In this edition

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Oh, Canada! We've Got a Productivity Problem

"Why isn't Canada an economic giant?" This was the headline of a Financial Times article highlighting our "vast potential" but suggesting we "underperform on the global stage."[1] It's a valid perspective. With the second-largest land mass globally and an abundance of resources, including oil and natural gas, minerals critical to the green energy transition and a strong agricultural industry, "by any measure, Canada's geography suggests it could be an economic powerhouse."[1]

We also boast a highly educated population and a strong standard of living. Yet, despite these advantages, Canada has had little productivity growth over recent decades, falling second to last among G7 nations, ahead of only Italy. Canadian workers produce only 70 percent of our U.S. counterparts' output, based on 2022 figures.[1]

Productivity is crucial for economic growth, as reflected in Statistics Canada's latest report of real GDP per capita now lagging seven percent below its long-term trend.[2] The Bank of Canada recently voiced its concerns, suggesting we have a "productivity problem" and highlighted three elements key to driving highly productive economies: i) capital intensity, including access to better machinery and new technologies to improve efficiency and output; ii) labour composition, improving skills and training; and iii) multi-factor productivity, using capital and labour more efficiently.[3]

How can we improve our productivity problem? Two recent op-eds published in the Globe & Mail provide some notable perspectives:[4]

- **Encouraging capital investment**, including in machinery and equipment, as well as intellectual property and skills training for workers to drive output. This may be fostered by lowering barriers to capital formation, such as tax rates.
- **Increasing competition by loosening restrictions**, including foreign investment controls, interprovincial trade barriers, foreign entry constraints and protectionism, as examples.
- **Reassessing current government spending**, including evaluating subsidies for industries, research and innovation that have not contributed to growth.
- **Increasing the supply of labour**. Immigration has helped, as have changing demographics that have increased the participation of women over recent decades. However, when normalizing labour participation as a proportion of the total population, employment rates have dropped from 75 percent to around 61 percent, a similar level to 1988.

Lessons from the Past: From (Almost) Worst to First

Let's not forget that it was just 30 years ago when Canada was referred to as "an honorary member of the Third World." At that time, we had the second worst fiscal position of the G7 (Group of Seven of the world's advanced economies), suffering from a "vicious debt circle" — ironically, similar to today, only Italy was worse.5

Yet, 1994 would be the turning point. Then-Prime Minister Jean Chretien and Finance Minister Paul Martin orchestrated one of the most dramatic fiscal turnarounds in history, with the greatest reduction in government spending since post-WWII. Canadian debt shrank from 68 percent of GDP in 1995/96 to 29 percent in 2008/09 and the budget was in the black for 11 consecutive years until the 2008/09 recession. Our fiscal position became the best of the G7. While it wasn't without significant sacrifice that the deficit was finally controlled, it is notable that Canada did not fall into recession during this time. In fact, what followed was "the payoff decade" when Canada outperformed the rest of the G7 in growth, job creation and inward investment.5

History is a reminder that profound change is possible, perhaps a lesson relevant to the situation in which we find ourselves today. While there's much work to be done, leadership from the top can drive transformation. Now it's time for us to get started.

1 https://www.ft.com/content/67e97cc4-6ab0-4e78-b4a8-7c97b8e52ada
2 https://www150.statcan.gc.ca/n1/pub/36-28-0001/2024004/article/00001-eng.htm
3 https://www.bankofcanada.ca/2024/03/productivity-problem/
4 https://www.theglobeandmail.com/opinion/article-what-might-a-serious-growth-agenda-look-like-more-labour-more-capital/
https://www.theglobeandmail.com/business/commentary/article-the-budget-needs-bold-change-to-fix-canadas-falling-productivity/
5 https://financialpost.com/uncategorized/lessons-from-canadas-basket-case-moment

Planning Ahead: A Rising Capital Gains Inclusion Rate[1]

It has been over 20 years since we've seen changes to the capital gains tax. Since late 2000, 50 percent (½) of realized capital gains have been subject to tax. As of June 25, 2024, the inclusion rate increases to 66.67 percent (⅔) for corporations and trusts, and on the portion of capital gains realized in the year that exceed $250,000 for individuals.[1] The table shows the impact on a capital gain of $500,000 for an individual (assuming no other gains). Are there ways to manage the potential tax bite? Here are a handful of ideas:

Weigh the benefits of a lower inclusion rate — Tax deferral is commonly viewed as a way to create greater returns since funds that would otherwise go to pay tax can remain invested for future growth. However, individuals may wish to evaluate the possibility of accelerated taxation at a lower rate versus deferred taxation at a higher rate: a higher inclusion rate for gains over $250,000. For example, based on a capital gain of $100,000 and a marginal tax rate of 48 percent, an investor would save $8,000 in taxes by realizing a gain at the lower inclusion rate. Yet, this comes at the cost of "pre-paying" $24,000 in capital gains tax today. If this amount was invested with a return of 6 percent per year, it would take 7 years of tax-deferred growth, based on a ⅔ inclusion rate, to beat the $8,000 in tax savings.

Spread gains over multiple years — If possible, consider realizing gains over multiple years to take advantage of the lower inclusion rate (under $250,000) versus a larger realized gain in a single year.

Crystallize gains — Deliberately selling and rebuying stocks to trigger a capital gain ("crystallizing") can reset the cost basis over time. This strategy, often used in years when an investor is in a lower tax bracket, may help to capitalize on the lower inclusion rate each year.

Plan to cover increased tax liabilities — Plan ahead for an increased tax liability. The use of insurance or other planning techniques may be considered to cover the eventual higher tax liability, such as for the transfer of family property.

A History of Capital Gains Tax in Canada

- **Pre-1972 –** Capital gains were not taxed
- **1972 –** Capital gains tax introduced; Inclusion rate set at 50%
- **1985 –** General capital gains exemption introduced – Up to a lifetime maximum of $100,000
- **1988 –** Inclusion rate increased to 66.67%
- **1990 –** Inclusion rate increased to 75%
- **1994 –** General capital gains exemption abolished
- **2000 –** Inclusion rate reduced to 66.67% (Feb.) and then reduced to 50% (Oct.)
- **2024 –** Inclusion rate increased to 66.67% ($250,000 threshold for individuals)

Source: "A Primer on Capital Gains Taxes in Canada," CBC, 10/18/2000.

Donate securities — Assuming new rules apply to the deemed disposition of assets at death, if you're considering donations in estate planning, consider using publicly-listed securities to a registered Canadian charity as any accrued capital gain is excluded from taxable income and a donation receipt equal to the value of the donated securities is received. Note: If managing over a lifetime, this doesn't apply to a situation in which the AMT is triggered.

How Much More For a $500,000 Gain?

Province	Tax Rate on Capital Gain*		Additional Tax
	½ Inclusion	⅔ Inclusion	
BC	26.75%	35.67%	$22,292
AB	24.00%	32.00%	$20,000
SK	23.75%	31.67%	$19,792
MB	25.20%	33.60%	$21,000
ON	26.76%	35.69%	$22,304
QC	26.66%	35.54%	$22,213
NB	26.25%	35.00%	$21,875
NS	27.00%	36.00%	$22,500
PEI	25.88%	34.50%	$21,563
NL/LB	27.40%	36.53%	$22,833

*For individuals based on top marginal tax rates 01/01/24.

Business owners — Evaluate whether certain assets should be held in the corporation or owned personally. For corporations, there is no $250,000 threshold; realized gains are taxable at a ⅔ inclusion rate. The use of corporate-owned insurance or an individual pension plan may be considerations for a business' tax strategy. Plan ahead to use deductions, such as the lifetime capital gains exemption, to reduce taxes payable on the disposition of qualified shares.

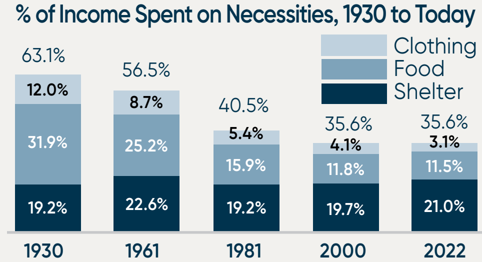
As always, seek advice from a tax expert regarding your situation.

1 Note: At the time of writing, legislation has not been enacted.

The Increasing Cost of Living: A Taxing Time

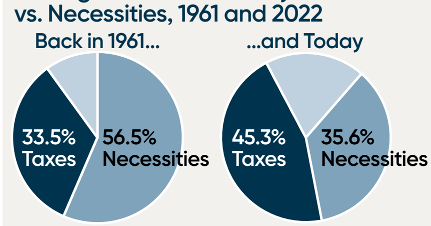
While the growing cost of living continues to be top of mind for many, a differing perspective has emerged on our cost pressures. Despite the rising prices we see today, the proportion of income spent on necessities like food and clothing has declined substantially over time. In 1961, Canadians allocated one-third of family income to these costs; today, they make up less than 15 percent.

% of Income Spent on Necessities, 1930 to Today



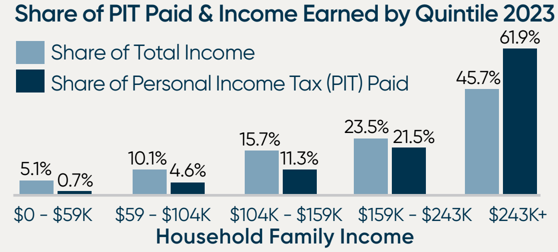
Instead, a recent report suggests that the burden of escalating expenses weighs more heavily on taxes.[1] The Canadian Consumer Tax Index tracks family expenditures on necessities (food, shelter, clothing) and taxes. Today, the average Canadian family spends 45.3 percent of income on total taxes (pie chart). Since 1961, there has been a 2,778 percent increase in the taxes we pay, far outpacing the 863 percent increase in the Consumer Price Index that measures changes in prices.

Average Canadian Family's Tax Burden vs. Necessities, 1961 and 2022



Who shoulders the heaviest tax burden? When comparing the share of tax paid to share of income, the highest-income earners do. The top 20 percent of income earners (family income over $243,000) pay 61.9 percent of personal income taxes (PIT) but represent only 45.7 percent of total income. Every other income group pays a smaller share of PIT versus share of income.[2]

Share of PIT Paid & Income Earned by Quintile 2023



1 https://www.fraserinstitute.org/studies/taxes-versus-necessities-of-life-canadian-consumer-tax-index-2023-edition
2 https://www.fraserinstitute.org/studies/measuring-progressivity-in-canadas-tax-system-2023

Your Home Is Not a Retirement Plan

Summer — the season for home sales — is here! With real estate prices continuing their rise, it may be tempting to see your home's value as a potential source of retirement income. However, when supporting clients in planning for retirement, it's generally not recommended to factor in a home's value as a primary part of that plan. While some homeowners consider downsizing as a way of unlocking retirement funds and others may look to borrow against their homes, there are reasons to exercise caution in relying on home equity for retirement. Here are a handful:

You may not move — If you are planning to sell your home and downsize, there is a good chance you may eventually decide not to move. Recent reports suggest seniors are now less likely to sell their homes before age 85; the sales rate among those ages 75 or more has been trending downward since the 1990s.[1] This may not be surprising. Selling a lifelong home can be more emotionally difficult than many anticipate. Many seniors remain in their dwellings to stay close to family, friends or their community and to maintain their sense of independence. Some have instead chosen to "downsize from the inside," using a small part of their homes to reduce costs like heating.

Low housing supply — Even if you do plan on downsizing or renting, will you be able to find suitable accommodation? While selling a home in this market may be easy, finding a suitable replacement may be more challenging given low inventories, including rental properties.

Moving can be expensive — The costs associated with moving homes may be greater than anticipated: real estate fees, lawyers' fees, land transfer tax, staging and other expenses can add up to be significant. There may also be other unanticipated expenses that come with a new dwelling, such as maintenance, renovations and, if you end up in a condo, monthly management fees. All of these costs can erode the net financial gain by downsizing.

Higher interest rates — Recent reports suggest that around 25 percent of retirees carry mortgages as individual wealth has shifted to real estate.[2] Many mortgage holders have seen mortgages reset at higher rates, leading to lower disposable income, especially for those on fixed incomes. While it's possible to access home equity for retirement, consider that this has become more costly with rising rates. Reverse mortgages, although not common in Canada, may allow you to borrow against home equity (usually up to 55 percent) with minimal proof of income. Yet, reverse lenders charge very high rates and there are few large providers. More commonly, a home equity line of credit, often secured prior to retirement when income is high, allows you to draw on the line as needed and pay interest only on what you borrow.

These are just a handful of reasons to exercise caution when considering home equity for retirement. For a deeper discussion on this, or any other aspects of retirement planning, please call the office.

1 "Canadian seniors not downsizing, partly owing to lack of options," S. Peesker, Globe & Mail, 02/12/24
2 "Wealth tied up in real estate can hurt your retirement," R. Carrick, Globe & Mail, 11/30/23, B10.

Timing Is Everything: Why Some Regret Taking Early CPP Benefits

With most Canadians choosing to start their Canada Pension Plan (CPP) benefits early, there's been growing attention to the potential advantages of waiting. Recall that starting CPP benefits before age 65 (as early as 60) decreases payments by 0.6 percent per month, whereas delaying beyond 65 increases payments by 0.7 percent per month, up to 42 percent (age 70). Actuarial studies continue to show that many people are better off delaying benefits as the break-even age[1] is often below the average life expectancy. Those who live past the break-even age will receive a higher overall benefit by waiting.

Of course, this decision is influenced by various factors beyond just life expectancy, such as immediate income needs. As more Canadians work past age 65, the impact of retiring early, or late, should also be a consideration. Working past age 65 and delaying benefits can lead to a potentially greater benefit. This is because CPP benefits are generally calculated using the best 40 years of income, usually between ages 18 and 65. Since lower-earning years tend to be at younger ages when first starting a career, extending the working years past age 65 may add higher-earning years to the calculation, thus increasing the benefit.

CPP Timing: Change Your Mind?

If you start benefits and change your mind, you can cancel CPP within 12 months of its start. The cancellation must be in writing to Service Canada and you must pay back the benefits received.

The good news? It doesn't work the other way: Any low-earnings years after age 65 will have no effect on the benefit calculation. Yet, if you retire before 65 and wait to take benefits, the zero-earnings years can negatively impact the benefit. Retiring at 60 and waiting to collect CPP at 65 could add five zero-earning years to the calculation.

Regrets, We've Had a Few...

Indeed, the old words of Frank Sinatra may be a reminder to carefully consider the timing decision. A recent article in the Globe & Mail highlighted Canadians who had "regrets" after starting benefits early:[2]

Impact on survivor benefits — One widow discovered that starting her own CPP reduced her maximum entitlement from survivor benefits. She was also unaware that survivor benefits would change when she turned 65 and hadn't considered the impact of deferring her own benefits beyond that age.

Legacy considerations — A man who wasn't in immediate need of the funds wished he had delayed his CPP after realizing how much more he would have left for beneficiaries. One study suggests that taking CPP at age 60 instead of 70 can forgo $100,000 of lifetime benefits.[3]

Inflation adjustments — Another retiree noted that had he waited, the multiplier for starting later would have further enhanced the inflation-indexed benefits.

Returning to work — One man who began receiving CPP at 60 and retired at 63 decided to return to work. He regretted starting early due to the taxes paid on CPP income during his subsequent employment.

1 The age at which total benefits received by delaying payments exceed total benefits received by starting payments earlier.
2 https://www.theglobeandmail.com/investing/globe-advisor/advisor-news/article-these-canadians-wish-they-had-waited-to-take-their-cpp-benefits-heres/
3 https://www.fpcanadaresearchfoundation.ca/media/5fpda5zw/cpp_qpp-reseach-paper.pdf

Why Have Central Banks Been Slow to Cut Rates?

With expectations for multiple interest rate cuts to start the year, why have the central banks been slow to move?

In the U.S., inflation has been more persistent in a relatively strong economy. This contrasts with Canada, where economic activity has been lacklustre and there have been greater indications that inflation is cooling.[1] On June 5, the Bank of Canada became the first Group of Seven central bank to reduce its policy rate, by a quarter-percentage point. However, the central banks continue to move cautiously.

Recall the considerable criticism central banks faced for their delayed response to contain rising inflation, which they dismissed as "transitory" in 2021. After aggressively raising interest rates in 2022, they have since been careful in their monetary policy decisions. One of the main reasons behind this caution is the lessons learned from the 1970s.

First: A Brief History

Just how bad was inflation in the 70s? It was a decade marred by persistently high inflation and high unemployment, or stagflation. In Canada, we grappled with an average inflation rate of around 8 percent, with inflation hitting two separate peaks: 11 percent in 1974 and almost 13 percent in 1981. In the U.S., inflation hit 14 percent by 1980. It was only when then-Fed Chair Paul Volcker aggressively raised the federal funds rate to 20 percent by 1981 that inflation would be contained, but this pushed the U.S. into severe recession. Canada would follow suit by hiking rates to a whopping 21 percent.[2]

Does today's inflation resemble that of the 1970s? Some argue that the underlying drivers of inflation share similarities. Back then, oil price shocks and energy supply shortages played a major role, compounded by the expansive fiscal and monetary policies of the 1960s and early 70s aimed at boosting employment. When inflation peaked in 2022, many attributed it to pandemic-induced supply chain disruptions, along with overly expansionary fiscal and monetary policies in response to the pandemic. While opinions may differ on the specific drivers, it's widely acknowledged that the slow response to curb inflation in the 1970s led to even higher interest rates and a more severe economic downturn.

The Psychology of Inflation and Unemployment

Today, the good news is that labour markets have shown relative resilience amid moderating inflation. Traditionally, inflation and unemployment share an inverse relationship, a concept observed in financial circles by the "Phillips curve." Periods of significant central bank-induced disinflation have often been accompanied by a recession and higher unemployment.[3] While the psychological impact of inflation is undeniable — most of us have felt the pain of rising costs with essentials like groceries — consider that the impact of increased unemployment may be far more profound. Various studies suggest that higher unemployment depresses our well-being more than inflation; almost twice as much in one study and up to five times in another.[4] Therefore, achieving a "soft landing" that maintains both labour and price stability is enviable — and still appears attainable.

The Bottom Line: Patience Has Been Needed

Nevertheless, the central banks remain cautious, mindful of the past. In navigating the ongoing battle against inflation, patience has been needed — akin to many aspects of investing. Interest rates, inflation and other factors will ebb and flow over time. Nobody can accurately predict their direction; there are many variables at play. As investors, we can assess the current and anticipated levels of risk and reward based on these changing macroeconomic conditions and make adjustments where necessary. However, the fundamental principles of investing still hold true: Challenging economic periods highlight the importance of prudent investment selection, maintaining a diversified portfolio with an emphasis on quality, staying disciplined and continuing to focus on the longer term.

1 https://www.cbc.ca/news/politics/bank-of-canada-macklem-closer-cutting-interest-rates-1.7191597
2 https://www.bankofcanada.ca/wp-content/uploads/2023/11/remarks-2023-11-22.pdf#chart6
3 https://www.reuters.com/business/retail-consumer/fed-needs-recession-win-inflation-fight-study-shows-2023-02-24
4 https://www.wsj.com/articles/inflation-and-unemployment-both-make-you-miserable-but-maybe-not-equally-11668744274

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