

The Need for Greater Accountability

Edmond G. Eberts

Chairman

RAPPORT Capital Formation Strategists Inc.



RAPPORT CAPITAL FORMATION STRATEGISTS INC.

703, 141 Adelaide Street West
Toronto, Ontario M5H 3L5

Telephone: 416-366-9264

Toll free: 800-363-8134

Fax: 416-366-1855

rapporrt@rapporrt.ca

www.rapporrt.ca

The Need for Greater Accountability

I do not know about you, but I always get a chuckle in reading the Thoughts On the Business of Life page of *Forbes* magazine. A recent quotation, attributed to one Marcel Pagnol, said: “The most difficult secret for a man to keep is his own opinion of himself.” Nothing could be truer as regards corporate CEOs and investment bankers, who are flying high, and politicians just before the winds of change blow them away.

KEEPING TRACK OF WHO IS PAID WHAT

Executive compensation in the U.S. is tracking at 431 times that of the average production worker. In 2004 the median CEO pay of the S&P’s 500 index companies increased by 30.2 percent to U.S.\$6 million, double the gain in 2003. Once again, there appears to be little relationship to share appreciation, the ultimate measure of success or failure of a corporation. Investors believe many CEOs are overpaid, and they are demanding greater accountability, and the right to vote on matters relating to such compensation. Fortunately, high-profile scandals and lobbying by heavyweights like Warren Buffett have put an end to rampant cronyism and the stock option bonanza of the 1990s. Changes in accounting practices have forced most companies to expense options, which is, after all, what they have always been, a charge against the earnings of the corporation.

Salaries are frothy these days. Corporate leaders, it seems, are getting paid lavish sums for coming, going, staying put, or even doing nothing at all. Retention packages are compelling. Buying newcomers out of non-competes is *de rigueur*. Recruiters and compensation consultants attribute the sweeter deals to a doubling in the turnover rate in CEO positions, heightened efforts to retain top talent, and the desire of directors to avoid messy exits. The good news is that a new SEC proposal will require the entire compensation of the CEO, CFO, and the next three highest paid executives be disclosed: pay and bonuses, stock and option grants, severance and retirement packages. More particulars about perks, ranging from club memberships and the use of corporate aircraft to tax payments, will also have to be divulged. The only propriety information would seem to pertain to the issuer’s short-term goals and long-term strategy, the very keys to allowing an investor to make an astute decision to buy, sell or hold onto an investment position. If such is still not forthcoming, it will remain up to the research analysts to ferret out the details. However, there is still little reason to believe the Wall Street investment bankers will ever give a damn, providing they continue to get a pound or two of the investors’ flesh. Their bonuses in 2005 totaled U.S.\$21.5 billion, well beyond the U.S.\$19.5 billion paid in 2000, as year-over-year revenue grew by 45 percent at most of the major firms.

CHARITY BEGINS AT HOME

Canadians are wealthier today than at any other time in our history. The net worth of households rose to \$4.6 trillion in the third quarter of 2005, being about six times annual disposable income, surpassing the previous high at the peak of the tech bubble in the spring of 2000. While the real estate sector has surged, the stock market has also been climbing. Meanwhile the savings rate remains weak, and the growth in household debt continues to outpace gains in personal disposable income, resulting in a quite unsatisfactory debt-to-income ratio of 108 percent.

So it is not surprising Canadians are far less generous with their charity giving than Americans, who donate 1.57 percent of their aggregate income, more than double the 0.7 percent we do. In Canada, 24.9 percent of all tax-filers make donations, compared to 29.4 percent in the U.S. Their average giving in 2004 was U.S.\$3,731, ours but \$1,165. If Canadians were as munificent, our charities would gain an additional \$8 billion a year in resources. Until we are, the less fortunate amongst us will have to continue to rely on benevolent government programmes. Even so, let us not forget what Sholom Aleichem is reported to have said: "Life is a dream for the wise, a game for the fool, a comedy for the rich, a tragedy for the poor."

Comparisons aside, Canadians gave a commendable \$7 billion to charities in 2005, not because of a new-found spirit of generosity, but due to larger gifts by fewer philanthropists demanding more control over how the money is to be spent. The trend toward donor-directed giving is not only revolutionizing how charities operate, in order to remain competitive many are having to cater to benefactors in the same way companies do for big customers, providing more financial disclosure than they have ever had to in the past. Naming rights and advance tax rulings are often part of the equation.

These changes in giving patterns by Canadians can be traced back to 1996 when the federal government made a radical shift in tax policy, opening the door to far larger gifts, including stocks, real estate, and other assets. This way of giving is likely to become even more prevalent as our population ages. The one possible drawback is that too many donor-directed commitments could threaten the very purpose of a charity, and ruin its ability to address the specific needs of its community. In short, if one is little more than a collection of these sorts of monies, can it really have a mission of its own? Then again, the rapid change in the nature of donations and increased competition may be good for them in the longer term as it will narrow their focus and make them more accountable.

INCREASING PERSONAL DISPOSABLE INCOME

While a record number of Canadians believe the nation is in a period of strong economic growth, the majority say they are still not seeing any gain in personal financial benefits. Despite a strong job market, low borrowing costs, and a boom in commodity prices, citizens in general are not particularly optimistic about their lot in life. Which is one of the reasons why the Liberal and Conservative election campaigns gave greater emphasis to tax cuts, rather than spending increases. Strangely enough, annual programme spending has been growing at an average compound rate of 8 percent per annum over the past five years. Given the election campaign promises, the trend is unlikely to change anytime soon. Furthermore, if recent history is any guide, actual government spending will outpace forecasts. The restraint of the mid-1990s would appear to be dead and buried!

Personal disposable income is an important indicator. The Liberal government took so

much of the country's economic growth for its own purposes there was little left over for the wage earners who generated it. Ordinary citizens have found themselves working in a treadmill economy: another day older, deeper in debt. When compared with Americans, our PDI is down one third in the past twenty-five years, with one half of the erosion taking place in the past twelve years. On a per capita basis, it now stands at 65 percent of theirs – the lowest level in fifty years. If this trend persists for another twenty-five years, we will find ourselves left with one-half that of our neighbours to the south. Obviously something has to be done to put the Canadian taxpayers back in the driver's seat. Any political party committed to doing so is likely to win a majority in the next federal election. While tax relief of any kind may be perceived by some as a sop to the rich, perpetual deferral of capital gains could do wonders for wealth creation to the benefit of all Canadians.

Even though Canada has the second-highest corporate taxes in the world, the argument for giving corporations further tax cuts loses much of its lustre knowing many are awash in profits, to the point they do not seem to know what to do with the bounty. Pre-tax profits rose 94 percent between 1999 and 2005, to \$213 billion. The after-tax tally is likely to reach \$130 billion, equivalent to a 60-percent jump in six years. However, in spite of record returns, Canada's growth in productivity is shameful compared to that of the U.S. Other than buybacks to counteract dilution caused by the exercise of stock options, all too few companies are investing enough in information and communications technology or capital equipment to ensure they become more proficient. So why do they deserve another round of tax cuts? Would not stepped-up depreciation on new capital investment and a reduction in personal tax rates be more to the point and far more politically expedient!

Overall tax balances are another big issue. In the early 1960s corporate taxes amounted to about 60 percent of personal tax revenues. They are now just 30 percent. The tax burden on the individual has, relatively speaking, doubled. Which helps to explain why our parents could afford children, a house, a car, and live fairly well on just one income, while most of our offspring struggle to get by on two. With the lopsided tax structure which favours income trusts over corporations, more and more of the tax responsibility will inevitably fall to individuals. Between corporate tax cuts and the rush to convert corporations into income trusts, it is entirely possible companies will pay the equivalent of only 15 percent of total tax revenues in the not-too-distant future, individuals fully 85 percent.

One of the ways to restore a better balance is to cutback on government waste and frivolous programmes, as individuals do not have the wherewithal to continue to carry an ever-increasing share of the load. Rather, it is vitally important we do all we can to increase personal disposable income. If we do not, our stature as a country and a people will continue to lose ground and that is to nobody's advantage.

As to how involved the federal government has become in our daily lives, consider the following. By 1970 transfer programmes required 4 percent of GDP, threefold more than in 1950. By 1962 Ottawa needed to tax away 9 percent of the country's personal incomes. By 1970 the take had risen to 18 percent and by 1990 it was upwards of 22 percent. Today the tally is greater than 30 percent, the inefficiencies and ineffectiveness crippling Canada's ability to be competitive in world markets. Rather than continue to be the supreme arbiter, dispensing special privileges, the federal government must become far less meddlesome in provincial and municipal affairs. The sooner such comes to pass the better the standard of living will be for all Canadians. Strangely enough, the province of Quebec alone has fought to guard its constitutional rights and responsibilities. No matter how distorted its effort

has been at times, we should be grateful it has stood its ground. There is no telling how much worse off the country would be otherwise!

A NEW PLAN OF ACTION

Although the proposed cut in the GST may well have been a brilliant vote-getting tactic, the Canadian government needs to develop comprehensive changes designed to stimulate economic growth, by simplifying the tax system and making it fairer and more relevant. With public discussion and debate as part of the process, economic reform capable of delivering greater returns for all citizens will serve as an important plank for the next federal election campaign. I am certain Stephen Harper and his opponents are acutely aware patronage and pork are traditions of the past! We must also open our markets to greater competition and foreign capital, expand cross-border trade, and cut red tape. As we fiddle, opportunities fizzle!

Though securities regulation and bank mergers are not the kind of issues that win elections, they are critical nonetheless, particularly for Canada which must encourage efficiency and productivity improvements if it ever hopes to compete effectively in the global economy. Though it can be said politicians rarely fulfill their election promises, it is even rarer for promises to be broken in favour of better ideas. With any luck, the new administration will represent a break with the past, and the practice of favouring politics over policy. If so, perhaps it will also realize the value of an adroit financial service industry, a competitive capital market, and a robust retirement system.

LOOKING TO THE FUTURE

Having won the election, Stephen Harper made two rather glaring errors even before Parliament was called into session. The first was to coax David Emerson to cross sides in the House of Commons with the intent of making him the Conservative cabinet minister responsible for international trade. In so doing, the Liberal member betrayed the voters who elected him, and the prime minister forsook his own party's faithful. The second faux pas was to assign Conservative Party strategist Michael Fortier to the Senate so he could be appointed to the cabinet as the minister in charge of public works. In this case, the prime minister snubbed Parliament and violated his own principle of establishing an elected upper chamber. As we voters all know, two wrongs never make a right. Nor has Stephen Harper ever tried to explain how these shenanigans are in keeping with his pledge of greater openness in government. Quite the contrary seems to be the case.

As far as Canadian voters go, if Stephen Harper was to admit to having blundered, the best way to make amends would be to call for a by-election in the Vancouver Kingsway riding and have David Emerson run as a Conservative. As for Michael Fortier, he should be installed in the PMO until such time as he is duly nominated and is elected as a Conservative from the province of Quebec. Until such happens, the press will not be as supportive of this minority government as it would otherwise be, and many voters will remain suspicious as to what the prime minister's next political move might possibly be. As he now surely knows, party hopping and groping for outsiders can be dangerous to one's reputation and should not be tolerated.

Even so, given how anxious the opposition parties are to avoid an early election, they will want the Conservatives to stay put for some time to come. So despite a precarious 125-seat minority, the balance of power, at least for the moment, rests with Stephen Harper.

Furthermore, the 37 percent of Canadians who voted for him thought they knew exactly what he stood for. It is doubtful many cast their ballot with a view to seeing how many compromises his party would make negotiating with the NDP, which is busy putting down roots in its new ridings. Or the Bloc Québécois, which is licking its wounds, while measuring the odds of success in calling yet another referendum. Or even the Liberals, who must come to grips with the reasons for their downfall, define what they will stand for in the future, and engaged in the internecine struggle of picking a new leader. Paying off the party's reported \$30-million debt will also be a struggle, as private giving remains minimal at best, and new laws prevent substantial donations from corporations, its traditional source of contributions. All of which helps to explain why none of the big name stalwarts appears willing to toss their hat into the ring. As such, there is little reason why the well-funded Conservatives should need to cede parts of their clearly focused agenda in order to gain opposition support for key policies, including the twelve-point programme to increase accountability, the most urgent task of the new government. Tax reform, law and order, the child care and health care agendas; the elimination of the national gun registry, the gag law, and the Wheat Board; the creation of a system of appointment for elected Senators, and the overhauling of the undemocratic way of picking Supreme Court justices; and, the rebuilding of the military to follow.

Without a single elected Conservative member from Montreal, Toronto, or Vancouver, the incoming prime minister should also be able to focus on the constitution and his intention to return the powers as dictated therein to the provinces, including the responsibility for municipal affairs. In the process he will challenge the Bloc Québécois, rendering its *raison d'être* redundant. Considering Conservative candidates came second in thirty-seven Quebec ridings, the party could well double, triple or even quadruple the ten seats it did win come the next federal election, almost enough to secure a majority. Voters from the (514), (416), and (604) area codes will want to reconsider who to vote for once they discover very few caucus members will be pushing urban issues until they do. Or what of British Columbia with its thirty-six ridings in play? It was to be the final word in shaping the federal government. Instead it turned its back on a chance to change things for the better. Adding to the muddle, the Conservatives took 37 percent of the votes across the province, a small improvement over 2004, yet dropped five seats to seventeen. Knowing, as they must have, that Stephen Harper was set for a minority or majority election victory, it is hard to fathom how replacing an incumbent with a new opposition member would possibly help their cause. But, perhaps that is business as usual in this unusual province!

In sum, the Conservative's gains came chiefly from the rural areas of Quebec and Ontario, and the West. The major urban centres hold rich political potential. Stephen Harper has a history of being underestimated and then overdelivering. A little out-of-the-box thinking might be in order for those who doubt his word. With expectations low, the stage is set for him to surprise once again. Whatever, he knows he must be articulate with, and accountable to, Canadians from coast-to-coast. Assuming the Conservatives abide by their promises, this year's activist agenda should pass. The second wave of tax cuts could come to be next year, and an election triggered a year later on some issue the opposition parties simply cannot support. The ballot question would then hinge on returning an effective government or taking a chance with a possibly unreformed or still confused Liberal Party. Whatever, those who had heretofore feared the Conservatives will be far less hesitant to vote for Stephen Harper knowing he sticks to his word. I predict he will gain a

majority the next time Canadians go to the polls. In his best interests and ours, I hope the election is not forced upon us for another two or three years from now.

IN CONCLUSION

Many of us have not been given the straight goods in the past. In nearly every instance it has cost us dearly in terms of our well-being, employment, wealth creation and sense of giving to others less fortunate than ourselves. Fortuitously, the tide of regulation is turning slowly but surely in our favour. It is our responsibility to see to it that everyone's lot in life improves and future generations do not repeat the mistakes of yesteryears. We all need to be more accountable than at any other time in our history.