Luxury Auto Sales in Canada

- **Luxury auto brands in Canada have suffered a prolonged retrenchment in sales spanning more than a year.**
- **An exceptional surge earlier in the decade came to an abrupt halt in 2018 as rising financing costs and falling home values eroded wealth and affordability despite a relatively benign economic growth environment.**
- **A recent uptick in sales this summer has been fueled by low interest rates and recovering housing markets, but a durable recovery remains fragile in light of the threat of new luxury taxes in Canada.**

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HARDSHIP FOR HIGH-END BRANDS

It has been a tough time for luxury auto brands in Canada. Since the summer of 2018, year-over-year sales have spent fourteen consecutive months in the red—half of those months double-digit declines. Despite a brief reprieve in the last three months, year-to-date sales are down by over 8% for 2019. This is steeper than the slump affecting all auto sales in Canada that are presently down by about 4% year-to-date (chart 1).

WHEN THEY ARE UP, THEY ARE UP

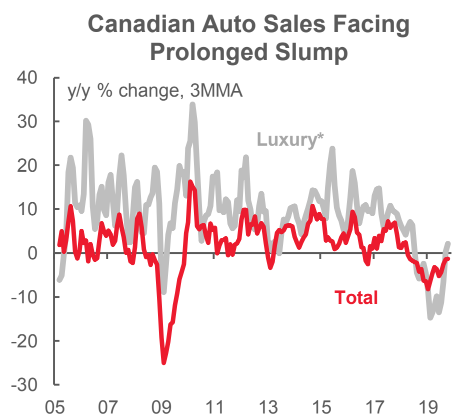
Luxury auto sales experienced a solid run of growth between 2010 and 2017. Sales growth significantly outpaced all light vehicle sales in Canada as the segment picked up market share. Luxury *brand* sales as a share of all new sales advanced from about 5% to 8% in this period. Sales of all luxury *models*—i.e., taking into account the emergence of new luxury *models* offered by mass market producers—accelerated even faster, accounting for about 12% of new sales by the peak in 2017. (This note focuses on luxury *brand* sales since this segment has been hardest hit in this downturn.) In peak sales seasons, it was not unusual to observe sustained year-over-year sales growth of luxury brands in the range of 15–20% for several consecutive months.

This sales boom was fueled by a variety of factors. An expanding economy played an important role as Canada emerged from the 2014–15 economic slowdown, supported by declining policy rates and accommodative fiscal support. Importantly for vehicle financing, Canada's 10-year sovereign bond yield declined progressively over this period from highs above 2.5% in 2014 to lows below 1% in 2016.

Skyrocketing home prices also boosted household wealth in key markets. Home prices in the Greater Toronto Area (GTA) and the Greater Vancouver Area (GVA) surged by close to 20% y/y at the market height in 2016–17. Canadians tapped into this home equity at an unprecedented pace through housing lines of credit and mortgage refinancing, almost doubling equity extraction between 2014 and its $89 bn peak in 2017. Vehicle purchases are among the top three uses of housing lines of credit, according to the Financial Consumer Protection Agency. Solid market performance also strengthened Canadians' net worth, particularly the more affluent, with growth in household net worth peaking at 8.9% y/y in late 2016.

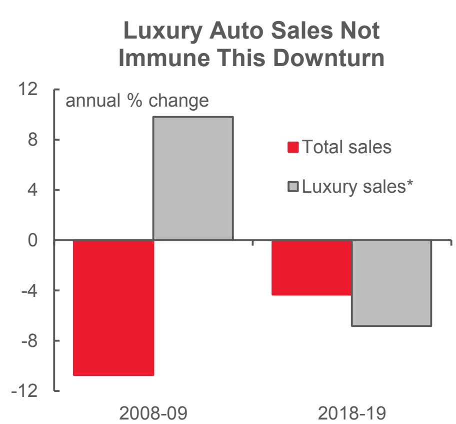
A growing cohort of upwardly mobile Canadians bolstered luxury auto sales. The industry catered to the preferences and pocket-books of the aspiring-wealthy with more affordable models that still carried the prestige of

Chart 1



* Audi, BMW, Daimler, Jaguar, Porsche.
Sources: Scotiabank Economics, Global Automakers of Canada, DesRosiers Automotive Consultants Inc.

Chart 2



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Sources: Scotiabank Economics, Global Automakers of Canada, DesRosiers Automotive Consultants Inc.

luxury brands. Many mass market producers also started introducing luxury lines within their product mix, blurring the boundaries around 'exclusivity'. The growth in entry-level luxury vehicles accounted for a significant portion of all luxury sales growth during this period.

WHEN THEY ARE DOWN, THEY ARE ...

Luxury auto brands have historically been relatively shielded from economic slowdowns. While sales have dipped seasonally and cyclically, the troughs have traditionally been shallower than those for all light vehicle sales in Canada. Even at the peak of the 2008–09 crisis, luxury auto sales posted only three months in negative territory, averaging 6% y/y declines in that period, whereas all vehicle sales troughed below 25% y/y with a year-long recovery. The slowdown in 2014–15 created a drag on luxury auto sales, but did not pull them into negative territory, unlike all vehicle sales which faced an albeit brief pullback.

The recent slowdown in luxury auto sales has been exceptional. For the first time in a decade, the pullback in luxury sales exceeded that of all vehicle sales (chart 2).

A PERFECT STORM

Luxury auto sales were battered by a variety of headwinds starting in 2018. Escalating financing costs cut into affordability as the Bank of Canada embarked on a policy rate tightening path, increasing its overnight policy rate by 125 bps to 1.75% where it still sits today. Meanwhile, the 10-year sovereign bond yield also rose on the back of a strengthening economy. This took a toll on all vehicle sales (chart 3).

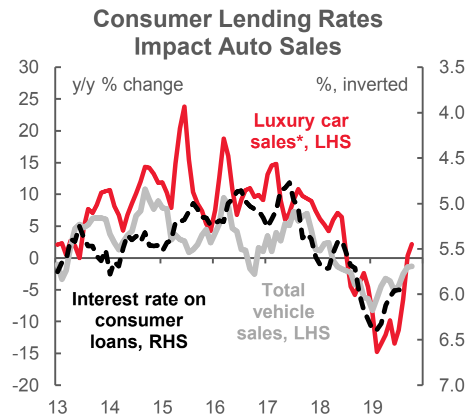
Household wealth was impacted by home price corrections in key markets. The introduction of tighter federal lending rules (e.g., B20), as well as locally targeted taxes (e.g., speculation and foreign-buyers taxes) in 2018 precipitated policy-induced housing slowdowns in the GTA and GVA. This led to double-digit contractions in year-over-year home sales and average home values dipped in both cities, eroding households' net worth. Luxury auto sales took a hit with Ontario and British Columbia accounting for about two-thirds of the market (chart 4).

Canadians not only saw a drop in their home equity, they also abruptly stopped cashing out on this equity. The use of housing lines of credit dropped by about 6% y/y in 2018 as they came under increased scrutiny from the Office of the Superintendent of Financial Institutions (OSFI), while mortgage refinancing pulled back by 8% y/y (chart 5). Other quasi-regulatory barriers may also have dampened purchases including an increased focus on due-diligence related to anti-money laundering policies and procedures.

Taxation likely played a role in the slowdown. On April 1, 2018, B.C.'s NDP government raised the provincial sales tax on luxury cars that added up to 20% to costs on top of the existing sales tax. In fact, luxury auto sales in BC reversed gears sharply in 2018, shifting from growth above 10% y/y in 2017 to a 5% y/y contraction in 2018. Ontario saw a gentler 'braking' with luxury sales growth above 10% y/y in 2017 slowing to a more moderate 3% y/y in 2018.

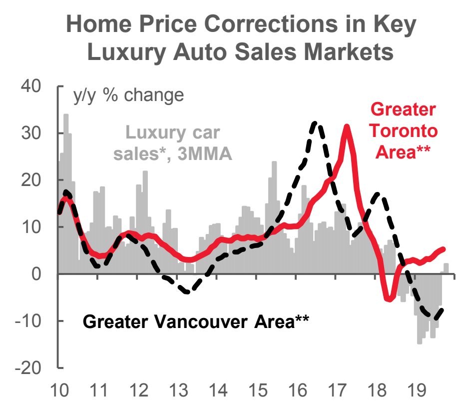
Price pressures may also have eroded affordability. Auto prices both as a component of inflation and on a per unit basis have been trending higher in recent years above and beyond the historical impact of exchange rate influences. A weaker Canadian dollar has traditionally pushed up auto prices with a one-year lag given a majority of vehicles (and/or their components) are produced abroad (chart 6). Other developments may be dwarfing this effect including consumer preferences for larger vehicles and upward price pressures on inputs such as labour and materials (e.g., steel and aluminum). Since mid-2018, the Euro has in fact been trending weaker against the Canadian dollar which theoretically would lessen price pressures on European-made luxury models but this has (yet) to play out substantively in the sales numbers (chart 7).

Chart 3



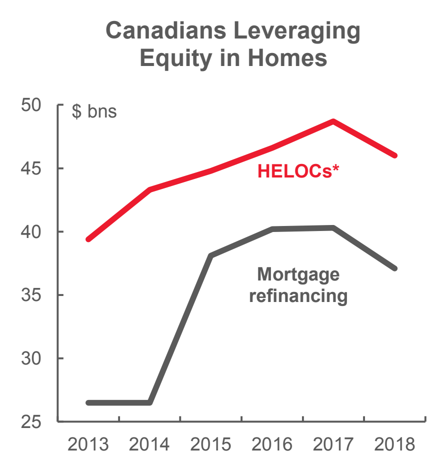
* Audi, BMW, Daimler, Jaguar, Porsche.
Sources: Scotiabank Economics, Bank of Canada Global Automakers of Canada, DesRosiers Automotive Consultants Inc.

Chart 4



* Audi, BMW, Daimler, Jaguar, Porsche.
** MLS composite Home Price Indicator.
Sources: Scotiabank Economics, CREA, Global Automakers of Canada, DesRosiers Automotive Consultants Inc.

Chart 5



Sources: Scotiabank Economics, Bank of Canada
**Housing Equity Line Of Credit*

Used autos no doubt picked up some of the slack. The sale of used vehicles typically picks up as the economy slows down (chart 8). The lifespan of the average vehicle has also increased over time creating a glut of decent second-hand cars in the market. Luxury models tend to have higher residual values than the average vehicle so this effect would be more pronounced.

THE ROAD AHEAD

Luxury auto sales are currently enjoying a brief reprieve from the prolonged descent. Sales posted three consecutive months in positive territory since August, albeit against a low bar of last year's significant declines. Lower costs of financing and strengthening home prices no doubt played a role. With the Canadian economy expected to strengthen next year, along with potentially lower policy rates, there is an upside for the segment. However, policy actions could counteract these tailwinds, at least for higher-end luxury vehicles.

A TAX ON A TAX ON A TAX

The Liberal government recently campaigned on a promise to ask "the wealthiest Canadians to pay a little bit more". They pledged to introduce a 10% luxury tax on personal automobiles, boats, and aircraft sales valued at $100,000 or more. The Parliamentary Budget Officer estimated this would generate close to half a billion dollars in government revenues by 2020, rising modestly thereafter. This rides a wave of left-leaning proposals on both sides of the border pitching various wealth tax proposals.

The economic argument for a wealth tax on automobiles is dubious. Most economists would agree that such a luxury tax is economically inefficient. It creates an artificial distortion in purchase decisions, leading to "deadweight losses" that reduce overall societal welfare. Some would suggest it represents a tariff barrier since it *de facto* translates into a tax isolated to imports given the lack of domestically produced options in Canada. In fact, Australia's luxury car tax has been one of the sticking points with the EU as it negotiates a trade pact.

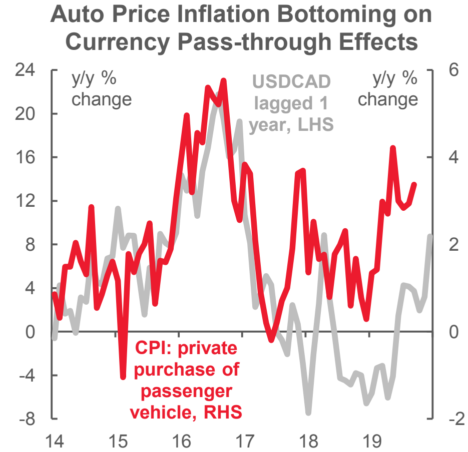
Luxury auto sales in Canada already face a plethora of taxes. Canada has a broad-based goods-and-service tax levied at the federal and provincial levels. In Ontario, the Harmonized Sales Tax (HST) sits at 13%, while British Columbia's combined Goods and Service Tax (GST) and Provincial Sales Tax (PST) amount to 12%. British Columbia's luxury auto surtax adds upwards of another 20% on the sticker price. Moreover, purchases are made with after-tax income. High-income earners across Canada already face significantly higher marginal personal income tax rates that kick in at substantially lower levels relative to peers.

A targeted tax on luxury automobiles is punitive. These vehicles are not inherently a sin purchase, nor do they create negative externalities that would warrant government intervention to curb purchases. In fact, local purchases benefit regional economies, while the luxury segment is a seedbed for innovation that trickles down to the rest of the sector. Furthermore, it is arguably not so much the elasticity of the purchase that is important as much as the mobility of the capital and its alternatives for deployment, including outside of Canada.

There are more efficient means to raise government revenues. For example, increases to broad-based consumption taxes could more efficiently raise revenues, which in turn could support a more significant redistribution of wealth according to societal preferences.

Ultimately, a comprehensive debate on Canada's broader tax architecture that weighs economic and equity objectives is warranted to ensure a piecemeal approach does not create unintended consequences where no one wins.

Chart 6



Sources: Scotiabank Economics, Statistics Canada, Bank of Canada.

Chart 7

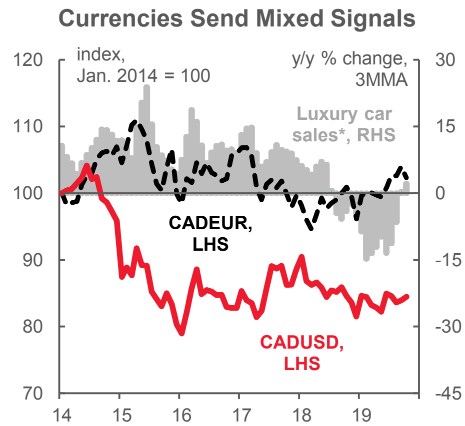


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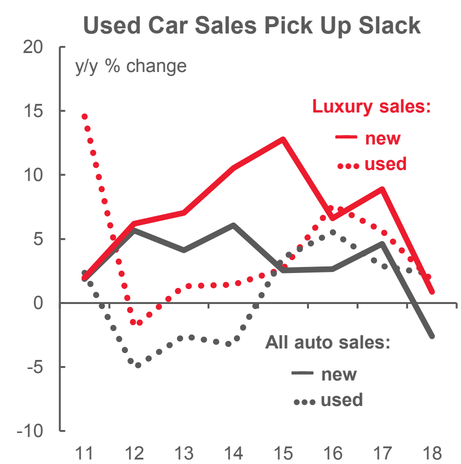
Chart 8



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