REGISTERED RETIREMENT SAVINGS PLANS

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TABLE OF CONTENTS

Introduction

Millions of Canadians are planning for their retirement relying on Registered Retirement Savings Plans (RRSPs) and private pension plans, either as their only future retirement income or to supplement the Canada Pension Plan (CPP) and Quebec Pension Plan (QPP). Approximately 5 million contribute to RRSPs. Another 3.7 million participate in registered pension plans (RPPs). Some are independent business people, others work in family businesses. Some are self-employed or work for organizations that have opted for RRSPs instead of RPPs. Our Alliance is representative of this Canadian diversity.

The objective of the Alliance is to maintain the current provisions of the *Income Tax Act* (the Act) and *Income Tax Regulations* (the Regulations) governing retirement savings. The current system is fundamentally good for the economy of Canada, and any changes made for short term deficit reduction will ultimately harm the economy in general and small and medium-sized business, in particular. Research shows that RRSPs are an important tool for small business retirement planning. Only in recent years have limits been adjusted to bring similar protection to those afforded under RPPs.

We have only just started to achieve a measure of equitable treatment for the retirement savings of the self-employed and employees not protected by employer pension plans. The current system provides for the harmonization of all tax-assisted retirement savings arrangements, which will only be achieved when the limits on money-purchase arrangements (including RRSPs) attain the equivalent limits already set for defined-benefit arrangements, such as employer pension plans.

Changes to RRSPs alone will discriminate against the self-employed and against employees without employer pension plans. These Canadians form the majority of the workforce now and in the future.

Arguments in favour of changes to the current system are based on two assumptions: firstly, that Canadians are saving sufficient income for their retirement and will continue to do so regardless of tax increases; and secondly, that the cost to the Government in lost tax revenues is enormous. Neither of these assumptions is valid.

Background

The fiscal theory underlying retirement savings is decades old. Contributions to registered plans are deductible and all earnings are exempt from tax until benefits are paid out from those plans. In essence the retirement savings system consists of a deferral of tax on contributions and earnings.

The pension tax reform of 1989-1990 does not change the underlying fiscal theory. It aims to achieve equity between the employed and the self-employed and between defined benefit arrangements and money-purchase arrangements (including RRSPs).

That equity was achieved by phasing in a higher contribution limit for money-purchase arrangements so that they could, in the future, provide a retirement income comparable to that furnished by a defined benefit arrangement. This objective of achieving equivalence permeates the Act and the Regulations and has resulted in a substantial and continuing realignment of retirement savings arrangements in Canada. That realignment, with its attendant compliance costs, borne by employers and employees, was based on the acceptance of the premises behind pension tax reform, which acceptance Canadians have demonstrated.

This realignment had a gestation period of over 5 years.[1] From the 1984 federal budget, which sought complete equity but with massive compliance costs, to the 1985 federal budget, which sought lesser compliance costs but with diminished equity, there issued pension tax reform, which yields substantial equity with substantial compliance costs.

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[1] Appendix A to this submission details the historical development of pension tax reform.

The Auditor General, in his 1988 report, estimated that pension tax reform would necessitate $330 million in start-up costs and $15 million in annual reporting costs. The Department of Finance disagreed and estimated that start-up costs would be from $60 to $70 million and that the annual reporting costs would be between $10 and $15 million. The independent consultant's report, upon which the Auditor General's report was based, had said that the start-up costs would be $395 million.

Accordingly, Canadians have already borne many of the costs of retooling the retirement savings system and will continue to do so. Having paid those costs, surely Canadians are entitled to the measure of equity that the system promises.

Governing Principles

There are disquieting rumours about possible changes to the current retirement savings system. As yet, the government has said little on this issue, other than to say that the retirement system is not inviolable.

The Alliance seeks to maintain the *status quo*. We should, therefore, deal with the principles that underlie the current system, and which continue to hold true: internal fairness and the accumulation of sufficient retirement income.

Internal Fairness

The current system was reformed to deliver internal fairness - if not quite yet, by 1996. It allows individuals to accumulate a pre-determined amount of private retirement savings. Taxpayers may, on a tax-assisted basis, earn a lifetime pension at the rate of $1,722 per year. In other words, an employee with 35 years of service may be entitled, on retirement, to an annual lifetime pension of $60,270. That level of tax assistance has been available to members of defined benefit plans since 1977. It has been frozen at that level since that time and will remain frozen until 1996.

The money purchase limits, including RRSP limits, have been phased in to eventually provide equivalent benefits. Accordingly, the annual RRSP limits, when fully instituted in 1996, will allow the self-employed to accumulate retirement savings equivalent to those of members of defined benefit plans.

Thus, one of the rationales underlying the current retirement savings structure is to eliminate the earlier discrimination against the self-employed. The self-employed will now be allowed to achieve retirement savings equivalent to those available to employees. RRSPs are not an isolated program under the Act, but rather an integral component of an indissoluble whole.

Accumulation of Sufficient Retirement Income

The limits set by pension tax reform are intended to provide a level of retirement income that will allow retired individuals to maintain their standard of living. It is generally felt that a retirement income equal to about 60-70 percent of pre-retirement income should not result in a marked change in one's standard of living.

Increasingly, it appears that individual taxpayers will need to rely more on private retirement savings and less on public programmes. It is important, therefore, that the tax system permit the accumulation of retirement savings sufficient to allow taxpayers to maintain their pre-retirement standard of living.

Indeed, it does not appear possible for money-purchase arrangements to reach, in most cases, the replacement ratio of 60 to 70 percent. Consider the following example.[2] Let us consider two taxpayers earning $50,000 and $100,000 respectively, in 1993 who maximize their contributions to RRSPs. What replacement income ratio can these taxpayers attain?

Assume that the taxpayers are married and that the annuity to be purchased from the RRSP, at

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[2] Taken from Sylvain Parent, FSA, FCIA, *RRSP income replacement levels: a case study*, 1993 Pension & Tax Reports; 4:93-94.

retirement, has the following characteristics: post-retirement indexation at 3% per annum with a spousal survivor benefit of two-thirds.[3] The results of this hypothetical are:

RRSP as a percentage of final year's salary at a 1993 salary of $50,000 ($100,000)			
Retirement Age	**Savings Start Age**		
	25	35	45
55	41.0% (31.6%)	24.7% (19.0%)	11.2% (8.6%)
60	54.4% (41.9%)	35.1% (26.7%)	19.0% (14.6%)
65	72.2% (55.7%)	48.8% (37.6%)	29.4% (22.6%)

The above table indicates, for example, that a 35-year old earning $50,000 in 1993 can, **at most**, earn a pension from an RRSP equal to 48.8% of his final year's income, if his retirement commences at age 65. In other words, after 30 years of working and saving, that individual will have a retirement income of less than half of his pre-retirement income. This is below the income replacement threshold assumed by pension tax reform itself. For the taxpayer earning $100,000 in 1993, his RRSP pension will be 37.6% of this pre-retirement income.

The only individual who attains an adequate replacement ratio, on these assumptions, is the 25-year old who saves for 40 years. It follows that, although the pension tax system espouses equivalence with the defined benefit pension plan, it does not attain it in practice.

Inequities in the Current System

3 Further assumptions are as follows: rate of return is 7.5% per annum; yearly salary increases are 5.5% per annum; mortality is 80% of the average of the 1983 Group Annuity Mortality rates for males and females.

In the current North American context, the limits of Canadian tax assistance for retirement savings are not generous. The equivalent money purchase and defined benefit limits for the United States, for example, are more than twice as generous as the Canadian limits. In addition, the Canadian system does not provide for deferrals of salary, as does the United States system.

Furthermore, inequities exist in the provision of supplementary retirement benefits. Supplementary benefits are those in excess of the $60,270 benchmark pension discussed above. They also include benefits that the Regulations, and the Department of National Revenue, do not allow to be paid from a registered pension plan. Servants of the people, such as Members of Parliament and Members of Provincial Legislatures, benefit from the privileged status of the payor of the pension, in that security of the pension promise is not an issue. Self-employed individuals and ordinary employees, on the other hand, must be concerned with the funding of their pension promise.

Requirement for Informed and Thoughtful Debate

In the early 1990s, annual contributions to RRSPs and RPPs exceeded $33 billion. Trusteed pensions, not including consolidated revenue fund plans, held $235 billion in assets at the end of 1992. The book value of the assets of such plans stood at $268 billion at the end of the first quarter of 1994. RRSP assets, not including self-directed plans, totalled $147 billion at the end of 1992.

In his discussion paper entitled *Creating a Healthy Fiscal Climate: The Economic and Fiscal Update*, released October 18, 1994, the Minister of Finance has indicated that the tax expenditure associated with all retirement savings for 1991 was $14.9 billion.

It is not surprising, therefore, that the Department of Finance should cast a covetous eye at the retirement savings system. We are concerned that a search for easy sources of revenue might prompt the government to change the existing rules in the Act governing retirement savings. It is submitted, however, that changes to the system, although fiscally attractive in the short term, would be detrimental to Canadian taxpayers in the long run.

Deficit reduction should not be the sole motivating factor for change to the retirement savings system. The existing complex web of rules governing retirement savings should only be touched if there are compelling reasons, unrelated to immediate deficit reduction, to effect change. This is particularly so given the recent and unfinished reform of retirement savings arrangements in this country.

It is clear that this debate has not yet begun and cannot be completed before the next federal budget. The prudent approach, therefore, is to defer any change to the retirement savings system until that debate has taken its course.

A Framework for the Debate

The following parameters should govern any consideration of the changes to the retirement savings system.

1. The Principle of Even-Handedness

It is clear that all components of the retirement savings structure are interrelated. As a result, it would be unfair to single out RRSPs for detrimental treatment. RRSP savings are no different from other forms of retirement savings.

2. A Tax Increase

According to a recent study of the Canada Tax Foundation, 3.7 million Canadians contributed to RPPs, and 4.8 million Canadians contributed to RRSPs, in the 1992 taxation year.[4] In that year, 69.7 percent of contributors to RPPs and 60.5 percent of contributors to RRSPs were in the middle income range ($25,000 to $60,000).

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[4] Perry, David B, *Everyone's Tax Shelter At Risk*, Canadian Tax Highlights, Volume 2, number 10, October 19, 1994; p. 75.

Obviously, the participation rate by Canadians in retirement savings arrangements is quite high. A change to the retirement savings regime, by limiting deductibility of contributions for example, would be viewed as a tax increase by users of these arrangements. Indeed, for those individuals, any negative change to the retirement savings arrangement will have the same effect as a tax increase.

3. Job Creation

The quest for deficit reduction should not obscure the important role that government can play in creating an environment conducive to increasing employment opportunities. As the government has previously stated, the bulk of job creation must come from small and medium-sized businesses. As a result, the current retirement savings regime, and in particular RRSP investments, should be viewed as an asset, and not a liability.

The ability to deduct savings for retirement has the effect of increasing aggregate private savings as a source of funds for capital investment.[5] Reducing the tax incentive for retirement savings could have the effect of reducing the amount of "pooled" capital funds that could be made available for entrepreneurial activities. It would also add to the cost of doing business in Canada and stifle future employment opportunities.

The rules in the *Income Tax Act* that permit RRSP contributors to put investments in small businesses are insufficient at present and must be strenghtened if the government wants to encourage job creation. *Canada's Economic Challenges*[6] shows that small business is playing an increasing role in the economy. Any reduction in the existing schedule of limits will hurt the ability of small business to create jobs.

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5 Andrews and Bradford, *Savings Incentives in a Hybrid Income Tax*, Studies of Government and Finance, The Brookings Institution, Washington, DC; February, 1988.

6 Department of Finance, January, 1994, p. 30.

Indeed, the government should consider measures to increase the access by small and medium businesses to the retirement savings capital pool. The latest report of the House of Commons Industry Committee makes the point well:

> *Ottawa should use tax incentives to help improve the competitiveness of the Canadian small business sector...One way the government can increase small business access to capital would be to permit owners, operators and other major shareholders to use funds from their registered retirement savings plans to buy equity in their business...that would increase the availability of such "love capital".*[7]

4. The Tax Expenditure Calculation

As indicated earlier, it is said that the tax expenditure for all retirement savings for 1991 was \$14.9 billion. That number suggests that the Government of Canada bears a high cost for its retirement savings system. However, it is our view that the calculation of that cost is not correct, with the result that the number is inflated.

The Department of Finance's calculation of the tax expenditure cost is arrived at by adding the value of deductions associated with contributions and the value of the tax shelter on earnings. From that result is subtracted the revenue generated from withdrawals. For example, for the 1991 taxation year, the \$14.9 billion number noted above is calculated as follows:

Tax expenditure (RRSP)

= value of deductions + value of tax shelter - taxes on withdrawals
= \$3.310 billion + \$2.960 billion - .735 million
= \$5.535 billion

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[7] Special Report, The Public Sector, October 24, 1994.

Tax expenditure (RPP)

= value of deductions + value of tax shelter - taxes on withdrawals
= \$4.460 billion + \$8.950 billion - 4.030 billion
= \$9.38 billion

Tax expenditure (RRSP + RPP) = \$5.535 billion + \$9.38 billion = \$14.915 billion.

The Government of Canada has itself admitted that its calculation of tax expenditures is subjective. In the case of tax deferrals, it has further stated that:

> *Estimating the cost of tax deferrals presents a number of methodological difficulties since, even though the tax is not currently received, it may be collected at some point in the future.*[8]

The government has also specifically commented on tax expenditures associated with retirement savings:

> *It should be noted that the RRSP/RPP tax expenditure estimates do not reflect a mature system because contributions currently exceed withdrawals. Assuming a constant tax rate, if contributions equalled withdrawals, only the non-taxation of investment would contribute to the net tax expenditure. As time goes by and more retired individuals have had the opportunity to contribute to RRSPs throughout their lifetime, the gap between contributions and withdrawals will shrink and possibly even become negative. An upward bias in the current estimates can therefore be expected to decline.*[9]

The method used to calculate the tax expenditure costs associated with retirement savings is based on the "current cash-flow" model. In effect, the calculation takes a snapshot of a given year and does not take into account future income flows. As indicated above, the calculation

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8 Government of Canada, *Personal and corporate income tax expenditures*, December 1993, p.4.

9 Ibid., p.53.

adds the value in a year of tax deductions to the lost tax on earnings, and subtracts the tax generated from withdrawals.
We argue that that model is flawed. Current demographics show that the system is not yet mature since contributions will exceed withdrawals for some time.

Once the baby boom generation begins to retire, withdrawals will exceed contributions. Substantial revenues will be generated for the fisc, revenues necessary to support government programs of the day. The value of the tax on those withdrawals is totally ignored in the static model adopted by the Department of Finance.

Statistics Canada projects that the proportion of the Canadian population aged 70 and over will increase from 7.84% in 1991 to 10.6% in 2010. The numbers of such individuals will increase from 2.102 million in 1991, to 3.355 million in 2010, a 59.6 percent increase. Those individuals will be drawing pensions, both from RRSPs and RPPs. Those pensions will be taxed and will benefit the fisc.

Furthermore, there is evidence to suggest that the calculation adopted by the Government greatly over-values the cost to the fisc. A US commentator has suggested that government also gains "additional corporate tax revenue on the extra capital stock that results from higher savings. The government's official revenue estimates ignore this increase in corporate tax receipts."[10]

To restate the position, the tax expenditure calculation adopts a static approach, both by considering only the current year's cash flows and by ignoring any secondary effects of the retirement savings pool. Until the true cost of the retirement savings system can be ascertained, the current estimates cannot be relied upon to justify change to the tax rules governing retirement savings.

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[10] Feldstein, Martin. *The Effects of Tax-Based Incentives on Government Revenue and National Saving*, NBER Working Paper #4021, March 1992. This position has been dismissed, out of hand and with no reasons, by two Canadian commentators: Ingerman, Sid and Rowley, Robin, *Tax Losses and Retirement Savings*, Canadian Business Economics, Vol. 2, No. 4, Summer 1994, pp. 46-54.

Trade-Offs

While the Alliance recognizes the need for the Government to get its fiscal house in order, with a particular emphasis on the expenditure side of the equation, a proper balance must be struck between short-term solutions and longer-term consequences.

One important consideration is the long-term pain that would result from Canadians having less financial flexibility to properly plan for their retirement. This long-term consequence must be measured against the short-term gain in revenues that would result from a freeze or reduction in the contributions to RRSPs and RPPs.

At a time when the Government is encouraging greater self-reliance in matters of finance, further limiting Canadians' ability to adequately plan for their retirement would serve to aggravate the public future dependence on government programs. Looking at current demographic trends, it is important to ensure that all Canadians have an opportunity to set aside necessary financial resources that will be drawn upon (and taxed) at the time of retirement. If the government is looking to become more efficient in its delivery of public sector programs, it should also ensure that the private sector is allowed sufficient flexibility to meet its needs. In this context, the current retirement savings plans should be considered an investment in the future and should not be tampered with or diminished.

Recommendations

I *THE ALLIANCE RECOMMENDS THAT THE FEDERAL GOVERNMENT CONSIDER THE TOTAL COST OF THE RETIREMENT SAVINGS SYSTEM BEFORE MAKING ANY CHANGES TO THE INCOME TAX ACT.*

II *THE ALLIANCE RECOMMENDS THAT THE EQUITY ESTABLISHED DURING PENSION REFORM NOT BE DISTURBED BY DISCRIMINATORY CHANGES AND THAT ANY FUNDAMENTAL CHANGES TO THE SYSTEM SHOULD INVOLVE A PROCESS OF INFORMED AND THOUGHTFUL INQUIRY AND DEBATE.*

III *THE ALLIANCE RECOMMENDS THAT THE FEDERAL GOVERNMENT FOSTER ECONOMIC DEVELOPMENT BY TREATING RRSP CONTRIBUTIONS AS ASSETS RATHER THAN LIABILITIES AND BY EXPLORING THE REGULATORY CHANGES NECESSARY TO ENSURE INCREASED ACCESS TO SUCH FUNDS BY SMALL AND MEDIUM-SIZED BUSINESSES.*