Policies, Preferences and Perversions in the Tax-Assisted Retirement Savings System

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Reform of the retirement savings system has been the subject of intense speculation and comment in recent years. The system has been criticized for reasons ranging from cost to equity. This paper attempts to evaluate the current tax-assisted retirement savings system in the context of stated federal government objectives of ensuring that all Canadians have adequate retirement income and encouraging increased private saving now to meet pension needs in the future. In particular, the paper addresses three questions: (1) Are these policy objectives being met in the most efficient way possible?; (2) Are there better alternatives?; and (3) Is the system fair? The paper concludes that further changes to the tax-assisted retirement savings system are advisable in order to increase both fairness and government revenue and to meet the government's stated policy objectives more efficiently and effectively than the current system seems able to do.

Au cours des dernières années, la réforme du régime d'aide fiscale à l'épargne-retraite a donné lieu à d'intenses conjectures et critiques qui portent autant sur le coût qu'il représente que sur son manque d'équité. Cet article tente d'évaluer le présent régime d'aide fiscale à l'épargne-retraite dans le contexte des objectifs énoncés par le gouvernement fédéral, soit que chaque citoyen canadien ait un revenu de retraite adéquat et que l'épargne privée actuelle soit encouragée afin de pourvoir aux besoins futurs. En particulier, l'auteure se penche sur trois questions, à savoir : (1) ces mesures sont-elles appliquées de la manière la plus efficace ; (2) existe-t-il de meilleures alternatives ; et (3) le système est-il équitable ? L'article conclut que des modifications supplémentaires au régime d'aide fiscale à l'épargne-retraite sont nécessaires afin d'augmenter l'équité ainsi que les recettes fiscales et de remplir les objectifs du gouvernement de façon plus efficace que ne semble le faire le présent régime.

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Introduction

> *There are important questions related to tax expenditures. Do they accomplish their poliey purpose in the most efficient way possible? Are there alternatives that are better? Are the individual tax expenditures in place fair? Or do they result in a situation where one part of society is bearing more or less of the burden than it should? In that sense, as Canadians examine the choices ahead, we would suggest that they look at tax expenditures in addition to program spending.*[1]
>
> The Honourable Paul Martin, Minister of Finance

The Minister of Finance, in his address to the House of Commons Standing Committee on Finance ("Finance Committee") prior to its first ever pre-budget public consultation hearings, suggested that tax expenditures as well as programme spending be considered as possible avenues toward deficit reduction. Many of the presenters at the hearings recommended paying particular attention to reducing the largest federal tax expenditure: tax-assisted retirement savings. A multitude of possible changes to the tax-assisted retirement savings system were suggested including reducing the contribution limits, converting the deduction to a tax credit and taxing the retirement fund. At the same time, there was a groundswell of support for the present system. Many of those who made presentations to the Finance Committee advanced dire predictions regarding the government's ability to meet its future financial obligations of providing Canadians with an adequate retirement income should the present system of tax-assisted retirement savings be altered. The Finance Committee made two recommendations. The first called for further study of the issues; the second suggested that no future changes be made to the retirement system without considering: (1) the need to encourage people to save more in order to decrease future dependence on government; (2) the desirability of equality in the tax treatment of different types of retirement plans; and (3) the desirability of equality in the tax treatment between public-sector and private-sector retirement plans.[2] Despite pre-budget emphasis on retirement saving, both at the Finance Committee level and in the media, only relatively minor changes were made in this area in the 1995 and 1996 federal budgets.

This paper will first attempt to apply the Minister of Finance's pre-budget questions to the tax-assisted retirement savings system in order to determine

[1] *Minutes of Proceedings and Evidence of the House of Commons Standing Committee on Finance* (Ottawa: Queen's Printer, 1994) at 58:14 [hereinafter *Minutes of Proceedings and Evidence*].

[2] See Canada, *Confronting Canada's Deficit Crisis — Building Our Next Bndget through Consultation: Tenth Report of the Standing Committee on Finance* (Ottawa: Supply & Services Canada, 1994) at 38 [hereinafter *Canada's Deficit Crisis*]. Thus, the Liberal-dominated Finance Committee is clearly committed to retaining tax incentives for retirement savings. However, this was not enough for the *Bloc Québécois* members of the Committee who, in their dissenting opinion, criticized the Liberals for refusing to eliminate the possibility of taxing pension and Registered Retirement Savings Plan ("R.R.S.P.") funds (*Canada's Deficit Crisis, ibid.* at 92). The Reform members did not specifically comment on retirement savings in their minority report but stated that they are against all tax increases and would only support tax changes if they were revenue neutral (*ibid.* at 104).

whether further changes are advisable with a view to increasing both fairness and government revenue and more efficiently meeting the government's stated policy objectives. Some of the options before the Minister of Finance for reforming tax-assisted retirement savings will then be reviewed. While the Minister did not effect significant reforms in this area in the current budget, future cost-cutting measures may well necessitate a closer look. This is particularly true given the government's commitment to "take action to reform Canada's retirement income system on a fairer and sustainable basis".[3] For the moment, suggestions for reform appear to be focused on the Canada Pension Plan ("C.P.P."), Old Age Security ("O.A.S.") and the Guaranteed Income Supplement ("G.I.S."). The 1996 federal budget provides for a new Seniors Benefit which will replace the latter two programmes commencing in 2001.[4]

As a preliminary matter, I will adopt the position of the Department of Finance which regards tax-assisted retirement savings plans as a tax expenditure[5] and will not discuss the difficulties in defining a tax expenditure.[6] My limited objective is to evaluate the current system in the context of stated federal government objectives.

I. The Present System

Canada's retirement income system has three main components: (1) publicly provided minimum-standards pensions;[7] (2) publicly provided earnings-related pensions;[8] and (3) privately provided earnings-related plans which include employer-sponsored registered pension plans ("R.P.P."s), deferred profit-sharing plans ("D.P.S.P."s) and R.R.S.P.s.

[3] Department of Finance, "Budget in Brief" in *Budget Papers* (Ottawa: Department of Finance Canada, 1995) at 13 [hereinafter *Budget Papers* 1995].

[4] See Department of Finance, *Budget Papers* (Ottawa: Department of Finance Canada, 1996) [hereinafter *Budget Papers* 1996].

[5] See Department of Finance, *Personal and Corporate Income Tax Expenditures* (Ottawa: Department of Finance Canada, 1993) at 52 [hereinafter *Income Tax Expenditures*]. According to Bernard Fortin, this is also the view of most specialists:

> The view that RRSPs form an intrinsic part of the tax structure is not likely to be shared by most specialists. For many of them, the main goals of RPPs and RRSPs are to provide an adequate level of income for people upon retirement and to stimulate retirement savings. In this perspective, RRSPs should be considered as true tax expenditures and the incidence of their net benefit becomes a relevant policy issue (B. Fortin, "Comment" in N. Bruce, ed., *Tax Expenditures and Government Policy: Seventh John Deutsch Roundtable on Economic Policy* (Kingston: Queen's University Press, 1988) 368 at 371).

[6] See N. Bruce, "Pathways to Tax Expenditures: A Survey of Conceptual Issues and Controversies" in Bruce, ed., *ibid.*, 21.

[7] These are publicly provided pensions which are not related to earnings and currently consist of the G.I.S. and the O.A.S.

[8] These pensions are provided through the C.P.P.

The tax-assisted portions of the retirement income system (R.P.P.s, D.P.S.P.s and R.R.S.P.s) were reformed in 1991 after more than ten years of task forces, studies, policy statements, press releases and draft legislation. Under the new rules, the tax deductibility of contributions to R.P.P.s, D.P.S.P.s and R.R.S.P.s has been integrated and standardized so that a comprehensive limit of eighteen percent of earnings or a dollar maximum (whichever is lower) now applies to all forms of registered retirement income plans.[9]

The limit on contributions is based on a conception of what an adequate retirement income would be. It has generally been accepted that to maintain the same pre-retirement standard of living after retirement an individual would have to receive approximately sixty to seventy percent of his or her pre-retirement income. The eighteen percent limit is based on the "rule of nine" — the assumption that, on average, it is necessary to contribute nine dollars in the current year in order to obtain one dollar of annual pension. Therefore, if one sets aside eighteen percent of one's income annually, one will receive a pension equal to two percent of earnings for every year of service. A two percent pension earned over a career of thirty to thirty-five years will replace an additional sixty to seventy percent of pre-retirement earnings in addition to what the public system delivers.

Individuals who are not members of R.P.P.s or D.P.S.P.s can contribute eighteen percent of the prior year's earned income up to a specified dollar maximum to an R.R.S.P. For R.P.P. and D.P.S.P. members the limit is reduced by the retirement benefits accruing to their credit under those plans.[10] The benefit accrual is used to determine a "pension adjustment" figure ("P.A."). The P.A. is subtracted from the individual's potential R.R.S.P. contribution room, as otherwise determined, in order to calculate what he or she may contribute to an R.R.S.P.[11] The P.A. is also used to limit the benefits that may be provided under R.P.P.s and D.P.S.P.s.[12]

The standardization of contribution limits for the various tax-assisted retirement plans has greatly decreased the disparity in access to tax assistance among those in different employment situations. One of the main criticisms of the prior system was the preferential tax treatment afforded to R.P.P.s which are available only to those employed by others but not to the self-employed.[13] Furthermore, R.P.P.s, in practice, were primarily offered only to those employees who worked in the public sector or for large corporations. As discussed below, however, the current system has not served to equalize access to tax assistance between low- and high-income earners or between members of private-sector and public-sector plans.

[9] See *Income Tax Act*, R.S.C. 1985 (5th Supp.), c. 1, ss. 147.1(8),147.1(9) for R.P.P.s, s. 147(5.1) for D.P.S.P.s, s. 146(5) for R.R.S.P.s [hereinafter I.T.A.].

[10] See *ibid.* at s. 146(5).

[11] See *ibid.* at s. 146(1) for the definition of "unused RRSP deduction room".

[12] See *ibid.* at s. 147(5.1) for D.P.S.P.s, s. 147.1(8) for R.P.P.s.

[13] The self-employed generally include farmers, professionals and business-persons.

The 1995 budget reduced the dollar limit on deductible R.R.S.P. contributions from 14,500 dollars in 1995 to 13,500 dollars for 1996 and 1997. In the 1996 budget this limit was frozen at 13,500 dollars until 2003. The dollar limit on contributions to defined contribution R.P.P.s was also reduced to 13,500 dollars for 1996 and then frozen. The dollar limit on contributions to D.P.S.P.s will continue to be one-half the contribution limit for defined-contribution pension plans. The maximum pension limit for defmed-benefit pension plans will be frozen at its current level through 2004. The pension and D.P.S.P. limits will be indexed beginning in 2005, and the R.R.S.P. limit will be indexed beginning in 2006.[14]

Essentially, the government has retained the integration of the contribution limits for the various tax-assisted retirement plans. This is consistent with the recommendations of the Finance Committee.[15] The government, however, has also retained its commitment to providing tax assistance for contributions based on earnings up to two and one-half times the average wage. Therefore, while there may be a delay in reaching the target maximum limits, the same targets remain. The result is that the current changes to contribution limits amount to no more than short-term tinkering that will not significantly increase tax revenue or fairness.

The government has also introduced certain adjustments that will make the tax-assisted retirement savings system marginally more equitable. Pursuant to the 1995 federal budget, the rollover of retiring allowances to R.R.S.P.s will be gradually eliminated. Perhaps more importantly, the over-contribution allowance of 8,000 dollars will be reduced to 2,000 dollars in 1996. This is the amount that may be contributed to an R.R.S.P. in excess of the limits for deductible contributions before a penalty tax becomes exigible.[16] In the past, financial advisors have suggested using this over-contribution room because of the ability to tax-shelter earnings, even though the taxpayer receives no deduction for the contribution and will be required to include the amount in income when it is withdrawn. The 1996 federal budget proposes to eliminate the seven-year limit on the carry-forward of unused R.R.S.P. room in recognition of the fact that many taxpayers find it difficult to contribute to an R.R.S.P. in the early stages of their working lives. In addition, the age at which individuals must mature their retirement savings is being reduced from seventy-one to sixty-nine years of age.

[14] See: "Tax Assistance for Retirement Savings" in *Budget Papers* 1995, *supra* note 3; "Measures Relating to Retirement Saving" in *Budget Papers* 1996, *supra* note 4 [hereinafter "Retirement Saving"].

[15] See *Canada's Deficit Crisis*, *supra* note 2 at 38.

[16] See I.T.A., *supra* note 9 at s. 204.2(1.1), which defines the cumulative excess amount in respect of R.R.S.P.s. Where a taxpayer has an excess amount in his or her R.R.S.P., a penalty tax is payable. A taxpayer who is at least 18 years of age, however, is permitted to contribute up to 8,000 dollars more than his or her contribution room before it is considered that there is an excess amount in the R.R.S.P.

The estimated cost of tax assistance through R.P.P.s and R.R.S.P.s in 1991 was 14.915 billion dollars at the federal level.[17] No estimates are available for the cost of the tax expenditure on D.P.S.P.s. It should be noted that estimates for each tax expenditure assume that there are no changes in other income-tax provisions, government policy, taxpayer behaviour or aggregate economic activity. Eliminating the tax assistance to R.P.P.s and R.R.S.P.s, therefore, may not result in an increase in tax revenue of approximately fifteen billion dollars, particularly if taxpayers could redirect their savings to another tax-assisted form. Furthermore, the R.R.S.P. tax expenditure estimates may exhibit an upward bias because, due to the immaturity of the system, contributions currently exceed withdrawals.[18] On the other hand, because the contribution limits were raised significantly in 1991 and since the participation rates have been increasing, one might expect that the 1991 figures may understate the current tax expenditure.[19]

It should also be noted that in comparing the cost of the tax expenditure estimates to direct spending, a dollar of tax preference is often worth substantially more to the individual than a dollar of direct spending since direct spending is usually included in the recipient's taxable income. Since all contributions and earnings are eventually taxed, the value of the tax assistance is sometimes doubted. The deferral of tax, however, does have a very real value to taxpayers. It also causes governments to incur significant costs since tax deferral is equivalent to an interest-free loan from the government in the amount of the tax otherwise payable. In addition, further tax revenue is lost through deferrals to the extent that taxpayers face lower tax rates in retirement than they do during their working lives.

II. The Policy Objeetives of Tax-Assisted Retirement Savings

The government has established two basic policy objectives behind providing tax assistance to retirement saving: (1) ensuring that all Canadians have adequate retirement income,[20] and (2) encouraging increased private saving now to meet pension needs in the future.[21] Ensuring adequate retirement income has generally meant both guaranteeing a basic level of retirement income for all Canadians and assisting them in avoiding serious disruption of their pre-retirement living standards. Maintaining pre-retirement living standards is generally considered to require sixty to seventy percent of earnings since income tax, personal savings needs

[17] See Department of Finance, *Agenda: Jobs and Growth Creating a Healthy Fiscal Climate* (Ottawa: Department of Finance Canada, 1994) at 89 [hereinafter *Jobs & Growth*].

[18] See *Income Tax Expenditures*, *supra* note 5 at 53.

[19] Empirical research has shown an increase of 14 percent in the number of R.R.S.P. contributors and an increase of 30 percent in the amount of R.R.S.P. contributions in 1991 (see H. Frenken, "Note on RRSP Contributions and Payouts" [1993] Persp. Lab. & Inc. 49).

[20] See Department of Finance, *Budget Papers* (Ottawa: Department of Finance Canada, 1984) at 18. This objective was established under Finance Minister, Marc Lalonde.

[21] See Department of Finance, News Release 89-132 (11 December 1989). This objective was established under Finance Minister, Michael Wilson.

and job-related expenses decline at retirement.[22] As discussed above, this is the basis for the current contribution limits for tax-assisted retirement saving.

The government's policy objectives are premised on the following assumptions: (1) tax incentives encourage saving; (2) publicly assisted earnings-related retirement plans are desirable; and (3) if the government fails to assist individuals to save for their retirement, they will become a burden on the state. The last assumption is based not only on the view that the state has an obligation to ensure its citizens have a basic retirement income, but also on the view that those who are assisted by the tax incentives are otherwise unlikely to have sufficient private retirement income. In fact, however, those members of society who receive the most benefit from tax-assisted retirement savings are those who are least likely to require public support in retirement.[23]

Some have argued that a paternalistic government programme that encourages or requires increased retirement savings is necessary to maximize individual welfare because people often do not act in their own best interests in planning for their retirement.[24] This alleged inability to plan responsibly may be due, in part, to the difficulties in determining one's necessary level of current saving in order to meet specific retirement goals — a process that involves complex calculations and assumptions as to inflation rates, interest rates, future income streams and needs. Psychological factors including impulsiveness, death anxiety, inconsistent preferences over time and situational preference changes may also affect the saving patterns of individuals. While these factors may strongly militate in favour of both publicly run compulsory savings plans and universal locking-in requirements,[25] they do not, in themselves, constitute a persuasive argument for earnings-related retirement subsidies.

Another argument in favour of retaining the current system is that retirement savings are a source of funds for capital investment, and that more saving generally is needed in order to facilitate economic growth in Canada. This reasoning, however, rests on the questionable assumption that the increased savings would primarily be invested to increase Canadian productive capacity.[26] Moreover, it is highly

[22] See K. Horner, "Policy Foundations of the New Tax Treatment of Retirement Savings" [1986] Can. Tax Found. 17:1 at 17:18.

[23] This is a design flaw of the current system. It is not fundamental to every possible tax-assisted retirement savings system.

[24] See: D.M. Weiss, "Paternalistic Pension Policy: Psychological Evidence and Economic Theory" (1991) 58 U. Chi. L. Rev. 1275; J. Bankman, "Tax Policy and Retirement Income: Are Pension Plan Anti-Discrimination Provisions Desirable?" (1988) 55 U. Chi. L. Rev. 790.

[25] Funds held under R.P.P.s are, in general, locked-in until retirement pursuant to pension benefits standards legislation. Generally, however, funds held under R.R.S.P.s and D.P.S.P.s may be withdrawn prior to retirement.

[26] As discussed at text accompanying notes 48-49, below, the current foreign-content rules do not prevent a large portion of retirement savings from being invested outside of Canada.

debatable whether tax incentives actually encourage saving or merely serve to channel savings to tax-assisted vehicles.

III. Does the Tax-Assisted Retirement Savings System Meet its Policy Objectives?

A. *Promoting Saving for Retirement*

There are several arguments against using a tax-assisted retirement savings system as a saving incentive: (1) tax incentives do not increase private retirement savings; (2) there are sufficient other tax incentives for saving; (3) increased saving is undesirable; and (4) fairness concerns. This last argument will be dealt with in the next section.

1. Do Tax Incentives Increase Private Retirement Savings?

There has been a great deal of debate among experts over whether tax incentives increase savings or whether they merely serve to redirect savings to a tax-assisted vehicle. There is no question that tax incentives for a certain type of saving will attract funds to that type. The important measure for determining the success of the incentive, however, is national savings which includes both public-sector and private-sector savings. The question is: what impact does tax-assisted retirement saving have on other forms of private saving and on government tax revenue.

Most economic studies in this area have focused solely on the effects of R.R.S.P.s on saving. The conventional economic view is that these vehicles have two conflicting effects on personal saving rates. The "substitution effect" dictates that a tax incentive for saving makes current consumption more costly relative to future consumption, with the result that an individual is likely to save more. The "wealth (or income) effect", however, recognizes that the tax incentive increases an individual's wealth.[27] The individual can now accumulate a target level of retirement income at a lower rate of saving; he or she may set aside less money since the government is also contributing. Increased wealth leads to increased consumption. In addition, the loss of the tax revenue caused by the incentives leads to a reduction in government savings (or an increase in the deficit).

According to Ragan, even the conventional view does not predict that R.R.S.P.s will necessarily increase national saving.[28] It predicts only that the substitution effect of the R.R.S.P. leads to more saving. Ragan argues that in a progressive income-tax system, the substitution effect of R.R.S.P.s actually works to reduce the

[27] See generally C. Ragan, "Progressive Income Taxes and the Substitution Effect of RRSPs" (1994) 27 Can. J. Econ. 43.

[28] See *ibid.* at 44.

level of personal saving. The result is that all the economic effects — substitution, income and revenue — operate to reduce national saving.[29]

In addition to the economic explanations, there are also psychological explanations for why tax incentives will or should operate to increase saving. For instance, individuals may save more because the advertising campaign around the annual deadline for R.R.S.P. contributions may remind and encourage people to save. If this is true, then increased saving may be the result not of the tax incentive, but, rather, of advertising. Moreover, as Ragan has pointed out, psychological explanations can go both ways. People may in fact save less because they fail to recognize the future tax liabilities of their R.R.S.P. saving and, consequently, perceive themselves to be wealthier than they are.[30] Without any empirical evidence, such arguments are not very persuasive.

Any impact of tax incentives on retirement saving appears to be dwarfed by the non-tax reasons for retirement saving, particularly lifecycle influences. The analysis of J.B. Burbidge and J.B. Davies indicates that participation in, and amounts contributed to, R.R.S.P.s increased with age (up to normal retirement age) and with income.[31] This is in line with the results of demographer David Foot's research which indicates that as Canada's population ages, savings should increase: "Front-end boomers entering their 40's are now entering their prime savings years ... [I]ncreasingly, baby boomers are worried about savings, so they are accumulating assets."[32]

In addition to the impact of lifecycle influences, there are other non-tax reasons for rational employers and employees to establish pension plans. A defined-benefit pension plan permits employers to reduce employee turnover and influence the age of retirement. In defined-benefit plans, retirement income is generally a percentage of earnings at the time of retirement or separation multiplied by years of service. If an employee changes jobs, the benefits from the first employer will be based on the salary at the time of separation. Thus, in calculating the employee's retirement income attributable to those years of employment, he or she will lose the benefit that would have resulted from future wage increases. In a defined-benefit plan, therefore, the value of pension accruals typically increases steeply with age and years of service.

Employees also receive certain advantages from pension plans independent of tax savings. Some may have difficulty saving on their own and find the forced-

[29] See *ibid.* at 56.

[30] See *ibid.*

[31] See J.B. Burbidge & J.B. Davies, "Government Incentives and Household Saving in Canada" in J.M. Poterba, ed., *Public Policies and Household Savings* (Chicago: University of Chicago Press, 1994) 19.

[32] D. Marston, "The Great Boom and Bust Ahead — an Interview with Demographer David Foot" *Cashing in ... Tapped Out* (Winter 1995) 5 at 6.

saving aspect of a pension plan attractive. Perhaps more importantly, employer-sponsored plans generally earn a higher rate of return from investments due to their professional management and because a higher percentage of their investments are usually held in equities. Pension plans may also reduce the cost of annuities by providing them at group rates. Furthermore, a defined-benefit plan gives the employee the security of a certain, known income stream during retirement.[33]

Theoretically, therefore, the effect of tax incentives on retirement saving is uncertain. While empirical studies undertaken in the late 1980s seemed to indicate a small increase in national savings, more recent work casts doubt on the proposition that tax assistance for retirement savings results in any increase in national *or* personal savings.[34] The net effect of tax assistance for retirement savings on total savings is, at best, ambiguous.[35]

A recent U.S. study supports the view that tax incentives do not work to promote retirement saving.[36] Similarly, an analysis of Canadian data suggests that very few people save only in the form of an R.R.S.P. This seems to indicate that an increase in contribution limits may have only wealth effects and no substitution ef-

[33] See D.I. Halperin, "Special Tax Treatment for Employee-Based Retirement Programs: Is it 'Still' Viable as a Means of Increasing Retirement Income? Should It Continue?" (1993) 49 Tex. L. Rev. 1 at 10.

[34] See *e.g.*: E. Duskin, "Changing the Mix of Public and Private Pensions: The Issues" in OECD, *Private Pensions and Public Policy* (Social Policy Studies No. 9) (Paris: OECD, 1992) 1; Ragan, *supra* note 27.

[35] This is the conclusion that many scholars have reached, including: Duskin, who states, "Empirical evidence on the savings effects of private pensions is scarce; what evidence exists is controversial" (Duskin, *ibid.* at 19); R.M. Bird, D.B. Perry & T.A. Wilson, "Tax Reform in Canada: A Decade of Change and Future Prospects" (Discussion Paper No. 1, International Centre for Tax Studies, Faculty of Management, University of Toronto, 1994) [unpublished]:

> It appears reasonable to conclude that the new system has generated greater contributions to RRSPs. Whether these contributions represent increased savings, or asset reallocations cannot be readily determined, however. Published studies of the impact of the RPP/RRSP system on savings show diverse results (Bird, Perry & Wilson, *ibid.* at 19).

M.E. Donnelly has also observed:

> Despite the fact that the government appears to have wholeheartedly embraced the point of view that increasing tax-assistance for retirement savings will encourage Canadians to save for their old age so that the government does not have to, the opinions of experts are decidedly mixed as to whether or not any additional net savings will be produced ... there is sound empirical evidence to suggest that the presence of government subsidies, whether delivered via the tax system or otherwise, likely brings about a *reduction* in savings (M.E. Donnelly, "Tax-Assisted Retirement Savings for Women in Canada — A Feminist Critique of Pension Reform" (LL.M. Thesis, University of Toronto, 1993) at 66 [hereinafter "Retirement Savings for Women"]).

Portions of the thesis were published in M.E. Donnelly, "The Disparate Impact of Pension Reform on Women" (1993) 6 C.J.W.L. 419 [hereinafter "The Disparate Impact"].

[36] See J.C. Gravelle, "Do Individual Retirement Accounts Increase Savings?" (1991) 5 J. Econ. Pers. 133.

fects. While the same analysis revealed a strong gross correlation between tax incentives for saving and the personal saving rate, the authors warned that careful empirical work would be required in order to accurately assess whether a causal link exists between these two factors.[37]

Furthermore, there appears to be a great deal of evidence to the effect that savings are generally unresponsive to tax rates. Over the last two decades there have been significant changes in real interest rates, the rate of inflation and tax measures, but "[t]he savings rates in most countries have remained relatively constant through most of recent history."[38] This uncertainty over the effects of tax incentives on retirement savings should, at the very least, lead the government to question the wisdom of spending such enormous sums on a programme with such uncertain results.

2. Other Tax Incentives for Saving

The tax-assisted retirement savings system is only one of many tax incentives for saving. Current contribution limits seem to reflect a belief that tax-assisted retirement savings can only occur through R.P.P.s, R.R.S.P.s and D.P.S.P.s, whereas in fact, any measure that subsidizes asset accumulation, in effect, subsidizes retirement income.

The treatment of principal residences under the I.T.A. is a good case in point. On disposition, principal residences are exempted from capital-gains tax and the proceeds of disposition can be used to provide retirement income.[39] Moreover, the imputed rent of owner-occupied homes is not income for I.T.A. purposes. The value of both of these tax savings depends on the value of the home owned by the taxpayer. Presumably, the greater one's income, the more expensive a home one can afford.

Burbidge and Davies estimate (using 1990 data) that one-half of personal net worth is in the form of owner-occupied housing and consumer durables, neither of which is taxable under the I.T.A. About one-third of personal financial assets are in fully tax-sheltered forms such as R.R.S.P.s or private pensions. In all, the income on approximately two-thirds of personal wealth is not taxable under the Canadian income-tax system.[40]

Tax preferences are also given to capital gains, giving a greater benefit to those who can purchase more expensive assets. Capital gains are taxed at the time of the disposition of the asset, not as they accrue. The value of this deferral is equivalent

[37] See Burbidge & Davies in Poterba, ed., *supra* note 31 at 55.

[38] N. Brooks, *The Canadian Goods and Services Tax: History, Policy, and Politics* (Sydney: Australian Tax Research Foundation, 1992) at 120. See also Brooks, *ibid.* at 121-24, for a general discussion of the empirical research on the effect of taxes on private savings.

[39] See I.T.A., *supra* note 9 at s. 40(2)(b).

[40] See Burbidge & Davies in Poterba, ed., *supra* note 31 at 25.

to that of an interest-free loan from the government in the amount of the tax that would be payable. Upon disposition of the asset, only seventy-five percent of the capital gain is included in income. Finally, until recently there was a 100,000 dollar lifetime capital-gains exemption. There is still a 500,000 dollar capital-gains exemption for "qualified small business corporation share[s]" and for "qualified farm property".[41] While these tax preferences are not generally viewed as part of retirement policy, their effect is similar to direct tax assistance for retirement saving in that they act to subsidize asset accumulation which can be used to provide retirement income.

3. Should Private Saving Be Encouraged?

It is far from universally accepted that an increase in private savings is necessarily beneficial for the economy. While a link is often suggested between increased saving and higher real investment, this assumes that, at least in the long run, economic resources are fully employed.[42] If an economy is in a recession, an increase in personal saving represents a reduction in aggregate demand which may prolong the recession.[43] For example, David Foot has suggested that increased saving has prolonged the current recession: "This saving trend is also a drag on the economy. The consumers that led us out of the '81/'82 recession are not around to lead us out of the '91/'92 recession and that's why people continue to experience tough times."[44]

In pre-budget consultations, Michael McCracken suggested to the Finance Committee that in attempting to reduce spending, the government should aim to minimize the harm to the economy by making cuts that lead to the fewest job losses and cause the least damage to hiring decisions, business investment, consumer expenditure and the like. He stated that with this aim in mind the government will focus cuts on people who save rather than on those with low incomes.[45]

In summary, increased personal saving results in decreased demand for goods and services and increased unemployment. Unemployment creates additional demands on government revenues and restricts personal saving opportunities.[46] Con-

[41] Both of these terms are defined in the I.T.A., *supra* note 9 at s. 110.6(1).

[42] There is also another implicit assumption. As Brooks has pointed out,

> what matters for economic growth is not household savings but total national savings. Both corporations and the government also contribute to national savings. If the rate of national savings is too low, it is not clear that household savings should be targeted for an increase (Brooks, *supra* note 38 at 116).

[43] See J.E. Pesando, "The Economic Effects of Private Pensions" in OECD, *supra* note 34, 126.

[44] Marston, *supra* note 32 at 6. S. Ingerman & R. Rowley, "Tax Expenditures and Retirement Savings" (1994) 2 Can. Bus. Econ. 46 at 48, have suggested that the 1991 reforms of the tax-assisted retirement savings system may have deepened the 1990-1991 recession and weakened the subsequent recovery.

[45] See *Minutes of Proceedings and Evidence*, *supra* note 1 at 59:26.

[46] See "Retirement Savings for Women", *supra* note 35 at 70.

versely, high levels of demand raise employment levels and, thereby, directly lower poverty levels: "They also improve the fiscal position of governments and improve the opportunities for expanding the current system of redistributive measures."[47]

Another argument against using government policy instruments to encourage private saving is that the underlying assumption that increased savings will result in increased domestic investment is flawed. This is no less true of retirement savings. Up to twenty percent of a fund's assets may be invested in foreign property before any penalty is imposed.[48] Recently, there has been a proliferation of investment vehicles created solely to avoid the foreign-content restrictions. There are certain hybrid schemes and segregated funds, widely advertised by insurance companies and investment dealers, which result in foreign investments being treated as wholly Canadian for the purposes of the penalty tax. Even savings that are invested in the shares or debt of active Canadian companies do not necessarily result in increased domestic productive capacity since the Canadian company may then use the funds raised to carry on business or invest abroad.[49]

B. Ensuring Adequate Retirement Income and Saving the Public Purse

Many of those who made presentations to the Finance Committee advanced dire predictions regarding the future financial obligation of the government to provide Canadians with an adequate retirement income should the present system of tax-assisted retirement savings be altered.[50] Such predictions are based on assumptions both about the cost of the tax expenditure relative to future costs and about those who benefit from tax-assisted retirement saving. It is implied that those who benefit now are those who otherwise would likely become eligible for direct government assistance during their retirement.

[47] Economic Council of Canada, *The New Face of Poverty: Income Security Needs of Canadian Families* (Ottawa: Supply & Services Canada, 1992) at 11.

[48] See I.T.A., *supra* note 9 at s. 206(2). The 20 percent figure refers to the cost amount of the property rather than to its current value.

[49] This is true only if certain conditions are met (see I.T.A., *ibid.* at s. 206(1)(d.1), proposed ss. 206(d.1), 206(1.1)).

[50] For example, Christine Hollett, Executive Director of the Advisory Council on the Economy, warned that by taxing pension plans the government may be gaining revenue today at the expense of tomorrow. She stated that if the provisions are changed,

> you'll find a major reduction in the amount of moneys people are saving for their retirement. When the working population of today approaches retirement tomorrow or next year or twenty years down the road, you'll face a major financial drain on your purse at that point (*Minutes of Proceedings and Evidence*, *supra* note 1 at 63:39).

See further statements to the same effect from: Martin D. Salloum, General Manager of the Edmonton Chamber of Commeree (see *ibid.* at 66:22); Michael White, representing the Employer Committee on Health Care (see *ibid.* at 66:86-87); Pierre Caron, representing the Retirement Savings Alliance (composed of the four largest pension consulting firms) (see *ibid.* at 73:35); Leo-Paul Landry, Chair of the RRSP Alliance (see *ibid.* at 85:5); George Anderson, President of the Insurance Bureau of Canada (see *ibid.* at 65:91); Robert Schultz, Chair of the Investment Dealers Association of Canada (see *ibid.* at 79:6).

The design of the tax incentive leads to inefficient and inequitable results. A deduction from taxable income gives the greatest incentive to save to those who need it least, namely, high-income earners who have the ability to accumulate significant assets before retirement and to take advantage of other tax incentives for saving. They are probably not potential candidates for future income-tested government programmes. Those who are likely to need assistance in obtaining adequate retirement income — low-income Canadians — receive little benefit from this costly government programme; a deduction is worthless to those who have no taxable income.[51]

As with all deductions, the value of a deduction for a contribution to a tax-assisted retirement savings plan increases as the taxpayer's marginal tax rate increases. Higher-income taxpayers receive proportionately more assistance for any given amount of retirement saving than a taxpayer whose marginal tax rate is below the maximum. For example, assume that there are three individuals who each contribute one hundred dollars to an R.R.S.P. The high earner who has a marginal tax rate of twenty-nine percent will receive a subsidy of twenty-nine dollars. The taxpayer who has a marginal tax rate of seventeen percent will receive a subsidy of seventeen dollars while the individual with no taxable income will receive no assistance whatsoever. Furthermore, since the level of permissible contributions increases with the level of earned income, the high-income earner is also able to contribute larger dollar amounts and, therefore, able to receive a larger benefit. In addition, the proportion of income that is available for saving or discretionary spending increases as income increases. High-income earners are, therefore, more likely to be in a position to contribute.

It should be stressed that the major tax benefit arising from the retirement saving incentives is not the deduction, but the sheltering, of investment income. High-income earners will also benefit to a much greater extent from the tax deferral on investment earnings for the same reasons outlined above. Since they would otherwise be paying tax on the income at a higher marginal rate, a greater amount of tax is deferred. Furthermore, because they have the legal and financial capacity to contribute a greater amount in absolute terms, they will also benefit from the deferral of tax on a larger amount of investment income.

This theoretical analysis may be verified empirically by an analysis of Revenue Canada data on annual contributions to R.R.S.P.s for the 1992 tax year.[52] Not sur-

[51] The regressivity of tax deductions and the failure of either deductions or credits (unless refundable) to help those without any taxable income are two common flaws with the tax-expenditures method of programme delivery. A subsidy can be more easily and directly targeted.

[52] See Revenue Canada, *Taxation Statistics* (Ottawa: Supply & Services Canada, 1994) [hereinafter *Taxation Statistics* 1994]. Some have argued that the lifetime of a taxpayer is a less arbitrary period than a year for the purpose of measuring tax incidence including the incidence of tax expenditures. Davies's study concludes that the incidenee of net benefits from R.R.S.P. saving over a lifetime is approximately as regressive as the incidence reported in annual studies (see J.B. Davies, "Incidence of

prisingly, both the percentage of tax-filers who contribute to an R.R.S.P. and the average contribution increase substantially as income rises. While only ten percent of tax-filers reporting income of less than 25,000 dollars contributed to an R.R.S.P. in 1992, over seventy-two percent of those earning over 100,000 dollars contributed to an R.R.S.P. Of those who did contribute, the average contribution for low-income earners (under 25,000 dollars) was 1,565.86 dollars, whereas the average contribution for high-income earners (over 100,000 dollars) was 9,560.97 dollars. The average tax-filer earning over 100,000 dollars contributes *forty-four* times as much to an R.R.S.P. as the average tax-filer earning under 25,000 dollars. When the different marginal income-tax rates of these two groups are factored in, the average benefit received by high-income earners is *seventy-five* times that received by low-income earners. Furthermore, these numbers fail to take into account those individuals who do not file a tax return.[53]

R.R.S.P. Contributions for 1992 by Income[54]

Income	*Percentage of all tax-filers*	*Percentage of tax-filers who contributed to an R.R.S.P.*	*Average contribution of tax-filers*	*Average contribution of ccntributors*
Under $25,000	61.5	10.0	$156.39	$1,565.86
$25,000 - $50,000	27.9	42.8	$1,119.80	$2,613.96
$50,000 - $70,000	7.0	60.9	$2,384.19	$3,918.03
$70,000 - $100,000	2.2	70.0	$4,191.41	$5,990.45
Over $100,000	1.3	72.1	$6,890.06	$9,560.97

The Ontario Fair Tax Commission has pointed out that what is considered to be an adequate retirement income for tax-assisted retirement savings purposes is much higher than what is considered to be an adequate retirement income for the purposes of other forms of government retirement assistance. The C.P.P. covers only twenty-five percent of the Year's Maximum Pensionable Earnings, which is equivalent to the average wage. By contrast, the earnings corresponding to the maximum contribution to tax-assisted retirement savings plans is approximately two and one-half times the average wage.[55] O.A.S. benefits are clawed back if the recipient has an income over, approximately, 55,000 dollars. The Ontario Fair Tax

Tax Expenditures in a Lifetime Framework: Theory and an Application to RRSPs" in Bruce, ed., *supra* note 5, 339 at 366).

[53] Pursuant to the I.T.A., *supra* note 9 at s. 150, an individual who has not disposed of capital property need not file a return for a year in which no tax is payable. While many individuals with no income would still file a return in order to claim the refundable tax credits, not all do. It has been estimated that as many as 15 percent of the lowest-income families do not apply for refundable tax credits (see Brooks, *supra* note 38 at 95).

[54] This chart is derived from data contained in *Taxation Statistics* 1994, *supra* note 52 at table 2, pp. 54-61.

[55] The federal government affirmed its commitment to maintaining this ratio in the 1995 Federal Budget.

Commission recommended that the maximum retirement benefit eligible for tax assistance be reduced to one and one-half times the industrial wage after which contribution limits should be indexed to maintain the ratio.[56]

Tax assistance for retirement savings tends to reinforce current economic inequalities. Therefore, it should not be surprising that women benefit to a much lesser extent from such assistance.[57] Women are less likely to have the jobs or the disposable income that enables adequate retirement savings. In addition, women are less likely to belong to a pension plan because they are disproportionately represented in low-wage, intermittent and part-time work. A pension model that assumes a thirty-five year stint in the paid labour force does not reflect the experience of most women. The present system, coupled with women's economic inequality, has translated directly into lower subsidies for retirement saving for women even though the poverty rate of elderly women in Canada is double that of elderly men.[58] The Women and Taxation Working Group of the Ontario Fair Tax Commission concluded that the current system of tax-assisted retirement savings results in systemic discrimination against women.[59]

A programme that gives no assistance to those most likely to rely on the government to provide them with a retirement income in the future and that, at great cost, primarily benefits those who are highly unlikely to require government subsidies to obtain a basic retirement income, can never be seen as a good policy. In these days of fiscal restraint and overwhelming public concern for the size of the government debt and social spending cuts, the continued existence of such a programme is not only wasteful but obscene.[60]

[56] See Ontario Fair Tax Commission, *Fair Taxation in a Changing World: Report of the Ontario Fair Tax Commission* (Toronto: University of Toronto Press, 1993) at 331-32 [hereinafter *Fair Taxation*].

[57] For instance, *Taxation Statistics* 1994, *supra* note 52 at table 4, p. 107, shows that in 1992, women made up 42 percent of R.R.S.P. contributors, but that only 34 percent of R.R.S.P. contributions were made by women.

[58] See "The Disparate Impact", *supra* note 35 at 421.

[59] See: Ontario Fair Tax Commission, *Women and Taxation* (Working Group Report) (Toronto: Fair Tax Commission, 1992) at 22; *Minutes of Proceedings and Evidence*, *supra* note 1 at 91:34 (M. Jackman, National Association of Women and the Law).

[60] It should be noted that R.R.S.P. funds can be withdrawn at any time. Therefore, there is no guarantee that they will be used for retirement. In fact,

> [d]ata for 1990 indicate that two-fifths of total RRSP income was reported as cash withdrawals by tax-filers under 55 years of age ... another fifth was paid to those aged 55-64 — of which 90 per cent was cash withdrawals! Fully three-quarters of RRSP income was in the form of cash rather than payments from annuities or a Registered Retirement Income Fund, ... a proportion which is hardly suitable for any normal pension programme (Ingerman & Rowley, *supra* note 44 at 52).

An obvious and simple way to improve the efficiency of the system would be to require that R.R.S.P. funds, like pension funds, be locked-in until retirement. Of course, such a requirement would not detract from any of the criticisms mentioned above.

IV. Redesigning the System

Numerous possibilities have been suggested for redesigning the current system with a view to making it more efficient, more equitable and less costly. In evaluating these alternatives the following general principles should be kept in mind: (1) tax treatment should be equitable between private-sector and public-sector plans; (2) tax treatment should be equitable among different types of plans; and (3) tax treatment should be equitable between high- and low-income earners. In order to meet the policy objective of saving the public purse from a future drain on revenue, the system should be designed to provide a greater benefit to low-income earners.

There are three main transactions that provide possible occasions for the taxation of retirement income: (1) contributions; (2) income derived from the investment of contributions; and (3) the payment or withdrawal of retirement benefits from the accumulated fund.

A. Reducing the Contribution Limits

Reducing contribution limits, either by reducing the maximum dollar amount, the percentage of earnings that may be contributed or both, was the suggestion for reform most often made to the Finance Committee[61] and was adopted to some extent by the government in the 1995 and 1996 federal budgets. As noted above, the Ontario Fair Tax Commission made the same recommendation.[62] The fairness and efficiency of the system could be improved somewhat by reducing the maximum dollar amount to a level that most members of the middle class could afford, thereby eliminating contribution room which is only available to those with very high incomes. The Confederation of National Trade Unions ("C.N.T.U.") has suggested that an appropriate amount would be 7,000 dollars or 8,000 dollars.[63] Under the current rules, these figures correspond to annual incomes of approximately 38,000 dollars to 45,000 dollars. An income of over 80,000 dollars would be required in order to reach the maximum contribution for 1995 of 14,500 dollars under the present rules.

Reducing the percentage of earned income that may be contributed would make it more difficult for low-income earners to reach the dollar maximum and, therefore, to receive a benefit similar to that accessible to high-income earners. While raising the percentage of earned income that may be contributed may be worth considering, it would be difficult, in reality, for a low-income earner to save more

[61] It was suggested by more than a dozen groups including: the Canadian Real Estate Association (see *Minutes of Proceedings and Evidence*, *supra* note 1 at 77:4); the Child Poverty Action Group (see *ibid.* at 82:3); and the Confederation of National Trade Unions (see *ibid.* at 62:12).

[62] See *Fair Taxation*, *supra* note 56 at 332. The Commission also noted that the limits have effectively been reduced in real terms over the years due to the effects of inflation (see *ibid.* at 332).

[63] See *Minutes of Proceedings and Evidence*, *supra* note 1 at 62:26 (P. Paquette, Secretary General, C.N.T.U.).

than eighteen percent of earned income. Such a move, therefore, might only serve to enhance the tax-assisted savings opportunities of those with significant investment income and low earned income. Essentially, the percentage should approximate that which low- or low- and middle-income earners can realistically contribute taking into account lifecycle saving patterns.

One way of making the system more progressive and of increasing tax revenues would be to restrict the deduction as income increases. The Carter Commission suggested that limits should be raised for low-income earners and significantly restricted for high-income earners.[64]

There is also the issue of maintaining equity between public-sector and private-sector pension plans. Not all public-sector plans are R.P.P.s due both to the government's tax-exempt status and because a large number of government plans are unfunded. In order to maintain equity it would be necessary to calculate a P.A. for each member of a non-registered public-sector plan and use it to reduce his or her R.R.S.P. contribution room. The last time the current system was reformed, the Department of Finance proposed calculating pension credits in respect of certain unregistered retirement plans maintained by tax-exempt employers so as to reduce the R.R.S.P. contribution room of those who are entitled to pension benefits under these plans.[65] While the proposed regulations are still not law, a P.A. is currently calculated in respect of certain non-registered public-sector arrangements.

B. Eliminating All Deductions for Contributions

Another option would be to eliminate the deduction for contributions to tax-assisted retirement savings plans altogether.[66] The question then arises as to how to tax employer contributions to R.P.P.s and D.P.S.P.s. For defined-contribution plans and D.P.S.P.s it is easy and reasonable to include the amount of the employer's contributions in the employee's income for the year as a taxable benefit. In a defined-benefit plan, however, there may be little connection between current employer contributions and the increase in an employee's wealth. To resolve this difficulty, the P.A., which is a method of measuring the accrual of pension benefits, could be used; the portion of the P.A. that relates to employer contributions could be included in the employee's income without adding significant complexity to the current I.T.A. provisions. In order to maintain equity between public-sector and

[64] See R. Krelove & S.A. Rea, Jr., "Private Pensions and the Tax System: Twenty Years After the Carter Commission" in N. Brooks, ed., The *Quest for Tax Reform* (Toronto: Carswell, 1988) 121 at 127. The Carter Commission also suggested that the maximum pension limit be independent of earnings and that withdrawals from R.R.S.P.s prior to retirement be limited. Excess withdrawals would be subject to a penalty (see *ibid.* at 127).

[65] See proposed regulations 8308.3 and 8308.4, which were part of the December 18, 1992 draft regulations.

[66] I note that this would not result in the elimination of contribution limits as the taxation of the funds' income would still be deferred. Therefore, this could be combined with changes to the contribution limits.

private-sector pension plan members, P.A.s should be calculated for all members of public-sector plans, and the portion relating to the government's contribution should, likewise, be included in each member's income.

Liquidity may become a problem if the amount of an employer's contribution is included in an employee's income. The employee will be taxed on an amount that is not available to help pay the tax. In practice, this should not be a problem since there would likely be a withholding requirement and since the income tax consequences would probably be taken into account in the negotiation of future employment contracts.

Finally, supporters of the current system may argue that eliminating the deduction for contributions would eliminate or greatly reduce the savings incentive. As discussed above, it is highly debatable whether tax incentives work to increase savings at all. To the extent that people contribute to their R.R.S.P.s more for the current deduction than for the sheltering of investment income, there may be some argument for taxing the fund instead. Practically speaking, however, financial advisors commonly suggest using the 8,000 dollars over-contribution room as a shelter, and a large number of individuals with sufficient financial resources to access it have taken their advice even though they not only receive no deduction for the contribution, but will have to include the amount as income when it is withdrawn. This seems to indicate that removing the deduction for contributions would not greatly affect the savings incentive.

If contributions to tax-assisted retirement savings plans are not deductible, then it is inappropriate to tax the entire amount of the pension benefit when it is received, since tax will already have been paid with respect to a portion of that amount. If the income of the funds is not taxed, it has been suggested that the full exemption from tax of the pension benefit would result in a similar impact on tax revenue as the current system, although the timing of the tax payments would be advanced.[67] In order to raise more revenue and improve equity there would have to be a system that distinguished between underlying contributions and income. One suggestion is to track the amount of contributions. If the entire amount in the R.R.S.P. were withdrawn at one time, determining the amount of income would be straightforward. If, as is more likely to happen, benefits are received in the form of an annuity or similar partial payment or withdrawal in any one year, the income portion could be determined using a formula similar to that used to determine the capital element of annuity payments.[68]

[67] See A. Dilnot, "Taxation of Private Pensions: Costs and Consequences" in OECD, *supra* note 34, 72.

[68] See I.T.A., *supra* note 9 at s. 60(a). It is interesting to note the relatively new Australian system where all tax-deductible contributions to pension plans are subject to a 15 percent tax when received by a fund. Investment income and capital gains are taxed at 15 percent, but capital gains are taxed after adjustment for inflation. Pension benefits are taxed at the individual's marginal rate less 15 percent. While this system has the effect of reducing the size of the budget deficit by bringing tax reve-

C. Conversion to a Tax Credit

Converting the current deduction to a tax credit at the lowest marginal income-tax rate (currently seventeen percent) would increase the progressivity of the system since all taxpayers with sufficient taxable income would receive the same tax benefit per dollar of contribution. Those with no taxable income would continue to receive no benefit from the tax-assisted retirement savings system. Replacing the deduction with a tax credit would also be less costly for government.

This approach was recommended by, among others, the Ontario Fair Tax Commission, who also recommended that withdrawals should continue to be taxed as ordinary income.[69] It was also the second most popular suggestion for reforming the tax-assisted retirement savings system which was presented to the Finance Committee in its pre-budget consultations.[70]

If a tax credit were used, it would require including in income an amount with respect to employer contributions to R.P.P.s and D.P.S.P.s, as discussed above. Furthermore, a tax credit would give rise to an increased possibility of double taxation, assuming that pension benefits and R.R.S.P. withdrawals would continue to be taxed at the individual's marginal rate. Such a risk would only arise, however, if the individual's marginal tax rate is higher than seventeen percent both at the time of contribution and at the time of withdrawal or receipt of the pension benefit.[71] Since individuals who fit this criterion are those who least need the subsidy, it is perhaps not unfair to reduce their benefits. The fear that the use of a tax credit might reduce the savings incentive for high-income earners appears to be unfounded since many individuals consider it to be in their interest to use the over-contribution room despite the much larger penalty involved.

D. Taxing Fund Investment Income

It is somewhat interesting to note that only one of the hundreds of groups that appeared before the Finance Committee suggested that the investment income of retirement funds be taxed.[72] It is unclear whether this proposal is unpopular, even among groups that advocate reform of the system, due to perceived technical or political problems. A superficial review of public opinion in the media indicates

nues forward, it is no more progressive than our current system (see D.M. Knox, *A Review of the Options for Taxing Superannuation* (Sydney: Australian Tax Research Foundation, 1990) at 43).

[69] See *Fair Taxation, supra* note 56 at 332.

[70] The representatives of at least seven groups suggested this option including the Child Poverty Action Group (see *Minutes of Proceedings and Evidence, supra* note 1 at 82:32-33), the Hamilton Chamber of Commerce (see *ibid.* at 72:99) and the B.C. Federation of Labour (see *ibid.* at 64:66).

[71] Even under the current system there is no guarantee that an individual's marginal rate will not be higher at the time of withdrawal or receipt of the pension benefit either due to increases in the individual's income or due to general increases in tax rates.

[72] The Ecumenical Coalition for Economic Justice suggested a modest tax on investment income (see *Minutes of Proceedings and Evidence, supra* note 1 at 72:18).

that any taxation of pension funds would be even more unpopular than decreasing the contribution limits or replacing the deduction with a tax credit.

One advantage of taxing the fund earnings rather than contributions is the revenue potential. It has been estimated that in 1992 the value of pension and R.R.S.P. funds in Canada was approximately 440 billion dollars.[73] The Department of Finance estimated that in 1991 the non-taxation of investment income in R.R.S.P.s and R.P.P.s cost the government almost twelve billion dollars. No numbers were available with respect to the revenue lost through the non-taxation of investment income in D.P.S.P.s.[74]

Furthermore, the tax exemption may lead to inefficiencies in the capital markets as different tax rates for different investors may affect their investment preferences. Particular transactions may become profitable due to the presence of tax-exempt investors. Such transactions may merely represent a transfer of taxable income to a tax-exempt investor. In addition, the tax structure offers an incentive for tax-exempt investors to favour debt over equity since dividends are paid from after-tax profits, whereas interest is paid from pre-tax profits. This preference can have a significant effect on government revenue since the I.T.A. permits a deduction for interest paid on the assumption that it will be taxable in the hands of the recipient.[75]

There are two basic ways of taxing investment earnings. Either the fund itself could be taxed directly, or the earnings could be attributed to the relevant individuals and taxed at their marginal rates. Problems arise with each of these approaches. It is impossible to apply a single tax rate to retirement funds without either maintaining the increased tax benefits to high-income earners or penalizing low-income earners for participating. In addition, it may be argued that a direct tax on retirement funds would increase inequities between public-sector and private-sector plans. The result of the tax on private-sector plans would likely be, at least in the long run, a reduction of the benefit level provided. Since the public sector is tax-exempt and since many of the plans are, in any event, unfunded, there would be no similar pressure to reduce the benefits provided under public-sector plans.

There do not appear to be any significant conceptual or administrative problems in attributing investment earnings to individuals with respect to defined-contribution R.P.P.s, D.P.S.P.s or R.R.S.P.s. For defined-benefit R.P.P.s, it would be necessary to include an amount with respect to the benefit accrual rather than the investment income, since the investment income, like a contribution, is not directly related to the ultimate benefit received by any particular plan member. This would be similar to the P.A. calculation. The issue of equity between public-sector and

[73] See Ingerman & Rowley, *supra* note 44 at 50. This figure includes the accumulated assets held under R.P.P.s and R.R.S.P.s but excludes assets held under D.P.S.P.s and in government-consolidated revenue arrangements.

[74] See *Budget Papers* 1996, *supra* note 4 at 18.

[75] See Dilnot in OECD, *supra* note 34.

private-sector plans could be resolved by requiring a similar calculation and inclusion for members of public-sector plans. The major problem with taxing investment income at the level of the individual is one of liquidity; quite simply, the individual beneficiaries may not have sufficient funds to pay the taxes as they become due. The problem is particularly acute with respect to R.P.P.s since pre-retirement withdrawals are prohibited.

E. Other Assorted Proposals

It is beyond the scope of this paper to exhaustively explore every possible reform. For the sake of completeness, however, I will list some other potential reforms:

> (1) A limit could be placed on the total amount of tax-assisted savings, that is, the value of all R.R.S.P.s held and all pension benefits. Once this limit is reached, the taxpayer would no longer be entitled to any deductions for contributions, and the investment earnings would no longer be tax-exempt.[76]
>
> (2) The age at which R.R.S.P.s must be terminated was reduced from seventy-one years of age to sixty-nine years of age in the 1996 federal budget;[77] it could be further reduced to sixty-five years of age so that tax could be collected earlier. Other tax deferral systems, such as registered retirement income funds, could be similarly restricted. This would be unlikely to affect any saving incentive.[78]
>
> (3) R.R.S.P.s could be subject to a locking-in requirement. This change might not have much of a current effect on revenue but would ensure that the funds are used to provide a retirement income.[79]
>
> (4) The 8,000 dollar over-contribution limit that was reduced to 2,000 dollars in the 1995 federal budget could be totally eliminated, especially since the I.T.A. permits a deduction for withdrawals (to offset the income inclusion) where an over-contribution has mistakenly occurred.[80] It is unlikely that an over-contribution would be made by mistake since Revenue Canada informs each taxpayer of his or her personal contribution limit for the year. This might not significantly affect revenue but would increase progressivity.

[76] See *Minutes of Proceedings and Evidence*, *supra* note 1 at 73:46. This was suggested by the Chair of the Finance Committee who pointed out that currently one could have millions in an R.R.S.P. (with good investment performance) and still have the earnings sheltered from taxation.

[77] See "Retirement Saving", *supra* note 14.

[78] See *Minutes of Proceedings and Evidence*, *supra* note 1 at 69:14 (D. Burrell).

[79] Among others, this was recommended by the Ontario Fair Tax Commission (see *Fair Taxation*, *supra* note 56 at 329).

[80] See I.T.A., *supra* note 9 at s. 146(8.2).

(5) R.R.S.P.s and pension funds could be required to invest a certain percentage of their assets in special government bonds. Assuming that the government bonds would not carry a market interest rate, this would, in effect, be a tax on the funds. For the reasons outlined above, this would not be a progressive measure. Furthermore, restricting investment in this manner might decrease the attractiveness of tax-assisted retirement savings plans even more than a direct tax since it may increase uncertainty about future government intentions.

(6) The current investment restrictions could be revised so as to permit less of the funds to be invested outside Canada. At present, the foreign-content rules permit twenty percent of a fund to be placed in foreign investments.[81] This percentage could be reduced so as to require greater investment in Canada.

Conclusion

The purpose of this paper was to determine whether further changes to the tax-assisted retirement savings system are advisable in order both to increase fairness and government revenue and to meet the government's stated retirement policy objectives more efficiently and effectively than the current system seems able to do. My conclusion is a resounding "yes". It is highly questionable whether the current tax-assisted retirement savings system meets its policy objectives of helping to ensure that all Canadians have adequate retirement income and encouraging increased private saving now to meet future pension needs. It is absolutely clear, however, that the system does not accomplish these policy purposes in either the most efficient or the most equitable way possible. Thus, the answers to the questions posed by the Minister of Finance in the quote cited at the beginning of this paper would suggest that major reforms of tax-assisted retirement savings should be pursued. Given the minor tinkering to the system in the 1995 budget, which was, generally, the toughest federal budget in decades, and the focus on publicly provided pensions in the 1996 budget, however, it may be unrealistic to expect such reforms in the foreseeable future.

[81] See *ibid.* at Part 11. As discussed at text accompanying notes 48-49, above, the current foreign-content rules may be inadequate to encourage investment in Canada.