C.D. Howe Institute

Backgrounder

www.cdhowe.org

No. 65, April 2003

New Poverty Traps:

Means-Testing and Modest-Income Seniors

Richard Shillington

The Backgrounder in Brief

Millions of Canadians accept the homogenous advice of governments and the financial community and put billions into RRSPs. However, for many lower-income Canadians RRSPs are a terrible investment. They are victims of a fraud, however unintentional. Only when more Canadians are aware of the perverse treatment of lower-income citizens' savings will Ottawa be forced to develop measures that reward, rather than punish, their savings efforts.

About the Author

Richard Shillington has a doctoral degree in statistics and has conducted research on health, social and economic policies for 30 years. He has worked for governments, the private sector and NGOs.

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Quotation with appropriate credit is permissible.

$5.00; ISBN 0-88806-580-9;
ISSN 1499-7983 (print); ISSN 1499-7991 (online)

Saving, the accumulation of wealth, is generally considered prudent. It can improve an individual's or a couple's retirement standard of living, and it may also be a useful cushion against unemployment or temporary financial needs.

Government incentives for saving, however, do not favour saving for Canadians at all income levels. Higher-income Canadians are allowed, indeed encouraged, to save for retirement, and that saving is supplemented with advantageous tax treatment, for example, contributions to registered pension plans and retirement saving plans (RPPs/RRSPs) can be deducted from taxable income (up to a limit), and the returns on funds in those plans are allowed to accumulate tax-free until withdrawal. Yet Canadians with lower incomes, those whose jobs tend to be without an employer pension, are allowed to save but get little or no effective tax assistance for that effort.

And for many Canadians in still less advantageous circumstances — those receiving social assistance, living in social housing, or receiving child-care subsidies —the government effectively punishes saving by making social benefits available only to those whose accumulated saving is miniscule. For example, a registered education saving plan (RESP) can leave an Ontario resident ineligible for child-care subsidies.

Many lower-income Canadians who are approaching age 65, moreover, are saving despite the fact that they will soon be subject to taxes and clawbacks that will effectively confiscate much of what they have set aside.

This *Backgrounder* describes these related problems in more detail and provides estimates of the number of Canadians affected. To address this problem, I suggest that the federal government introduce a savings mechanism better suited to lower-income Canadians: the form of tax-prepaid savings plans (TPSPs) as advocated by Kesselman and Poschmann (2001). Further, because these Canadians' savings are often totally confiscated in taxes and the loss of benefits, governments collectively should review the design of income-tested support programs for seniors to ensure that they receive some advantage from having saved.

Taxation and Retirement Savings/Income

The tax advantages of RRSPs and employer pensions are well known. Contributions are deductible, funds grow tax-free, and taxes are generally deferred from high- to low-rate periods in individuals' life cycle. These tax deferrals account for the federal government's single largest tax expenditure, about $15 billion in 2000 (Canada 2001).[1]

What about income during Canadians' retirement years? The current system of the Old Age Security (OAS), the Guaranteed Income Supplement (GIS), and the Canada and Quebec Pension Plans (CPP/QPP) has had considerable success in reducing poverty rates for seniors, particularly couples. Yet according to commentators such as W.M. Mercer's Malcolm Hamilton (see, for example, Cohen

1 The amount is offset in the longer term as governments receive taxes on withdrawals of RRSP funds.

Table 1: *Distribution of Retirement Assets By Household Characteristics: Presence of an Employer Pension and the Size of those Assets*

	Total	With a Pension Plan	Without a Pension Plan
		($ billion)	
Total	1,000	850	160
nil	—	—	—
$1–$100,000	170	120	60
$100,000 +	830	730	100
		(%)	
Total	100	85	16
nil	0	0	0
$1–$100,000	17	12	6
$100,000 +	83	73	10

1999), saving for retirement is futile for lower-income Canadians. According to one Canadian Chamber of Commerce report, the system says to people at low-income levels, "Do not save — public programs will provide you with a minimum income in retirement that you will not be able to significantly augment through your own savings efforts" ([n.d.], 2).

This judgment rests on the fact that many of the programs that have alleviated very low incomes among the elderly strongly discourage saving by lower-income Canadians. For this poorer population, contributions to RRSPs during their working years make little sense (Shillington, 2000).

Moreover, for retired Canadians, the GIS nullifies the advantages of RRSPs because it generally has a 50 percent reduction rate (every $1 increase in income reduces the benefit by 50 cents). Further, about half of GIS recipients pay income tax.[2] They face an effective marginal tax rate (EMTR) of at least 75 percent (the 50 percent from the GIS reduction rate plus 25 percent from the income tax).

Retirement Savings of All Canadians

Thanks to Statistics Canada's new *Survey of Financial Security* (2001), which makes cross-country information on retirement assets available for the first time, we can get a clear picture of how various Canadians fare if and when they save for retirement. Table 1 provides an overall look at the retirement savings of all households categorized by their access to employer pensions.

Retirement assets, through employer pensions, RRSPs, and registered retirement income funds (RRIFs) amount to about $1 trillion dollars. The largest part — about $600 million — is in employer pensions; about $340 billion is in RRSPs, and about $70 billion is in RRIFs.[3]

2 This reduction is partly the result of de-indexing the age credit for 15 years. Indeed, fixing the overlap between taxation and GIS receipt would go a good way in fixing the savings disincentive.

3 Author's tabulations with data from Statistics Canada (2001).

Table 2: *Distribution of Households near Retirement (55–64) by State of Retirement Savings*

	Households (%)	RRSP Amounts (%)	Total ($B)	Average ($B)	Retirement Savings (%)	Total ($B)	Average ($B)
No Retirement Savings	21	0	—	—	0	—	—
Futile Retirement Savings (under $100K)	32	11	11	22,000	7	20	40,000
RRSP's without Employer Pension (over $100K)	6	31	30	300,000	11	30	300,000
RRSP's Supplement Employer Pension (over $100K)	41	58	57	95,000	83	240	400,000
Total	100	100	98	65,000	100	290	193,000

Source: Survey of Household Finances, STC.

The data in Table 1 concern the distribution of retirement savings. Overall, about 82 percent of them are in the hands of the 24 percent of households with more than $100,000 in retirement assets.

Looking more closely at the table, one notes that about 29 percent of households have no retirement savings. The households with less than $100,000 make up 47 percent of Canadians and if they are near retirement or retired, they should be labelled futile savers (a term explained below). But some of this group are younger and, before they reach age 65, they accumulate retirement savings sufficient to be of benefit to them. About 3 percent of the population have no employer pension but an RRSP in excess of $100,000. The remaining 21 percent of households have total retirement savings of more than $100,000; only about a quarter of their savings are in RRSPs, yet the average amount, $68,000, is still much larger than the average of $15,000 for those with modest retirement savings.

Retirement Savings of Near-Seniors

The data in Table 1 are for households of all ages, some already retired and some very young.[4] Here, however, I look at *near-seniors*, households where the older spouse is age 55-to-64.

Predicting which of these families are likely to receive the GIS cannot be done with precision. It will vary with age, family type, and other income, particularly CPP/QPP income. For the purposes of this study, I assume that households with less than $100,000 in retirement assets are going to be GIS-eligible on retirement.[5] Most of these households have no employer pension or have plans likely to be inadequate to lift them off the GIS.

Table 2 divides near-senior households into four categories based on the size of their retirement assets and their use of RRSPs. The first group (no retirement

4 Drawing inferences about young people's assets from data would be difficult. Also, many may now have low incomes that will later increase.

5 The justification for this assumption is that an annuity purchased with $100,000 will pay roughly $10,000 per year (varying with age, sex, and type of annuity), which is generally not enough to make a senior ineligible for GIS.

savings) includes more than a fifth of near-senior households; their only employment-related retirement entitlement will be the CPP/QPP. The next category, almost a third of the total, is labelled *futile savers* because their retirement savings, excluding CPP/QPP entitlements, are less than $100,000. They are likely to be GIS recipients, and much, if not all, of the proceeds of their saving will be lost to taxes and the clawback of income-tested benefits. Near-senior households in the third group, about 6 percent of near-seniors households, have no employer pension but their RRSP assets exceed $100,000; they are unlikely to be eligible for GIS. Households in the last category have an employer pension and pension assets exceeding $100,000 representing about 41 percent of near-senior households; they will not be eligible for GIS.

One may sympathize with the plight of the 21 percent of households who have not saved. Given current regulations, however, these nonsavers may be better off than those Canadians whose retirement savings are modest. Although the amounts saved may have required significant sacrifices, they will have little impact on the households' standard of living at retirement because the tax advantage of saving will be more than offset by the reduction in income-tested benefits.

Therefore, our real sympathy should be for the 32 percent who have fallen for the bad advice coming from governments and the financial community: that everyone should save in an RRSP. These households have sacrificed current consumption to accumulate, on average, $23,000 in an RRSP ($38,000 if we include other pensions). The primary beneficiary of this saving will be the federal and provincial governments because most of the income from it will be confiscated by income-tested programs and income taxes. To the extent that these households were misled, they have been defrauded. The near-seniors in this category of futile savers hold an estimated $11 billion, or 11 percent of the country's total RRSP assets. If this percentage holds for all ages, then RRSP accounts contain about $40 billion of assets that will likely benefit governments more than their owners.

Clearly many Canadians, mostly those with lower incomes, are making sacrifices to save in RRSPs, although better financial advice would have them save elsewhere. Sadly, no one seems to have much interest in informing these people of the futility of their savings. Neither does government seem interested in developing savings mechanisms, such as tax prepaid savings plans (TPSPs), that would make more sense for this population because withdrawals in retirement would not be taxed as income and would not reduce GIS entitlements.

GIS Recipients

The Canadians at risk of getting essentially no benefit from their saving are those who receive the GIS (currently about 37 percent of seniors). Generally, the GIS goes to seniors with no employer pension or a small one and with only modest amounts in an RRSP (say, less than $100,000).

Some people are surprised to learn that many lower-income Canadians saved at all. Poverty might be expected to preclude saving, but the data suggest otherwise. Table 3 reports the situation of near-retirement, low-income households. Half have some retirement saving but it usually amounts to less than $100,000. In

Table 3: ***Savings of Low-income Households (Current Family Income under $30,000) Nearing Retirement (Older Spouse Aged 55–64)***

	Households	Retirement Assets	Average RRSP	Average Retirement Assets
	(%)		($)	
No Savings	50	0	0	0
With Savings — Subtotal	—	—	40,000	100,000
Modest Savings (under $100K)	34	22	17,000	32,000
With Savings ($100K+)	16	78	88,000	246,000
Total	**100**	**100**	**20,000**	**50,000**

Table 4: ***Retirement Savings of GIS Recipients***

	Receiving GIS Only (EMTR at least 50%)	Receiving GIS and Paying Income Tax (EMTR at least 75%)	Total
		$ Billion	
RRSPs	2.7	9.0	12
RRIFs	1.0	4.4	5
Pensions	2.3	17.5	20
Total	**6**	**31**	**37**

EMTR = Effective Marginal Tax Rate

these low-income households, the average value of the retirement savings is $50,000; RRSPs are about 40 percent of this amount.

The available data on the assets of current GIS recipients reflects how many have retirement savings that they generally can not benefit from (see Table 4).

GIS recipients have about $12 billion in RRSPs, $5 billion in RRIFs, and an additional $20 billion in private pensions. The greatest impact of these funds is to reduce the cost of government programs, rather than to improve seniors' standard of living. After the GIS clawback and income taxes, many of these individuals receive at most 29 percent of their retirement funds.[6]

Many GIS recipients live in nursing homes or social housing, use provincial prescription drug plans (with deductibles that vary by income), get refunds from the goods and services tax (GST) and some provincial refundable tax credits, and receive meals-on-wheels or home care. Withdrawals from RRSPs are treated as income for determining eligibility for these benefits and thus reduce their value. Many seniors, such as those in Ontario nursing homes, get no benefit from their RRSP assets because their effective EMTR equals or exceeds 100 percent.

Overall, lower-income Canadians who use RRSPs receive some tax saving when they make their deductible contributions, but it is totally inadequate compensation for the clawbacks and loss of income-tested benefits they face during retirement (see calculations in Shillington, 1999). One weeps for those Canadians who follow the undifferentiated advice to save in RRSPs. They have scrimped to save modest amounts in RRSPs; only tax experts and the bureaucrats know that

6 Unless they withdraw all the assets in one year in order to minimize the impact on taxes and benefits.

this effort will be of almost no value to them. This situation cries out for making current information available or reforming taxes and transfers.

Statistical Summary

Overall, my further analysis of the data presented in Statistics Canada (2001) highlights the following.

- About 30 percent of all Canadian households have no retirement savings; about 20 percent have no pension but an RRSP that is unlikely to be of real value to the saver. About 50 percent have an employer pension.
- The data for households nearing retirement (the older spouse is age 55-to-64) suggest that about 25 percent of those saving in an RRSP are ill-advised to do so; they do not have an employer pension, and the RRSP contains less than $100,000.
- About 75 percent of the RRSPs held by those without an employer pension are worth less than $100,000, inadequate to be of real value.
- An analysis of GIS recipients indicates that about 23 percent have an RRSP (average value $43,000). About 29 percent of GIS recipients have a pension (average value of $65,000), and about 40 percent have an RRSP or a pension. The majority of these funds will benefit governments, rather than the saver.
- About 10 percent of all the funds in RRSPs — or about $30 billion — is unlikely to be of value to the saver.

Policy Considerations

Does Canada's current retirement savings system work? No, when assessed against the following selected but key objectives.

Objective	*Results*
Income is adequate:	
Absolute (against some poverty guideline)	Arguably met for senior couples; less clear for singles
Relative (against preretirement income)	Met for lower-income Canadians; others have received tax assistance, but RRSP limits restrict replacement income for the very well-off
Savings can better retirement:	
Lower-income Canadians	Virtually impossible for poorest 40 percent
High-income Canadians	Difficult above RRSP limit (no tax assistance plus the inflation component of invesment income is taxed)
Transparency (Canadians are informed how government regulations affect them)	Absolutely unmet for individuals without paid advice and sometimes unmet even for those who receive such advice

The current system clearly fails to provide an effective means for lower-income Canadians to significantly improve their retirement standard of living. This perverse circumstance is compounded because very few individuals — and virtually none of those affected — are aware of this fact.

The failures of the system suggest the possibility of relief through several changes, such as adjusting the age credit for low-income seniors, introducing TPSPs for Canadians, and giving lower-income Canadians a realistic forecast of the disincentives they face in retirement.

The Age Credit

As already noted, about half of GIS recipients pay income tax. Fixing the overlap between that taxation and the GIS receipt would go a good way toward fixing the saving disincentive. The easiest method would be to adjust the tax's age credit, at least for GIS recipients.

TPSPs

Kesselman and Poschmann (2001) advocated introducing TPSPs because of two groups of Canadians that are not well served by the current tax regime: lower income individuals (for the reasons already indicated) and those whose saving is restricted by RPP/RRSP limits (their retirement income will fall below 70 percent replacement rates). TPSPs would be a major mechanism for providing relief. They could be designed to exclude high-income individuals (as is the case in the United States) or they could encourage savings more generally.

Granted, the introduction of TPSPs would be a major exercise for Canadian governments, citizens, and the financial community. Yet TPSPs exist in both the U.K. (as Individual Savings Accounts) and in the U.S. (as Roth Accounts), so implementation is certainly feasible.[7]

Financial Advice for Lower-Income Canadians

Little or no informed financial advice specific for lower-income Canadians exists, so they tend to accept the same advice widely publicized for the general population: that RRSPs are the most effective vehicle for saving for retirement.

Overall, the effect of the present system is to largely offset, through increased taxes and loss of benefits, the additional income that lower-income Canadians can generate from their retirement savings through RRSPs and pensions. Awareness of the ineffectiveness of saving for lower-income Canadians is limited to experts inside government and in the financial and research community. Not only is the advice in the mass media inappropriate for lower-income Canadians; it is often wrong. An informal survey of various websites offering assistance on retirement planning uncovered *none* that mention the GIS. As a consequence, they give

7 Kesselman and Poshmann (2001) covers the administration, costing, and issues of integration with RRSPs and pensions.

erroneous information about how much saving a person needs to gain a given income-replacement rate at retirement. For example, some websites indicate that low-income Canadians need to save up to 30 percent of their income in an RRSP to achieve a 70 percent replacement rate at retirement. In fact, many low-income Canadians do not need to save to achieve that replacement rate. And if they do save, an RRSP is the worst possible vehicle.

Thus, advisers of lower-income Canadians are in a difficult situation. They must tell these potential savers that the general media advice concerning RRSPs does not apply and that they can save more effectively outside an RRSP. A little honest advertising could greatly improve the situation.

Concluding Remarks

Millions of Canadians accept the homogeneous advice of governments and the financial community and put billions into RRSPs. They sacrifice in the short term in the belief that their savings will significantly enhance their standard of living at retirement. For many Canadians — those with employer pensions or significant wealth — this confidence is justified; RRSPs are a very effective investment tool. But for other Canadians, RRSPs are a terrible investment.

These futile savers have been misled. They are victims of a fraud, however unintentional. One suspects that this perversity developed not by design but because no one was interested in how tax and transfer policy was affecting low-income Canadians.

So long as awareness of this fraud is limited to a small number of technical experts, politicians and senior bureaucrats have little incentive to correct the situation. That correcting the unreasonable status quo is the right thing to do has, thus far, been insufficient motivation for action in Ottawa.

Only slowly and with difficulty is the word seeping out that RRSPs are a poor savings vehicle for the GIS-destined. That RRSPs are a poor investment vehicle runs contrary to the monolithic financial advice that they are good for everyone. The small voice warning low-income Canadians must fight the advertising onslaught each January and February in RRSP-selling season.

Assisting lower-income Canadians appeals only to charitable notions of public policy. Only when more Canadians are aware of the perverse treatment of lower-income Canadians' savings will Ottawa be forced to develop savings mechanisms that reward, rather than punish, those savings efforts.

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