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Communiqué

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Ottawa squeezing Canadians' pensions, says C.D. Howe Institute study

Recent and prospective changes in Canada's retirement income system will adversely affect far more Canadians than is generally realized, says economist David W. Slater in a *C.D. Howe Institute Commentary* released today. Slater, a former chair of the Economic Council of Canada who has considerable experience in the pensions field, points out that the new "seniors benefit" proposed in the 1996 federal budget, and the new caps on Registered Pension Plan (RPP) and Registered Retirement Savings Plan (RRSP) contributions established at the same time, will significantly reduce the number of Canadians for whom saving in pension plans is both attractive and possible.

The study, entitled *The Pension Squeeze: The Impact of the March 1996 Federal Budget,* gives the seniors benefit, which is scheduled to replace the current old age security (OAS) and guaranteed income supplement (GIS) in 2001, a mixed review. Slater praises it for targeting benefits more precisely to low-income individuals and couples. He notes, however, that the abrupt transition from the more generous OAS/GIS system will mean that accidents of birth date (before or after the "grandparenting" cutoff of age 60 by December 31, 1995) will cause incomes of otherwise similarly situated middle-income seniors to differ by many thousands of dollars each year. He also warns that the steep disappearing rate of the seniors benefit — 20 cents per dollar of outside income over most of its range — will combine with hefty marginal personal income tax rates to severely depress the incentive for middle-income seniors to save for retirement.

When it comes to RPPs and RRSPs, Slater focuses on the lower dollar limits on annual contributions that are now in place through to 2005. Although these limits have been justified with regard to the need to limit the tax assistance available to high-income savers, Slater warns that even low rates of inflation over the next decade will push middle-income earners into territory where the limits may affect their retirement saving. The removal of limits on carrying forward unused contribution room, he notes, will help ease this restriction for many people.

While acknowledging that each individual element of the changes that have been made to Canada's retirement income system can be justified on the basis of fiscal pressures and redistributive objectives, Slater argues that issues of fairness and punitive taxback rates make

fine tuning necessary. He warns, moreover, that the changes to RPPs and RRSPs may depress national saving, contrary to the imperative of preparing for a larger retired population. For many thousands of Canadians, he concludes, the changes will require much greater saving outside pension plans if the standards of living they had previously expected in retirement are to be achieved.

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Communiqué

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Ottawa resserre les boulons du système de pensions des Canadiens, indique une étude de l'Institut C.D. Howe

Les changements qui ont été récemment apportés au système de revenu de retraite du Canada ainsi que ceux sont envisagés nuiront à bien plus de Canadiens qu'on ne le réalise, affirme l'économiste David W. Slater dans un *Commentaire de l'Institut C.D. Howe* publié aujourd'hui. M. Slater, un ancien président du Conseil économique du Canada qui possède une vaste expérience dans le domaine des pensions, indique que la nouvelle « prestation aux aîné(e)s » avancée dans le budget fédéral déposé en 1996 d'une part, et les nouveaux plafonds imposés aux cotisations à un régime de pensions agréé ou à un régime enregistré d'épargne-retraite d'autre part, réduiront considérablement le nombre de Canadiens pour lesquels l'épargne par le biais des régimes de retraite est non seulement intéressante mais également possible.

L'étude, intitulée *The Pension Squeeze: The Impact of the March 1996 Federal Budget (Le resserrement des pensions : les répercussions du budget fédéral déposé en mars 1996)* réserve un accueil mitigé aux prestations aux aîné(e)s, qui doivent remplacer d'ici l'an 2001 la Sécurité de la vieillesse (SV) et le Supplément de revenu garanti (SRG). Slater applaudit le fait qu'elles ciblent plus précisément les prestations aux individus et aux couples à faible revenu; toutefois, remarque-t-il, comme la transition du sytème plus généreux de la SV et du SRG vers la nouvelle prestation est soudaine, elle causera plus de problèmes dûs à l'âge (qui est fixé à 60 ans d'ici le 31 décembre 1995 pour le maintien des droits acquis) et elle entraînera une divergence de plusieurs milliers de dollars chaque année entre des personnes âgées qui se ressembleront en tout autre point. Il avertit également que le taux plutôt raide d'élimination des prestations aux aîné(e)s — soit 20 cents par dollar de revenu d'autres sources sur presque tout l'ensemble — en s'alliant à des taux marginaux importants d'imposition du revenu des particuliers, inhibera sérieusement l'incitation des personnes âgées à revenu moyen à épargner pour leur retraite.

Pour ce qui est des régimes de pension agréés et des régimes enregistrés d'épargne-retraite, M. Slater se concentre sur les limites plus basses imposées aux contributions annuelles qui sont maintenant en place jusqu'à l'an 2005. Bien que l'on puisse justifier ces limites en raison du besoin de diminuer l'aide fiscale offerte aux épargnants à revenu élevé, M. Slater indique que des taux d'inflation même modérés au cours de la décennie à venir placeront les salariés à revenu moyen dans une situation où ces limites nuiront à leur épargne-retraite. Il souligne toutefois que l'élimination des limites sur le report des droits inutilisés de cotisation permettra à de nombreux individus d'alléger ces restrictions.

Tout en reconnaissant que chaque élément individuel des changements qui ont été apportés au système de revenu de retraite peut être justifié en raison des pressions financières et des objectifs de redistribution, Slater soutient qu'une mise au point s'impose, étant donné les problèmes d'inéquité et les taux de réimposition punitifs. De plus, il avertit que les changements apportés aux régimes de pensions agréés et aux REER pourraient entraîner une baisse de l'épargne, ce qui va à l'encontre du besoin pressant de se préparer à une population de retraités plus importante. Pour plusieurs milliers de Canadiens, les changements exigeront qu'ils épargnent plus et ce en dehors des plans de pensions, s'ils veulent conserver pour leur retraite le niveau de vie auquel ils s'attendaient.

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The Pension Squeeze:

The Impact of the March 1996 Federal Budget

by

David W. Slater

Two changes in Canada's retirement system introduced in the March 1996 federal budget will have large and lasting effects on the future retirement situations of millions of Canadians. Those with low incomes will be better off in many respects. But those with middle and upper-middle incomes will be worse off, and many will have to adapt their programs of preparation for retirement.

The first change, scheduled for 2001, is a switch from the existing old age security (OAS) and guaranteed income supplement system to a new seniors benefit, which will be nontaxable and tested against *family* income. For each dollar of extra income, the taxback (benefit loss plus marginal income tax increase) will be larger than prevails for the OAS.

The second change, which is being phased in over the next decade, combines a reduction in the tax deferrals available through registered retirement savings plans (RRSPs) and registered retirement plans and a requirement that withdrawals from these plans begin at age 69 (rather than at 71). For many Canadians, the result will be increased personal income taxes (PITs) now and smaller accumulations of funds at retirement.

These restrictions will immediately affect Canadians who use all their RRSP room and had 1995 earned incomes of more than $75,000. But since the new contribution limits are expressed in dollar terms, the point of impact will fall annually over the decade, becoming as low as a 1995 income of $59,204 if inflation averages even 2 percent.

Two unknowns prevent complete analysis. One is the inflation level for the next decade. The other is what changes will be made in the contribution rates for the Canada and Quebec Pension Plans. Nevertheless, it is clear that the 1996 budget rules and the PIT system will interact to affect the retirement planning of thousands, perhaps millions, of Canadians.

Main Findings of the Commentary

- The federal budget of March 6, 1996, introduced far-reaching changes to Canada's retirement income system for elders that will be phased in over the decade ending in 2005:
  - A new seniors benefit (SB) will replace the existing old age security (OAS) and guaranteed income supplement (GIS). It will become effective in 2001.
  - Tax deferrals for registered retirement plans (RPPs) and registered retirement savings plans (RRSPs) are being reduced and their use restricted in some ways but eased in others.
- For low-income Canadians, the SB will bring net benefits greater than those of the OAS/GIS. But because the new program's income testing will be more severe than the existing clawback, middle- and upper-middle-income Canadians who retire after 2001 will receive reduced benefits. Persons who turned 60 before January 1, 1996, can receive benefits under the existing programs if they wish.
- Replacing the OAS/GIS with the SB will yield the federal government expenditure savings in the long run because, collectively, the losers from the change will lose more than the gainers will gain.
- While the SB is an attractive reform, some features may not appeal to Canadians: a couple's, not an individual's, income will be tested; lost benefits will combine with the marginal personal income tax to impose severe taxbacks on additional income, even at modest levels; and the net losses to middle-income couples will be large. Moreover, the luck of having a birthday just before, rather than just after, January 1, 1996, will bring sizable gains.
- For RPPs and RRSPs, the principle of the budgetary changes is to reduce the limit on tax deferrals to persons whose income is two times the average wage. (The previous factor was two and a half.)
- For RRSPs, some rules have been restricted, but others, such as the carryforward of unused contribution room, have been eased.
- The public impression is that the new RRSP/RPP contribution limits will not affect persons whose 1995 income was less than $75,000. But if Canada experiences any inflation during the next decade, even at a very low rate, people with substantially smaller 1995 income could be affected.
- Given the new limits, hundreds of thousands of Canadians will likely experience reductions in the benefits they receive from RRSPs and RPPs.
- Individuals can offset potential reductions in retirement income by increased saving in programs that receive no government assistance. But the cost will be higher personal taxation and lower consumption before retirement.
- The changes are likely to affect national saving, probably as a net reduction.

The March 1996 federal budget introduced two large changes in Canada's retirement income system. First, a new seniors benefit (SB) will replace the existing old age security (OAS) and guaranteed income supplement (GIS) programs and some allowances. Second, the tax allowances for registered retirement plans (RPPs) and registered retirement savings plans (RRSPs) and related programs are being reduced, and the rules restricted in other ways. Some conditions are, however, being eased; RRSP participants will have more flexibility in making contributions during their working lives.

The goal of both sets of changes is to make the federal government's programs of taxation and transfers fairer among Canadians and to reduce the fiscal burden arising from the programs. But fairness, like beauty, is in the eye of the beholder, and serious questions arise. Considering the tax and retirement income system as a whole, will the changes provide a fair distribution of taxes and a transfer for middle-income as well as lower income Canadians? Who will benefit and who will be worse off? By how much? What will be the effect on the federal government's fiscal position and the economy? To examine these issues is the purpose of this *Commentary*.

It is organized as follows. The first section recalls the rationale for government involvement in the retirement income system, lists the four tiers of Canada's system, and describes the strategic choices and specific concerns policymakers faced in making the recent changes. In preparation for the rest of the paper, it also examines the Canadian distribution of income among households and among elders.

The second section of the paper details the switch to the SB, the third the new RRSP/RPP rules, and the fourth possible interactions among the two reforms. In all these sections, I make liberal use of hypothetical cases and assumptions about likely rates of inflation.

The next section considers possible changes in the Canada and Quebec Pension Plans (CPP/QPP). Although unknown at the time of writing, it seems likely that these changes will involve some increase in contributions beyond what had been scheduled previously. If so, they could interact with the RRSP and RPP programs of middle-income Canadians.[1]

Finally, I give some consideration to the overall effects on national saving and government finances.

A brief summary conclusion then closes the *Commentary*.

Before beginning, I should make it clear that I stand by my already-published view[2] that some reduction in the generosity of public assistance for the retirement income of better-off Canadians is desirable. But that is not the point. What will be the views of Canadians generally when they see the results of the changes clearly? For many Canadians, major adjustments in their preparations for retirement will be required as a result of the changes, which may also have undesirable effects on national saving.

Government Involvement in the Retirement Income System

Canadians' primary responsibility for elders' income lies with individuals and their families, not governments. Financial assets from personal savings programs, equities, inheritances, property, owner-occupied housing, and family support make up a larger share of the income of elders than all government, government-assisted, and employer-based pension plans taken together. Government and government-assisted pension programs are, however, major components of the system, especially for individuals whose earnings during their working lives were below average Canadian income levels.

What are the main rationales for government and government-assisted pension programs? The first is to cope with the potential poverty of elders who were not able to save adequately for their retired state because of a combination of dozens of reasons (such as low-income jobs, intermittent employment, ill health, family obligations, or the misfortunes of life). The second is to ameliorate the inadequate provision for elderhood by most people

on their own during their working lives. Governments, employers, unions, and fraternal organizations share in paternalistic efforts to counter this general myopia in urban industrial-commercial societies.

In nearly all countries, these two motives lead to government involvement in the retirement income system, though specific structures and programs vary. Canada is very much among these countries.

The Four-Tiered Canadian System

Since the mid-1960s, Canada has had what is best characterized as a four-tier retirement income system. It comprises:

- *The OAS/GIS allowances and provincial supplements*. Paid for out of general revenue funds, mostly of the federal government, these programs are primarily concerned with anti-poverty objectives. The OAS used to provide all elderly Canadians with some income replacement regardless of need, but the clawback introduced some years ago now limits the net benefits for middle- and upper-middle-income people.

- The employment-based CPP/QPP. Mandatory contributions from employers and workers provide the latter with income replacement during retirement. Finance has mainly been on a pay-as-you-go basis (that is, current contributions on behalf of the employed are intended to pay for the retirement benefits of elders). The maximum retirement benefit is limited to about 25 percent of the average wage. Thus, from the OAS/GIS and CPP/QPP programs combined, a person who earned the average wage and qualifies for full benefits now receives gross income replacement of about 41 to 43 percent of his immediate preretirement wage.

  Under the existing personal income tax (PIT) structure, the average effective tax rate is higher on preretirement income than on retirement income from public pension programs. Thus, a single retired person who earned the average wage receives from the combined government programs after-tax benefits of more than 50 percent of his or her preretirement income. For a person who earned twice the average industrial wage, the after-tax ratio is about 30 percent.

- Employer-based RPP and related programs, and RRSP programs (whether employer or personally based). During their accumulation, these funds receive government assistance through both the deductibility of contributions in measuring taxable income and the exclusion from taxable income of investment earnings within the programs. (The PIT is applied to withdrawals.) The tax relief is limited by rules about the amount of contributions that can be deducted in measuring taxable income. Taking account of the benefits of the tax deferrals and the subsequent taxation of withdrawals, commentators generally agree that participants in RPPs and RRSPs are net lifetime beneficiaries of tax relief.[3]

- Other provisions for future income. Much diversity characterizes the elements of this tier; the important consideration for this paper is that they receive little or no government assistance. In Canada, the most important item is the equity that people build up in their owner-occupied housing. Although such equity is not assisted by mortgage income deductibility (as it is in the United States and some other countries), no tax falls on the implicit income from owner-occupied housing or on capital gains from the disposition of such housing.

  Equity in life insurance policies that include savings features used to be an important element of this fourth tier but is less so now. Annuities acquired without government tax assistance are important; so are deposits in financial institutions, stocks and bonds held directly or indirectly, and real property.

Strategic Choices

Behind the necessity of changed strategies for Canada's retirement system lies a combination of three familiar forces: demographic, economic, and fiscal changes.

Demographic trends are bringing about a major and lasting increase in the proportion of retirees to workers in the Canadian population. Long-run trends in birth rates and immigration have decreased for several decades, while survivor rates have increased. Canada will also experience a large cycle of increased retirements between 2015 and 2035, echoing the country's postwar baby boom. That cycle will eventually be reversed, but, like the long-run demographic trends, it will impose large increases in the dependency ratio during the next four decades.

The second major force is the slowdown of growth in real income and productivity. The income for elders in any decade has to come from the national income produced and available to a country during that decade. In other words, future income provides the support of future elders. When the current retirement income programs were set up in the 1960s and 1970s, the expectations were for Canadian productivity to grow more than 2 percent per annum compounded. Yet the experience of the past decade and a half and the consensus on future prospects are for productivity growth rates of 1 percent per annum or less. Such prospects do not hold out much promise of a significant economic growth dividend from which Canadian society can meet the country's future needs and requirements, including the burden of increased dependency ratio.

The third force is the size of the national debt and deficits and the resulting pressure to reduce government program expenditures despite the increasingly heavy real costs of health care, education, and social welfare. Every government program, including retirement income, has become a candidate for reduction or at least increased efficiency.

Given the strength of these three forces, it is not surprising that analysts are seriously considering proposals for fundamentally restructuring Canada's retirement income system. Scrapping the CPP/QPP and replacing them with mandatory individual retirement saving accounts, rethinking benefits and contributions, making basic changes in the system's financing, and more have been proposed.[4] This Commentary is not the place to argue the merits or problems of these various proposals.[5] But it is in this context that the 1996 budget changes must be seen.

Judging by that budget and by the record, the government of the day has opted for the strategy of fixing, tuning, and adapting the existing structure and rules rather than fundamentally redesigning the system. The changes that have been announced so far are not trivial, and more are to come, but they do not go as far as some commentators would like.

Specific Concerns

In shaping the 1996 budget changes to the retirement income system, policymakers had to address several specific issues in the existing programs.

The OAS/GIS and PIT Allowances

When instituted, the OAS and various PIT allowances were available to all Canadian seniors, no matter what their income. (In contrast, the GIS has always been tested for low levels of family income.)

Universality began to disappear in the current decade with the institution of an OAS clawback in 1990. Under it, seniors whose individual net income exceeds a threshold of just over $50,000 must pay back their OAS benefits at a rate of 15 cents for every dollar of "excess" net income. The PIT system is used for this clawback.

In the 1995 taxation year, the amount used as an age deduction in the PIT also became income tested. It is reduced by 15 cents for each dollar of net income over $25,291.

The PIT pension allowance — up to $1,000 of some pension income that can enter the

calculation tax credits — remains in place today. (It will, however, disappear when the SB is implemented in 2001.)

The original universality of most benefits for seniors had been a crude concession from the past, when most elderly Canadians were relatively poor. Yet even with the introduction of some income testing, the OAS/GIS, age, and pension allowance programs were still flawed in responding to need, as well as confusing and unfairly related to other programs for poor elders. The entanglements of the PIT system and the OAS/GIS programs were particularly messy, giving rise to many inequities among Canadians who were essentially in the same circumstances. The GIS program required continuing monitoring, administration, and decisions.

Worst of all, the benefits for elders who had few, if any, other sources of support were widely regarded as mean, rather than generous. Yet even with the OAS clawback and income testing of the age allowances, individuals well up the income scale were still receiving substantial net benefits from the programs. Spouses were receiving net benefits that did not reflect family income, as did spouses in the GIS program. Two-income families with the same total income could receive different benefits.

The SB and related changes are intended to deal with a number of these issues by incorporating into a single, income-tested benefit several of the existing piecemeal programs, including the OAS, the GIS, and the PIT age and pension allowances and by eliminating the inequity of treatment between one- and two-income couples.[6]

The new program will provide slightly larger net benefits to households (couples and unattached individuals) that otherwise would have low income; middle- and upper-middle-income households will get reduced or no benefits. In the aggregate, the losers will lose more than the winners gain, so the net fiscal burden will be lessened. Finance Minister Paul Martin stated this intent in his March 1996 budget speech:

> This reform will make the pension system sustainable. It will do so by targeting help to those who need it most. And by slowing the rate of growth of public pensions, the danger of crowding-out other essential programs and services is being addressed.

The RPP/RRSP Programs

For the RPP/RRSP programs, the principal complaints have been overgenerous tax allowances for higher-income individuals and excessive costs for governments (that is, taxpayers in general). Another concern has been the inflexibility in the use of tax concessions during an individual's working life.

In recent years, roughly speaking, benefits from contribution allowances have been available to people with up to two and a half times average income — a limit many people considered too generous.[7] Even if the deferrals did not reduce government revenues in the long run, the argument went, well-off people receive net benefits and the less well off pay net costs in the form of larger tax bills.

Moreover, the deferrals represent current tax expenditures — that is, they reduce government revenue now and in the immediate future. Even if the government received larger revenue in the long run, could the deferrals be accepted now by current governments and current taxpayers?

Thus, when the federal government published estimates that its tax expenditures on RPPs and RRSPs amounted to $15.7 billion (net of taxation of withdrawals) in 1993,[8] the vision of huge fiscal costs arising from concessions that benefited well-off Canadians captured the public attention. Provincial tax expenditures from the concessions have been estimated for 1993 as another $7–8 billion.[9] By 1995, the tax expenditures through the RPP and RRSP programs for both levels of government could hardly have been less than $25 billion.

Given this background, it is not surprising that the federal government is reducing the limits on contributions deductible in reckoning taxable income or that it is doing so in such as way as to affect the concessions to people

Table 1: ***Income Distribution, 1994***

Income Group	Families		Unattached Individuals		Combined	
	%	Number	%	Number	%	Number
($ thousands)	*(percent)*	*(thousands)*	*(percent)*	*(thousands)*	*(percent)*	*(thousands)*
<10.0	2.2	180	18.7	720	7.5	900
10.0–24.9	17.1	1,390	45.6	1,750	26.3	3,140
25.0–39.9	20.2	1,640	19.7	750	20.0	2,390
40.0–49.9	13.0	1,050	7.8	300	11.3	1,350
50.0–59.9	12.4	1,000			9.8	1,170
60.0–79.9	17.4	1,410	8.4	320	12.8	1,530
80.0–99.9	9.1	740			6.3	750
≥100.0	8.7	705			6.2	740
Summary						
Estimated number	8,100,000		3,840,000		11,940,000	
Average income *($)*	54,153		23,746		44,382	
Median income *($)*	48,091		17,196		32,045	
Third quartile *($)*	70,000–74,900		30,000–39,900		60,000–64,900	

Note: Because of rounding, the percentage columns do not add exactly to 100. The number columns do not add to the estimated totals because Statistics Canada derived the estimates from its survey of samples, which are subject to statistical error distributions. Neither the rounding nor the statistical properties errors affect the general accuracy of the information the table conveys.

Source: Statistics Canada, *Income Distribution by Size in Canada, 1994*, cat. 13-207 (Ottawa, 1995).

with middle and upper-middle income but not to those with average or lower income.

The central principle of the changes (examined more carefully below) is to provide the tax relief only to people with income up to two times the average wage. A transition program, stretched out over the ten years from 1996 to 2005, is to effect the change to the new restricted levels of tax allowances.

In addition are revisions to the age limits for RRSP contributions and withdrawals, changes that are intended to increase the future revenues of governments but that will have important implications for some individuals. The proposals also introduce an important element of flexibility in the use of RRSP contribution room by replacing the seven-year carryforward with one applicable over the whole of a person's working life up to age 69.

As Martin said in his 1996 budget speech, the intent is

> to encourage Canadians to save for their own retirement, through RRSPs and RPPs.... We are proposing a number of changes that will better target this assistance to modest- and middle-income Canadians, while limiting the cost to taxpayers.

"Modest- and Middle-Income" Earners

Before going further with my analysis, I need to pinpoint Martin's "modest- and middle- income Canadians." It is important to know specially what income groups the budgetary changes will affect and how many households those groups include.

Statistics Canada annually publishes a rough idea of this information. Tables 1 and 2 are built up from that source's data for 1994.

Table 1 shows the distribution by income groupings for Canadian families and unattached individuals of any age. The median family income (half had more and half less) was $48,091. The third quartile (three-quarters had less and one-quarter more) was in the $70,000–74,999 range. The "modest- and middle-income"

Table 2: *Household Income Distribution by Age of Household Head, 1994*

Income Group	Age Group						
	≤24	25–34	35–44	45–54	55–59	60–64	≥65
($ thousands)				*(percent)*			
<10	34.3	7.4	5.2	5.4	9.4	11.6	1.9
10.0–24.9	38.8	22.3	15.7	13.3	16.9	26.7	54.5
25.0–39.9	15.2	24.1	19.0	15.9	17.8	23.3	22.2
40.0–49.9	5.6	13.7	14.2	11.3	12.7	9.3	7.4
50.0–59.9	2.5	12.6	12.7	11.9	10.0	7.7	5.1
60.0–79.9	2.5	13.0	17.1	18.3	14.2	10.4	5.0
80.0–99.9	0.3	5.1	8.5	10.9	9.0	5.7	2.0
≥100.0	0.6	3.0	7.6	13.0	11.2	5.4	2.0
				Summary			
Estimated number	729,000	2,545,000	2,773,000	2,132,000	755,000	740,000	2,264,000
Average income *($)*	19,291	41,777	52,007	59,286	53,187	40,264	30,310
Median income *($)*	14,315	37,718	47,078	53,315	45,110	33,119	22,781
Third quartile *($)*	25,000–29,900	55,000–59,900	65,000–69,900	75,000–79,900	70,000–74,900	50,000–54,900	35,000–39,900

Note: Because of rounding, the percentage columns do not add exactly to 100. The number columns do not add to the estimated totals because Statistics Canada derived the estimates from its survey of samples, which are subject to statistical error distributions. Neither the rounding nor the statistical properties errors affect the general accuracy of the information the table conveys.

Source: Statistics Canada, *Income Distribution by Size in Canada, 1994*, cat. 13-207 (Ottawa, 1995).

earners might reasonably be taken as those families falling between the first and the bottom of the third quartiles — that is, with income of about $25,000 to $70,000. Within this broad grouping, upper-middle-income families could be taken as those between the median and the top of the third quartile — that is with income of about $48,000 to $75,000. The modest- and middle-income brackets, so defined, included about 4 million families, of which about half were in the upper-middle-income range. And of the total 8 million families, about 2 million were *above* the modest- and middle-income range, having 1994 annual income of $72,500 or more. In this contest, they could be called high-income families.

For unattached individuals, the median 1994 income was $17,196 and the third quartile was in the $30,000–39,999 range. (The low figures for unattached individuals reflect the preponderance of low income among young people and among unattached seniors.)

Table 2, which combines families and unattached individuals, gives some indication of the effect of age on income distribution. Nearly three-quarters of the households headed by someone 24 years old or less had a 1994 income of less than $25,000. At the other end of the age scale, more than half of the units whose head was age 65 or over fell into that low-income range.

Of households headed by someone in the middle-age ranges (say, ages 45 to 54), however, about 2.1 million units fell between the median of $53,315 and the third-quartile range of $75,000 to $79,999 and were thus in the upper half of the modest- and middle-income range. About 900,000 households headed by 45-to-64-year-olds had income of more than $75,000.[10]

From OAS/GIS to the Seniors Benefit

The introduction of the OAS was Canadian governments' earliest and most fundamental action in the field of ameliorating poverty among elders. Subsequent improvement in

benefits, the addition of guaranteed income supplements, and the protection of the security of the program have been widely supported by people of all political stripes.[11]

It has, however, needed reform for some time, and in its 1995 budget, the federal government signaled its intention of revamping the OAS/GIS and set out its principles for change. The payments going to today's seniors would be fully protected. The changes would give "undiminished protection for all seniors who are less well off; and a continuation of full indexation of benefits." The OAS would be provided on the basis of the combined income of spouses (as was currently the case for the GIS) and would feature greater progressivity of benefits by family income level. Finally, program costs would be controlled.[12]

The 1996 budget introduced the reformed program. A booklet explained:

> The new Seniors Benefit will replace the existing OAS/GIS benefits. It will be completely tax free and will incorporate the existing age and pension income tax credits. It will begin in 2001.[13]

Under the new program, net benefit levels for the lowest-income seniors will be increased by $120 a year more in 2001 than they would have been under the OAS/GIS:

> The benefit levels and threshold will be indexed to inflation. This is an improvement in the current system where the thresholds are not fully indexed.... For couples, the amount of the payment will be determined on the basis of combined income of the spouses, as is the case now with the GIS.[14]

The level of the nontaxable SB will depend on the recipient's income from other sources, as well as single or couple status. In the initial year, 2001, a single person with no income from other sources will receive $11,420, and a couple $18,440:

> The benefit...[will be] reduced by 50 cents for each dollar of income until it reaches $5,160 per senior which is equal to the level of current OAS payments adjusted for projected inflation to the year 2001.[15] Beginning at the income level of $25,921, the benefit...[will be] is reduced by 20 cents for each dollar of additional income.[16]

As a result,

> [o]nce in the new system, single seniors will no longer receive government assistance when their annual income exceeds $52,000 [in 2001 dollars]...Once in the new system, senior couples will no longer receive assistance when their annual income exceeds $78,000.[17]

As already noted, the SB will increase net benefits for some individuals and families in the lower ranges of other income and still reduce government costs.

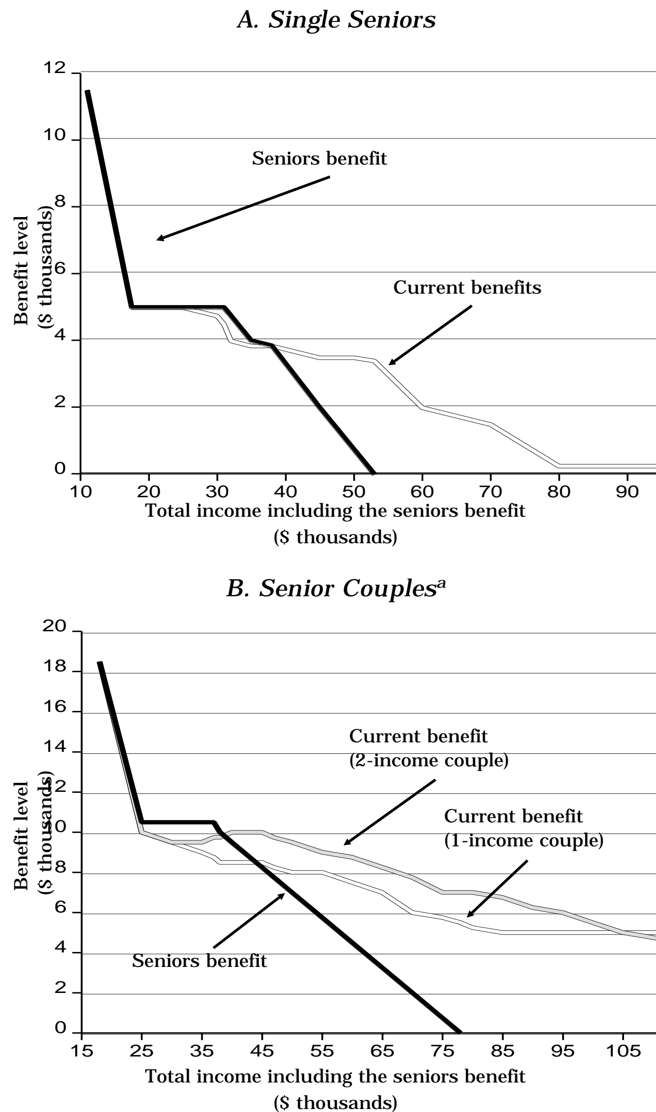
How can this be? The SB booklet is quite clear about this point in two charts (reproduced here as Figure 1). Seniors who have middle income from other sources will have markedly reduced or no net benefits from the SB, whereas they would have continued to receive benefits under the old system (even netting out the clawback and the planned reductions in the PIT's age and pension allowances). The reductions in benefits for such households will be sufficient to more than balance the increased costs of benefits to low-income seniors.

Extrapolating from the 1994 income distribution data (Tables 1 and 2) and using demographic trends, I calculate that, when the SB system is mature by 2010 or 2015, at least 300,000 or 400,000 Canadians — perhaps more — will receive smaller benefits from it than they would have received from the OAS/GIS plus tax allowances program, even if the OAS clawback continued as it is structured at present.

How Large Are the Changes?

These reductions of net benefits are quite substantial. For example, a single person who retires in 2001 with other income of $50,000 a year will experience a reduction of net benefits beginning at $2,480 a year as a result of the new system's replacing the old system.

Figure 1: ***The Federal Government's Comparison of Benefits under the SB and OAS/GIS Programs***



[a] Couples with at least one spouse age 65 or over.

Source: Canada, *The Seniors Benefit* (Ottawa, March 6, 1996), charts 3 and 4.

How much larger a retirement fund would that single person have to acquire to be as well off in retirement under the new as under the old system? The answer depends, of course, on interest rates and life annuity terms. But using a 4 percent nominal compound rate of discount, the present value of the loss of benefits for a single person at age 65 is about $32,000.[18] This amount is the principal value of the annuity required to compensate for the losses due to the switch to the SB. For a 45-year-old who wishes to acquire an annuity to offset the potential losses at age 65, the present cost is $18,000 to $20,000.

As another example, a two-income couple retiring in 2001 with other income of $78,000 will experience a reduction of net retirement benefits beginning at $6,000 a year, plus the loss of the $1,000 pension credit, for a total of $7,000. For a couple in which the senior spouse is age 60, this loss will be equivalent to the income from an annuity costing $76,000 to $88,000 in 2001 (or $62,000 to $73,000 in 1996.)

Another way to view the changes is to examine the marginal tax rates that will apply to seniors, including both the actual PIT and the taxback of benefits under the seniors program. For a single person with other income of $40,000, the incremental federal and provincial PIT (including surtaxes) on the next $1,000 of taxable income was about 41.8 percent in 1995. In that income range, the loss of SB arising from the additional $1,000 of other income will be $200, which is equivalent to a taxback rate of 20 percent. The combined marginal rate on the additional $1,000 of other income will be 61.8 percent.

For a one-income couple with income from other sources of $74,000, the marginal federal and provincial PIT in 1995 was about 52.7 percent. For an increment of other income of $1,000, the additional income tax will be about $527 and the loss of SB $200, for a combined taxback of $727 — that is, 72.7 percent of the additional outside income.

Over the ranges of income at which a high taxback rate will apply to the SB and high marginal tax rates to the PIT, the combined bite out of incremental income will be very large — providing powerful incentives for tax avoidance and evasion.

For people in the lower range of incomes, the taxback effects will be different but still

severe. Consider a single person with income other than the SB of $28,000. If that amount increases by $1000, his SB reduction will be 20 percent or $200. The marginal increase in federal plus provincial PIT increase on the $1,000 will be 25 to 27 percent (depending on the provincial residency) — an increase of $250 to $270. The total taxback will thus be between $450 to $470 — a marginal rate of 45 to 47 percent.

The SB loss and additional PIT will be the same for a one- or a two-income couple whose base other income is $28,000. The lowest marginal PIT will apply, adding to the 20 percent loss of benefit.

In brief, the potential implications for retirement savings by people in the low but not lowest income brackets are severe. For them, any saving program that could add to their potential income will be subject to severe taxbacks. To put it mildly, the incentives for saving by such people would be weak.

Grandparenting

The Seniors Benefit booklet reads:

> [A]ll Canadians who reached age 60 by December 31, 1995 (i.e. who qualify for OAS/GIS by December 31, 2000) will have the choice of moving to the new system or keeping their monthly OAS/GIS payments as currently structured, for the rest of their lives. These payments will continue to be fully indexed, and OAS payments will continue to be taxable and subject to the current high-income recovery.[19]

Thus, the booklet continues:

> [E]very current senior and those over the age of 60 will receive, at the least, the same payment as they do now. If the new system turns out to be better for them, they will be able to choose the new system. In couples where only one spouse is age 60 or over, both spouses will be eligible to receive OAS when they reach 65. Seniors may also opt into the Seniors Benefit at any time.[20]

Once in the SB program, a person or couple has to remain in the system.

The grandparenting is not complete in that those who opt for the old system will lose the income-tested age allowance and the pension allowance they now enjoy in calculating their PIT. (These allowances will disappear for everybody, but the scale of the new SB will take the losses into account for future low-income seniors.)

Choosing between OAS/GIS and the SB

Single seniors who now have an annual income (including OAS/GIS) of up to approximately $40,000 will receive higher benefits as a result of shifting to the SB. Those with income above $40,000 will be better off opting for continued benefits under the old system.

One-income couples with an annual income (including OAS/GIS) of up to approximately $45,000 will receive higher benefits under the new system; those with higher income will have larger net benefits by continuing in the old system. For two-income couples, for whom the SB will be based on total spousal income, those with family income of less than $40,000 will generally receive higher benefits from the new system; those with income over $40,000 will be better off sticking to the old one.

Facing the Notch Problem

Grandparenting introduces a severe notch problem — a substantial difference for individuals just one side or the other of the dividing line. The difference in income and wealth for a person whose sixtieth birthday was on January 1, 1996 (and thus cannot choose the OAS/GIS option) and one whose sixtieth birthday was December 31, 1995, will be quite severe. For a single person with other income of $50,000 in 2001, the net benefit under the SB will be $350 a year; under the old system, the amount will be $2,830 a year. At age 65, the difference of $2,480 will have a capitalized value of about $32,000. In other words, the person with the less fortunate birth date will have to accumulate about an extra $32,000 in

personal financial assets to be as well off in gross income as the person one day older.

The same kind of notch problem can arise for a two-income couple. If the elder of the two spouses turned 65 just before or just after January 1, 1996, that accident of fate will result in large differences in retirement income. For a two-income couple with total other income of $70,000, the SB will be $1,510 per year and the OAS/GIS benefit will be $6,230 — a difference of $4,720 per year. The capitalized value of that difference will be about $60,000.

These gaps will be reduced slightly when differences in the PIT are taken into account. Nevertheless, the notch differences are severe, and some smoothing out may be desirable. The solution may be to increase the clawback under the OAS/GIS system so that it is less attractive and to ease the clawback on the SB.

Considering Fairness

The case for grandparenting the OAS/GIS for people now between ages 60 and 65 is ambiguous. On one side of the argument is the fact that Canadians who are in the middle-income ranges but far from rich will get smaller benefits out of the new system than the existing one. These people have been counting on their OAS/GIS benefits as a significant part of their retirement income, and many of them have neither the means nor the time to offset the reductions that immediate implementation of the new plan would introduce.

On the other hand, those Canadians between ages 60 and 65 who are eligible to receive CPP/QPP benefits in the next few years will receive pensions that are very large compared with their contributions. Moreover, the notch problem will always seem arbitrary.

Whether the five-year period of choice and the scale of the taxbacks under the old and new systems are fair remains to be determined. Providing a longer period of grandparenting options and making the advantages of staying with the old system more generous would increase the costs of the changeover to governments. Providing a shorter period of grandparenting and making the advantages smaller might be seen as inequitable, even though government total fiscal positions would be improved. As to the fairness in relationship to the CPP/QPP, many low-income Canadians receive no or little benefits from such programs.

A Summary

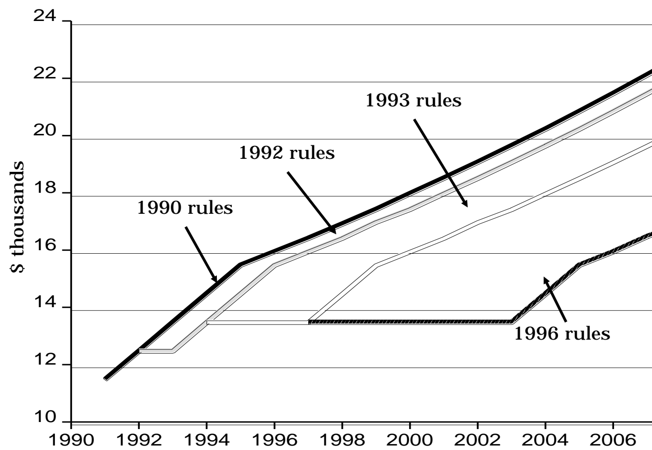
To sum up, the OAS/GIS programs have been one of Canada's great social policy successes, but they needed reform. Even with the clawback, the system was becoming expensive, and some people, particularly spouses with income well above average, were getting benefits that were clearly overgenerous.

The fundamental philosophy of the design of the new SB has many attractions. Given the country's high PIT rates, however, the taxback looks to be very severe in the middle-income ranges. The age notch problem appears to be excessive. Although the SB will not be taxed, the system will be only partly disentangled from the tax system in a fundamental sense. Finally, since Ottawa's basic income tax receipts will be reduced, so will those of most of the provinces, at least under their current rates and regimes (in which all but Quebec levy their PIT as a percentage of federal tax).

Changed Limits for RRSPs and RPPs

The federal government's principle in reducing the retirement savings that receive income tax relief is, as already explained, to target that relief to modest- and middle-income Canadians,[21] with the transition from the old to the new limits taking place over the decade from 1996 through 2005. Although the changes being made for participants in RRSP programs, RPP programs, and mixed RRSP/RPP programs are comparable, they are easier to explain separately, so I shall do so as I analyze the effects of the changes for individuals in various circumstances.

Figure 2: *The Changing Dollar Limits on RRSP Contributions*



Note: I have applied indexation of 3 percent per year, compounded, when applicable. The index is based on an assumed increase in the annual wage that is compatible with a 2 percent per year increase in the consumer price index).

Prior to the 1996 budget, the federal government had several times introduced changes to the RRSP/RPP program (see Figure 2 for an illustration). What is significant about the new regime is the principle of reducing indefinitely into the future the limitation of RRSP and RPP tax relief to incomes below twice the average wage, a change that will affect a sizable number of people.

Essentially, the new rules could increase the PIT, or decrease retirement income, or some combination for people with income in the top quartile of the income distribution. According to Table 1, that quartile comprises about 2 million families and unattached individuals. The number actually and immediately affected will be smaller (because not everyone, even at this income level, uses all of his or her RRSP/RPP room and because most of the units reported in Table 1 are families while the RRSP/RPP tax break goes to individuals). Nevertheless, my rough estimates suggest effects for 500,000 to 800,000 households.

People whose RPP and RRSP programs now use the maximum room for deferrals permitted under the Income Tax Act will feel the impact immediately. For those who do not now use the maximum room, the immediate effects may be nil or small, but their potential room will be reduced and the limits will bite in the future.

At what point will the new limits become binding? People with 1995 earned income of over $75,000 will see their taxes increased and their pensions from RPP and RRSP programs reduced in 1996. From then through 2005, the restriction will intensify yearly, even with low rates of inflation, because of the way the limits are fixed in dollar terms. By 2005, the changes will have affected people with 1995 earned income as low as $55,000 if inflation averages 3 percent per annum and $64,000 if inflation averages 1 percent.

RRSPs and RPPs are, of course, only one component of retirement savings. People can and do save outside RRSP and RPP programs (savings that I refer to herein as “outside savings”). By increasing these outside savings, individuals can offset the decreases that the reduced limits make in their retirement income from RRSP or RPP programs, but the cost will be higher income taxes and reduced consumption during the accumulation period. At the other extreme, people can maintain consumption with more severe reductions in potential retirement income.

Assumptions

Most of the rest of this section comprises analyses of the effects of the RRSP/RPP changes on individuals in various situations. To construct these analyses, I used the following simplifying assumptions, none of which distorts the general conclusions.

- *Replacement income ratios in RPPs based on the latest year’s income* (rather than the usual average of the best three or five years before withdrawal starts). This assumption simplifies the computations but leads to small overstatements of pensions arising from typical defined-benefit programs.

Box 1: *Calculating the Pension Adjustment (The Factor of Nine)*

Since 1989, a central principle of Canada's RPP and RRSP programs has been that an individual should be able to mix the two and receive the same incentive treatment. If his RPP program does not use up all the permitted tax deferrals, then he should be able to use an RRSP program to top up his retirement saving within the overall limits. The deductibility of contributions should be the same for the two elements of the total program; so should the deferral of taxation of investment income within pension and RRSP funds. People with limited RPPs should have large room for simultaneous participation in RRSPs; people with generous RPPs should have little or no room for simultaneous participation in RRSPs.

To make such a system operational, the RRSP-equivalence of a person's RPP program had to be established. This is what Revenue Canada calls the pension adjustment (PA).

The calculation uses what is called the "factor of nine" because a pension accumulation equal to 1 percent of income before retirement for a maximum of 35 years of service is assumed to be valued at 9 percent of current income, minus $1,000.

An RPP with generous options, providing pension benefits per year of service equal to 2 percent of the average of the final three years of preretirement income for 35 years of service is taken to employ all the allowances measured by 18 percent of current income, less $1,000. The room left to participate in an RRSP program is the $1,000 per year.

Consider another plan that has equally generous provisions except that its undertaking is to provide benefits equal to 1.5 percent of the final three years' average salary times up to 35 years of service. Applying the factor of nine (9.0   1.5), Revenue Canada deems such a program to have a pension equivalence of 13.5 percent of current income (three-quarters of the standard allowance of 18.0 percent) minus $1,000. That equivalence leaves room for simultaneous RRSP participation of just over 4.5 percent of current income (subject to whatever dollar limits the tax legislation and regulations permit).

Note: A useful explanation and evaluation of the factor of nine is provided by Canadian Institute of Actuaries, *Troubled Tomorrows* (Ottawa, 1995).

- Two sets of low inflation projections, both of which are consistent with the current policy of price stability. One set assumes that, from 1995 through 2005, the compound rate of increase of the consumer price index (CPI) will average 2 percent per year and the compound rate of increase of wages and salaries 3 percent per year. Real rates of interest (investment returns) are assumed to be 4 percent per year. The other set assumes that, during the 11-year period, the compound CPI increase will average 1 percent per year and the compound increase of wages and salaries 2 percent. I also include one example of higher rates of price and wage inflation to show how severe the fixed dollar restraints will be if the government's target rates for inflation are exceeded.

- *The current method of calculating RRSP room for someone who has an RPP.* What Revenue Canada calls the pension adjustment (PA) is a measure of the assumed RRSP-equivalent contribution to a particular RPP (see Box 1). The PA is deducted from the individual's RRSP limit to determine the room remaining for RRSP contributions. (If, for example, her RRSP limit is $10,000 and her RPP is valued at $8,000, the RRSP room is $2,000.) Many people believe that the PA is too restrictive of tax relief on retirement savings in the private sector.[22] Nevertheless, I use it here for relating RPP and RRSP programs.

- *The PIT schedules that applied to Ontario residents in 1995, including federal and provincial surtaxes.* These schedules were approximately the Canadian average in that year. If 1996 changes were taken into account, the PIT rates here would have been a little lower.

Table 3: *Effects of Reduced RRSP Limits on a $75,000 Earner*

	1995	2000	2003	2005
	Inflation of 2% per year; wage increase of 3% per year			
Income *($)*	75,000	86,946	95,008	100,794
RRSP contribution limits				
18% of income *($)*	13,500	15,650	17,101	18,143
Dollar maximum *($)*	13,500	13,500	13,500	15,500
1996 max/18% of income *(%)*	100.0	86.3	78.9	85.4
	Inflation of 1% per year; wage increase of 2% per year			
Income *($)*	75,000	82,806	87,874	91,425
RRSP contribution limits				
18% of income *($)*	13,500	14,905	15,817	16,457
Dollar maximum *($)*	13,500	13,500	13,500	15,500
1996 max/18% of income *(%)*	100.0	90.6	85.4	94.2

Effects of Changes in RRSPs

My first examination is of RRSPs alone; the hypothetical individuals may have other savings for retirement but not RPPs.

The 1996 budget allows contribution deductions for RRSPs up to 18 percent of income or a fixed limit of $13,500 through 2003 and a limit of $14,500 and $15,500 in 2004 and 2005, respectively. These dollar limits replace the 1995 budget's limits of $13,500 for each of 1995, 1996, and 1997, $14,500 for 1998, $15,500 for 1998, and an amount indexed to the average wage thereafter. The lower of the dollar limit or the 18 percent of income limit applies throughout.[23] (A case can be made that 18 percent of income is too much, and that a better reform would be to decrease that limit but maintain higher dollar limits. For this paper, however, I restrict the examination to the combination of limits proposed in the budget.)

Illustrative Cases

The effects can be seen from an illustration in which 1995 income was $75,000, equal to the level at which 18 percent of income is $13,500 (the same as the dollar limit). For subsequent years, I made projections for each of the two inflation cases. Table 3 sets out the income projections and RRSP contribution limits for 1995 to 2005.

The new limits are significantly smaller than the immediate pre-1996 budget limits, and the reductions occur for the smaller as well as the larger rates of inflation. In 2003, for example, in the 2 percent inflation case, the contribution limits are more than 20 percent lower than they would have been using the 18 percent of income reference. In the same year, for the 1 percent inflation case, the maximum is reduced by nearly 15 percent.

Even the 2 percent case reflects a low rate of inflation, but the reductions in the contribution limits are large. If inflation averages 3 percent per year between 1995 and 2005, the reductions will be even larger — by more than 25 percent against the 1995 budget maximum or 18 percent of income.

To put the point another way, if the individual uses all the room provided by the RRSP maximums in preparing for retirement, the reductions in the limits imply reductions in the RRSP retirement income target of 15, 20, or 25 percent, depending on the degree of prospective inflation. If the person is not using the maximum limits for RRSP contributions, the reduced limits would shrink her unused room.

For the person who uses the maximum contribution limits, the changes also increase

Table 4: *Income Profiles for Which the 1996 RRSP Limits Do Not Become Effective*

	1995	2000	2003	2005
	Inflation rate of 2% per year; wage increase of 3% per year			
Income *($)*	59,204	68,634	75,000	79,565
RRSP contribution limits				
18% of income *($)*	10,657	12,354	13,500	14,322
Dollar maximum *($)*	13,500	13,500	13,500	15,500
1996 max/18% of income *(%)*	126.8	109.3	100.0	108.2
	Inflation rate of 1% per year; wage increase of 2% per year			
Income *($)*	64,010	70,672	75,000	78,028
RRSP contribution limits				
18% of income *($)*	11,522	12,721	13,500	14,045
Dollar maximum *($)*	13,500	13,500	13,500	15,500
1996 max/18% of income *(%)*	117.2	106.1	100.0	110.4

personal income taxes (because of the decrease in the RRSP contributions that can be deducted from total income in calculating taxable income). If nothing else is changed, the person's current consumption can increase (the reductions in RRSP contributions are larger than the increase in PIT), but this byproduct is bizarre.

Another way to look at the 1996 changes is to calculate how low a person's 1995 income would have to be to escape totally from the effects of the new limits. Since the scheduled limits will bite most severely in 2003, to have no effect they have to be nonbinding in that year. That situation will occur if income in 2003 is $75,000. Table 4 shows the necessary income profile. Under the 2 percent inflation case, an income of $59,204 in 1995 will cumulate to $75,000 in 2003. For the 1 percent inflation case, the 1995 income is $64,010.

In brief, people with current income of more than $59,204 (or $64,010) may be affected by the reduced limits sometime in the decade, losing either their maximum RRSP limit or the unused room in their programs.

To keep these matters in perspective, however, the reader should recall that the 1996 federal budget imposed new restrictions on limits that had already been reduced in the 1995 budget.

Increased Outside Savings

A person who has been using her full RRSP contribution room could offset the reduced RRSP saving limit by increases in her outside saving, buying Canada savings bonds (CSBs) or other government bonds, stocks, annuities, property, and so on out of after-tax dollars. When the dust clears, she could end up maintaining her retirement saving (and paying more PIT). At the other extreme, her neighbor could maintain his current consumption (despite some increased PIT from the reduction in his RRSP room) and reduce his overall retirement saving. A third person might choose some intermediate position.

Even in 1996, people who had income of $75,000 or more in 1995 faced choosing among some combination of reduced retirement saving, increased PIT, and reduced consumption possibilities during the period of accumulating savings. And many more Canadians will confront these choices in the decade to come.

Table 5 works out an example for a person with an initial income of $75,000. He is age 45 in 1995 and at the start of the year has an accumulated RRSP fund of $200,000, built up from previous contributions and investment income.[24] The calculation assumes inflation of 2 percent per annum, wage increases of 3 per-

Table 5: ***Illustration of Savings Programs***

	1995	2005	2015
Income *($)*	75,000	100,800	135,500
RRSP contribution			
Old rules *($)*	13,500	18,100	24,400
New rules *($)*	13,500	15,500	20,800
Outside saving contribution *($)*	0	2,600	4,400
Total RRSP fund			
Old rules *($)*	200,000	625,800	1,425,700
New rules *($)*	200,000	597,100	1,320,100
Total outside fund *($)*	0	27,800	92,300
Saving as a % of income			
In RRSP, old rules *(%)*	18.0	18.0	18.0
In RRSP, new rules *(%)*	19.0	15.5	15.4
Outside fund *(%)*	0	2.5	2.6
Personal income tax			
Old rules *($)*	20,600	31,700	46,900
New rules *($)*	20,600	33,600	48,600
New rules plus outside fund *($)*	20,600	34,500	51,400
Consumption			
Old rules *($)*	46,900	50,900	64,200
New rules *($)*	40,900	51,700	66,000
New rules plus outside fund *($)*	40,900	48,200	59,700

Note: Despite the individual's comparable savings efforts under the old and the new rules, the funds accumulated in the RRSP (new rules) and outside savings combined cannot quite reach the level of the RRSP under the old rules. The reason is the difference in personal income tax, which will arise under the existing structure and rates.

cent a year, and a constant real rate of interest of 4 percent. It is assumed that, under the old limits, the contributions deductible in reckoning taxable income begin at $13,500 in 1995 and are indexed at the average wage rate. The new limits are those set out in the 1996 budget.

Notice that, under the old limits, the RRSP fund would accumulate to $1,415,700 in 2015, when the person reaches age 65. Under the new limits, it will accumulate only 93.3 percent of that amount — to $1,320,200.

Notice, too, that the 1996 budget contribution will have restricted the size of the fund by almost $30,000 by the end of 2005. This restriction will continue to limit the growth of the fund in subsequent years. Whenever a fund is limited at some point of time, it thereafter holds less capital to earn investment returns, so the effect is perpetuated.

Qualitatively, any other set of assumptions would produce similar results. If the initial income were higher than $75,000, the new limits would be even more restrictive on the growth of the RRSP fund. If the inflation rate were higher, the new limits would be more restrictive because they are fixed in dollar terms.

Unfortunately, the story is more complicated. Neither the contributions to nor the investment earnings in an RRSP account are subject to PIT during the accumulation period. But outside saving programs do not qualify for deductions of contributions in reckoning taxable income. The investment earnings of such funds may or may not be taxable during accumulation, depending on the savings contract.[25] (In principle, if such saving programs receive no tax deferrals for contributions or investment income, they ought not to be taxed on withdrawal. In practice, however, withdrawals from outside savings programs are usually taxed, except for withdrawal of capital that received no tax deferral.)

Generally speaking, outside saving is at a net lifetime tax disadvantage compared with

saving in an RRSP. Thus, policies that reduce RRSP saving, even if partially offset by increases in outside saving, generally result in net increases in a person's PIT burden.[26]

For the illustration in Table 5, I assumed that the person continues to contribute 18 percent of his salary income to retirement savings, making as large a contribution as allowed to his RRSP saving and putting the balance in an outside program.

If both programs receive the same rates of investment returns, the taxpayer can end up with a combined retirement fund approximately as large as if the new RRSP limits had not been imposed. Such a complete offset in accumulation of fund can be achieved, however, only by paying a larger tax bill and reducing consumption during the period of accumulation.

The hypothetical individual could, of course, choose from a wide range of other options, resulting in some, but not complete, replacement of the decreased RRSP fund and some, but somewhat smaller, increases in PIT and reductions of consumption during the accumulation period.

The bottom line on retirement funds is that the new limits will force many individuals to consider some combination of more constrained possibilities: a smaller total savings fund, higher taxes, and/or less consumption.

Adequacy of Retirement Income

I have worked out the above illustrations under the assumption that the hypothetical individual makes a sustained and huge commitment to building up retirement income funds. Consistently contributing to an RRSP at the rate of 18 percent of gross earned income for a period of 35 or more years requires a very high preference for retirement income over current consumption. Not surprisingly, then, the possible replacement income ratio at the time of retirement from such a program could be very large — initially as much as 80 percent of a nonindexed pension — much larger than the conventional retirement income targets.[27]

Two qualifications should be kept in mind, however. First, inflation during the period of retirement will reduce the replacement ratio of then-current incomes, dramatically so for compounded inflation rates even as low as 2 percent per year. A decade of 2 percent inflation rates will decrease the real value of a fixed-dollar pension by more than 20 percent. To put the point another way, a pension indexed at 2 percent per annum costs at least 20 percent more than an unindexed pension.

Second, in evaluating preparation for retirement, upper-middle-income Canadians have to consider the bite taken by high marginal PITs. In Ontario in 1995, for example, the marginal tax (federal and provincial, including surtaxes) was more than 54 percent.

Carryforward of RRSP Contribution Entitlements

In addition to tightening the RRSP contribution limits, the 1996 budget introduced some other changes. One was the elimination of the seven-year limit on the carryforward of unused RRSP room. Finance Minister Martin explained the reasoning behind the new policy:

> [M]any taxpayers may go through lengthy periods — such as early in their careers or when they are raising children — when they are unable to set significant amounts aside for retirement. This measure will make the tax assistance system fairer and more effective by increasing the ability of individuals to make up for low savings level in earlier years....The more generous carryforward provisions will help individuals save adequate amounts for retirement within somewhat lower annual contribution limits.[28]

This mainly good-news story has some potential problems. Under the previous carryforward provisions, unused RRSP entitlements beginning with 1991 could be carried forward for up to seven years. The carryforward was subject to a cap (350 percent of earned income in the current year), but in general if a person had $9,000 of room available in a particular

year but made a contribution of only $8,000, she could carry forward the unused room of $1,000 for seven years. Now, any person who has unused room at any time (including room accumulated during the 1991–95 period) can carry it forward indefinitely and make additions during the period of future earnings. (The record of accumulated unused room will be maintained and provided by Revenue Canada — though a person is wise to maintain his own records.)

The use of accumulated unused RRSP room to make additional contributions in any particular year will be at the discretion of the individual taxpayer. Presumably, if a person has a windfall of earned income in some year, he can use some of it to make contributions to an RRSP program that year in excess of the year's annual allowance. Such action will draw down the bank of accumulated unused contributions but also reduce his taxable income for the year in question.

The changes involve a tradeoff for individuals. Since the total room for each year has been reduced, the unused room that can arise in any future year will be smaller. But since unused room can accumulate for a longer period, the total relief from the provision is potentially larger.

This increased flexibility in retirement saving is very attractive. The normal life cycle of households is to give priority to financing the acquisition of housing and durables and the raising of children during the earlier years of working life; the concern with, and ability to give, higher priority to saving for retirement increases in middle age and the years just before retirement. Additionally, many people experience year-to-year instability in their income. They will now be able to tune their RRSP contributions to their situation.

Of course, the change may encourage some people to delay their contributions to an RRSP program — a tactic usually not to their advantage. Because delay slows the increase of the RRSP fund and thus its tax-sheltered investment income, taxpayers who delay contributions will accumulate smaller funds and reap smaller retirement income benefits.

The role of RRSPs in individual retirement programs raises a number of difficult microeconomic and taxation issues that go well beyond the scope of this paper. All that matters here is that the extended carryforward privileges appear to be a substantial improvement for all taxpayers who find RRSP programs otherwise attractive.

A problem for the government that could arise with the new policy is the potential instability of future tax revenue, which will depend on the size of the accumulation of unused RRSP room and when it is used.

The government cannot have it both ways: to provide flexibility to people is to introduce the possibility of unforseen variation in tax revenue. The law of large numbers, however, suggests that the variance for government income will be less than for individuals. Moreover, the government has greater capacity to cope with possible variations than do individuals.

Overall, the new carryforward provisions are a major improvement in the Canadian retirement income system, particularly for middle- and upper-middle-income families and individuals.

Lower Age Limit for Contributions and Withdrawals

Another change in the RRSP (and RPP) rules is a drop in the age limit for both contributions and withdrawals. The 1996 Budget Plan says:

> [T]he budget proposes to reduce the age limit for contributing to RPPs and RRSPs from 71 to 69. Individuals must begin drawing on their pensions and RRSPs by the end of the year in which they turn 69. This will limit the use of RRSPs for unnecessary tax deferrals, and better target them to their intended purpose of providing retirement income.[29]

The reduced contribution age limit will affect only a few people. Taxpayers with earned income during the years when they were 70 and 71 had been able to make further contri-

butions to their programs under the previous rules. They will no longer be able to do so. But the proportion of the Canadian workforce that has significant earned income at ages 70 and 71 is small;[30] thus, the potential contributions to RRSP programs will be little affected.

The sheltering of investment income in an RRSP program is a different matter. Under the previous rules, a person could postpone withdrawals from the RRSP program when she was ages 70 and 71, two years during which the investment income could accumulate tax free. Under the new rules, the fund at the end of the year in which she becomes 69 is the base for the registered retirement income fund (RRIF) or other arrangements from which she must make withdrawals. That fund will be smaller than if withdrawals could be delayed. Withdrawals (from that smaller fund) will have to start earlier. And PIT must be paid on withdrawals when they start, so the tax-deferral provision of an RRSP will be less generous. Other things being equal, the withdrawal amounts for ages 72 and beyond will be smaller than they would have been under the previous rules, so the retirement income from the RRSP program will be smaller.

Figure 3 illustrates the effects of these changes. The fund must begin to decrease on the last day of the year in which the individual turns 69. The mandatory withdrawals, which start at that time, are relatively small at age 72.

Only under rather special circumstances will significant effects arise from these changes. Most people start withdrawing funds from an RRSP program at about age 65 in order to provide retirement income, so the new rules will not affect them. They would no longer be contributing to their RRSP program or postponing withdrawals when they were 70 and 71.

The principal advantage of the old rules was the two years of additional tax sheltering of investment income. But to

Figure 3: ***Effects of Lower Age for Withdrawals from an RRSP/RRIF Program***

Note: The exact effect of the 1996 changes will, of course, depend on two things. The first is the rate of investment earnings within an individual's RRSP/RRIF. Here I have assumed that that rate is 6 percent per annum.

The second is the rate of withdrawals. Under the 1995 rules, the minimum withdrawal rate was 7.4 percent of the fund at age 71. Under the 1996 rules, a slightly lower withdrawal rate has been assumed.

Given these assumptions, the fund in the example begins to decrease in the first year of withdrawals. If the investment rate exceeded the initial withdrawal rate, however, the fund would continue to grow for some years after withdrawals began.

benefit from that advantage, a person had to be able to support himself from other means during the years when he was 70 and 71. The numbers of Canadians who have sufficient wealth outside their RRSPs and who could easily liquidate some of it at that age appears to be small. For those who are affected, however, the reductions in benefits will be large — a more than 12 percent decrease in annual withdrawals. The maximum RRSP/RRIF fund may be reduced by 14 percent or more, depending on the rate of investment earnings.

Effects of Limitations on RPPs

The 1996 budget also includes new rules for RPPs. The new rules will affect pension programs other than defined-benefit plans (such as defined-contribution plans) in much the same way that they affect RRSPs. So I focus here on defined-benefit plans.

The effects on those plans will be considerable because the maximum pension limit for defined-benefit RPPs will be frozen at its current level of $1,722 per year of service through 2004, substantially reducing the retirement income of many upper-middle-income Canadians and increasing their PITs. The initial impact will fall on those who had 1995 income of more than $86,100, but if inflation over the next decade averages only 2 percent, the freeze will eventually reduce pension limits for workers who made a little less than $61,000 in 1995. For all these people, retirement income from their defined-benefit plans as a proportion of terminal working income will be substantially reduced.

$1,722 and All That

Before the 1995 budget, the contribution limit to a defined-benefit RPP was the lesser of 18 percent of income by employee and employer together, or a maximum of $1,722 per year of pensionable service up to a maximum of 35 years. The $1,722 limit was to be indexed at the average wage beginning in 1996. The 1995 budget, however, froze the dollar maximum at $1,722 per year of pensionable service for 1997 and 1998, with indexation to the average wage to begin in 1999. The 1996 budget extends the freeze through 2004, with indexation to the average wage to commence in 2005.

Thirty-five years at $1,722 per year implies a maximum pension of $60,270 under a defined-benefit pension plan. As already noted, for many upper-middle-income participants in RPPs, the new rules will reduce their potential pensions, reduce their contributions, and increase their PITs indefinitely into the future.

Illustrative Cases

As with RRSPs, the size of the potential effects can be estimated by considering income projections between now and 2005. The reason is that the dollar limits on RPP benefits are fixed through 2004, but individuals' income will grow at rates determined by productivity and inflation. The fixed pension limit will thus become a smaller and smaller portion of future income. The maximum income replacement ratio for an RPP (together with CPP/QPP for integrated plans — see Box 2) used to be nearly 70 percent for income of $86,100; that ratio may now fall considerably.

To put the point another way, people with income of $66,000 or even less in 1995 can achieve the 70 percent replacement ratio from RPPs only if inflation averages 2 percent or less through the decade.

In the hypothetical cases I analyze here, the individual's RPP program leaves no room for RRSP participation from current income. I use two scenarios — the same ones as in the RRSP analysis — one with an average inflation rate of 2 percent per annum during the next decade and a wage increase of 3 percent per annum compounded, and the other with an average inflation rate of 1 percent per annum and a wage increase of 2 percent per annum.

Tables 6 and 7 set out the results for two initial salary cases. In Table 6, the one most readily compared with my analysis of the re-

Table 6: ***Effects of Pension Limits for a $75,000 Earner***

	1995	2000	2004	2005	2015
	Inflation rate of 2% per year; wage increase of 3% per year				
Income *($)*	75,000	86,946	97,858	100,793	135,458
Maximum pension permitted					
70% of income[a] *($)*	52,500	60,862	68,501	70,556	94,821
1996 limit *($)*	60,270	60,270	60,270	62,078	83,428
1996 limit/70% of income *(%)*	100.0	99.0	88.0	88.0	88.0
	Inflation rate of 1% per year; wage increase of 2% per year				
Income *($)*	75,000	82,806	89,632	91,425	111,446
Maximum pension permitted					
70% of income[a] *($)*	52,500	57,984	62,742	63,997	78,012
1996 limit *($)*	60,270	60,270	60,270	61,475	74,938
1996 limit/70% of income *(%)*	114.8	104.0	96.1	96.1	96.1

[a] Pension of 70 percent of income is equivalent to RPP contributions of 18 percent of income.

duced RRSP limits, the hypothetical individual has a 1995 salary of $75,000, for which the maximum pension contribution (18 percent of 1995 income) would be $13,500 in 1996. In Table 7, the person's 1995 salary is $86,100. Eighteen percent of that amount equals the $15,500 maximum pension contribution, and for 35 years of service, such a program would yield a defined-benefit pension of $1,722 (1995 dollars) per year of service on retirement.[31] (This level of benefits would include CPP/QPP benefits if the plan was integrated.)

In both cases, I assume the taxpayer makes maximum use of the pension allowances under the new rules and would have done so under the old system.

Figure 4 traces the dollars per year of service that the first person can receive, given the assumptions and either 1 or 2 percent inflation. Even with an average inflation rate as low as 1 percent per annum, the 1996 limits become binding before 2005. With 2 percent inflation, the limits bind more quickly and more severely on the future RPP pension. By 2004, it will be 12 percent less than it could have been under the 1995 budget limits.

For a person with a 1995 income of $86,100, the reduced pension limits will bind even sooner and more severely. By 2004, the maximum RPP pension will be almost 16 percent smaller than it could have been under the 1995 rules.

How low must a person's 1995 income be in order to escape the effects of the new RPP rules? Since the maximum bind will take place in 2004, what income in that year would be unaffected by the new limits? It is $86,100, for which the 70 percent income standard yields

Box 2: ***Employer-Based Pension Plans That Are Integrated with the CPP/QPP***

Many employer-based pension plans (especially defined-benefit plans) are integrated with the CPP/QPP. Though the details vary widely, the general principles of integration are simple. First, if an employee is to receive CPP/QPP benefits, the integrated pension plan is set up to yield him smaller benefits than he would obtain under an unintegrated program. Second, if the employee and his employer are paying contributions to the CPP or QPP, the contributions on his behalf to the employer-based pension plan are reduced because of the integration.

Note: For a careful exposition of the issues and situation, see Hubert Frenken, "The Impact of Changes in the Canada Pension Plan on Private Pensions," *Canadian Business Economics* 4 (Summer 1996): 65–72.

Table 7: ***Effects of Pension Limits for an $86,000 Earner***

	1995	2000	2004	2005	2015
Income *($)*	86,100	99,813	112,341	115,711	155,506
Maximum pension permitted					
1995 rules: lesser of *($)*	60,270	63,940	71,965	74,124	99,616
and 70% of income[a] *($)*	60,270	69,869	78,639	80,998	108,854
1996 limit *($)*	60,270	60,270	60,270	62,078	83,428
1996 limit/1995 limit *(%)*	100.0	94.3	83.7	83.7	83.7
1996 limit/70% of income *(%)*	100.0	86.3	76.6	76.6	76.6

[a] Pension of 70 percent of income is equivalent to RPP contributions of 18 percent of income.

a pension of $60,270, the same as is permitted by $1,722 per year of pension for each of 35 years of pensionable service. From that marker, I calculated the corresponding income limit for previous years back to 1995 (see Table 8). If inflation is 2 percent per annum, people with 1995 income of about $66,000 will be unaffected by the limits. If inflation is 1 percent, people with income in 1995 of about $72,000 will be unaffected. For all RPP-users with higher 1995 income, contributions and retirement income will be reduced and PIT increased.

Pension information on 1993 incomes[32] suggests that, at the moment, at least 100,000 Canadians will be affected by these changes, but the numbers can be expected to increase rapidly during the next decade.

Offsets to the Reduced RPP Limits

People whose RPPs are reduced by the new limits can offset these reductions in whole or in part by increased "other savings" programs. But the cost will be even higher personal taxation and less current consumption. The possibilities and tradeoffs are essentially the same as those already discussed in the analysis of reduced RRSP limits.

The bottom line is that the freeze will lead to reductions of maximum RPP programs for a large number of people and the

Figure 4: ***Effects of Inflation on the RPP Dollars per Year of Service Received by a $75,000 Earner***

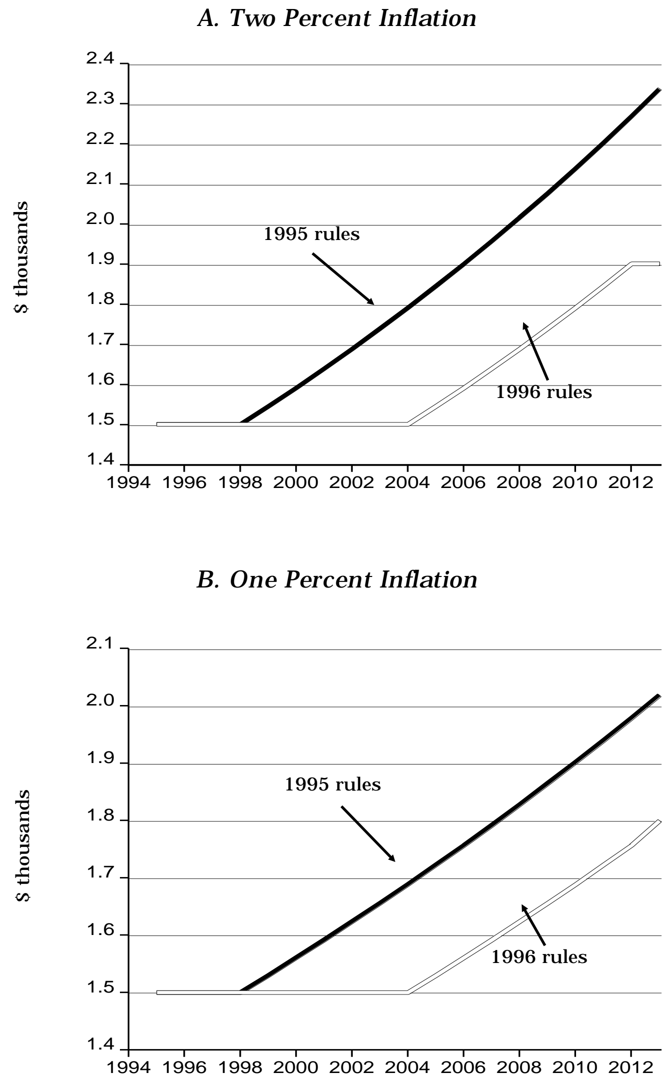


Table 8: ***Income Profiles for Which the 1996 RPP Limits Are Not Binding***

	1995	2000	2004	2005	2015
Inflation rate of 2% per year; wage increase of 3% per year					
Income *($)*	65,989	76,499	86,100	88,684	199,183
70% of salary *($)*	46,192	53,549	60,270	62,078	83,428
1996 limit *($)*	60,270	60,270	60,270	62,078	83,428
1996 limit/70% of salary *(%)*	130.5	112.6	100.0	100.0	100.0
Inflation rate of 1% per year; wage increase of 2% per year					
Income *($)*	72,045	79,544	86,100	87,822	89,579
70% of salary *($)*	50,431	55,680	60,270	61,475	74,938
1996 limit *($)*	60,270	60,270	60,270	61,475	74,938
1996 limit/70% of salary *(%)*	119.5	108.2	100.0	100.0	100.0

possibilities of offsetting such limitations on retirement saving will be more costly than if the freeze had not been instituted.

The Rationale for the Freeze

Why is the limit on pensions from defined-benefit plans being frozen? The reason is to maintain the equivalence of incentives for individuals with RPPs and those with RRSPs. The tax reform of the 1980s increased the limits on RRSP contributions to correct the unfair treatment of them compared with RPPs. Since the RRSP allowances for tax relief are now to be reduced, so must be the limits of tax relief for defined-benefit plans to maintain the equivalence.

The principle is to treat equitably people who face different retirement saving opportunities and circumstances. It would be grossly unfair to give tax privileges for retirement saving to government workers and employees of large corporations that provide RPPs and not to give comparable treatment to participants in small businesses, independent professional practices, and nonunionized employees. The technique of introducing the limitations is different for the RRSPs and the RPPs, but the effects are roughly comparable in size and timing.[33]

The Effects of Changes on Mixed RPP/RRSP Programs

How will the new regime affect people who have RPP programs and RRSP top-ups? The first call on the new allowances is to sustain the individual's RPP program. His RRSP room will be reduced or, if necessary, eliminated. If the pension limits are very severe, even the RPP program will have to be cut back.

The impact of the reduced RPP and RRSP allowances will depend on the person's income range and on the rates of inflation during the next decade and more. For sufficiently low incomes and low rates of inflation, the reduced limits will have no effect. But incomes do not have to be all that high nor inflation all that rapid before the new limits bite.

I worked out an illustrative case for a taxpayer with an income of $75,000 a year starting in 1995 and the 2 percent inflation scenario. The results are shown in Figure 5 and Table 9, which use a slightly simplified case to demonstrate that the reduced limits will fall primarily on the RRSP component of a combined RPP/RRSP program.

The two panels of Figure 5 show the outcomes clearly. The new limits begin to reduce the combined saving program immediately, and their effects will become more severe during the decade that ends in 2005. Because the RPP pension contribution continues to be made

at the level of 13.5 percent of income, the full impact of the reduced limits falls on contributions to the RRSP program. The benefits under the individual's RPP can be maintained, but his RRSP's investment earnings are reduced.

Under the new limits, the RRSP fund can reach only $90,000 by 2015, whereas under the 1995 limits, it could have reached $179,100. In other words, the lower limits will reduce the accumulated RRSP fund by nearly $90,000 by 2015. Depending on the handling of the RRSP, the smaller amount could yield a gross income of $9,000 per year in retirement, and the larger fund a gross income of $18,000 per year.

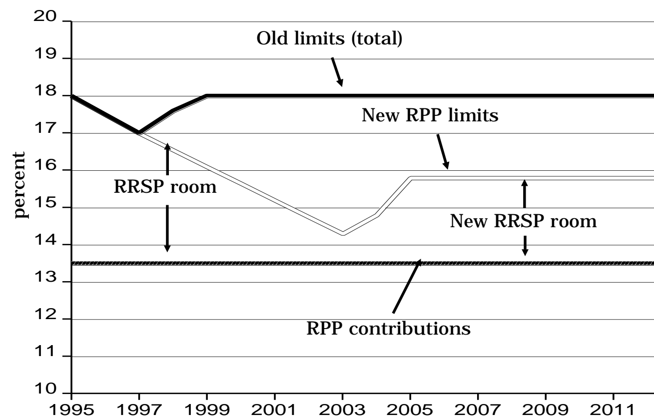
The results would differ quantitatively for different assumptions regarding initial income, rates of inflation and rates of investment earnings, but the qualitative conclusions would be similar. For any given initial income, the lower the rate of prospective inflation, the less restrictive the new limits (which are fixed in dollar terms). But even for an initial income at or a bit below $75,000 per year and an average rate of inflation as low as 1 percent per year compounded, the new limits will bite, mainly by reducing the top-up of RRSP programs in mixed RPP/RRSP retirement saving programs.

An affected taxpayer may find some comfort in contribution rates that are lowered overall as a percentage of income and higher current consumption despite higher PIT. But if the person wishes to offset, in whole or in part, the reductions in his RPP and RRSP programs, he can do so only by increasing his other saving programs at a cost of yet higher PIT and reduced current consumption.

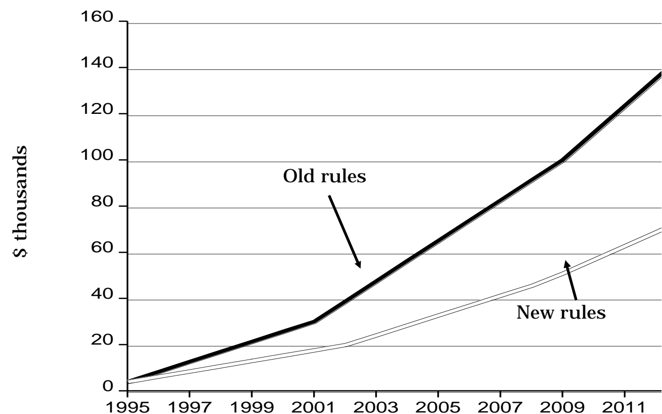
Figure 5: *Effects of the Changes on a Mixed RPP/RRSP Program*

Case: RPP has defined benefits of 1.5 percent of final salary × up to 35 years of pensionable earnings; 1995 salary is $75,000 per annum. Under 1995 rules, RRSP room would have been 4.5 percent of current income. Inflation averages 2 percent compounded, and wages rise by 3 percent a year compounded.

A. RPP plus RRSP Contributions as a Percentage of Salary



B. Size of RRSP Fund



The Whole Package: OAS/SB and RRSPs/RPPs

Will the reduced RPP and RRSP limits interact with the OAS or the new SB? Yes, at least for a few Canadians who are receiving the federal benefit and drawing retirement income from an RPP or an RRSP (or a mixture of the two).

The qualitative integration of the two kinds of elder programs is easy to understand (though the precise calculations are complex). The logic is simple. If a benefit is income tested and a person's income is reduced, the net benefit becomes larger.

Consider, first, a retiree who receives the OAS and pension income. Other things being

Table 9: *Effects of RPP/RRSP Limits on a $75,000 Earner*

	1995	2004	2005	2015
Inflation rate of 2% per year; wage increase of 3% per year; real interest rate of 4%				
Income *($)*	75,000	97,959	100,793	135,458
Old contribution limits				
As a % of income				
RPP *(%)*	13.5	13.5	13.5	13.5
RRSP *(%)*	4.5	4.5	4.5	4.5
Total (%)	*18.0*	*18.0*	*18.0*	*18.0*
Dollars per year				
RPP *($)*	10,125	13,211	13,607	18,287
RRSP *($)*	3,375	4,403	4,536	6,095
Total ($)	*13,500*	*17,614*	*18,143*	*24,382*
New contribution limits				
As a % of income				
RPP *(%)*	13.5	13.5	13.5	13.5
RRSP *(%)*	4.5	1.3	1.9	1.9
Total (%)	*18.0*	*14.8*	*15.4*	*15.4*
Dollars per year				
RPP *($)*	10,125	13,211	13,607	18,237
RRSP *($)*	3,375	1,289	1,893	2,554
Total ($)	*13,500*	*14,500*	*15,500*	*20,831*
Maximum RPP pension				
Old rules *($)*	39,375	51,375	52,917	71,156
New rules *($)*	39,375	51,375	52,917	71,156
RRSP fund at end of year				
Old rules *($)*	3,577	50,923	58,827	179,124
New rules *($)*	3,577	29,333	32,047	89,971

Note: This illustration is not strictly accurate in that it takes no account of the $1,000 factor in calculating the PA on the RPP. This omission (which simplified the calculation) does not affect the main story, whose central point is that, for a mixed RPP/RRSP program, the reduced contribution limits will fall primarily on the RRSP component. They will affect the RPP portion only when (and if) the room for RRSP participation has been exhausted.

equal, the effect of the reduced limits is to reduce the RPP or RRSP pension. The OAS is taxable income that is clawed back at a nominal rate of 15 percent of incremental income and an effective rate of 8 to 9 percent. Thus, if the new limits reduce the retiree's RPP or RRSP pension, the dollars taken by clawback from the OAS will be smaller and the remaining benefit larger.

If, for example, the person is in a 40 percent marginal PIT bracket and his pension is reduced by $1,000, the net clawback on his OAS benefits will be reduced by $90. In other words, he will have $90 in additional net benefits from the OAS to add to his pension income. On balance, the loss of $1,000 of RPP or RRSP income less the $90 increase in OAS benefits leaves him a net $910 worse off.

The same kind of result will apply for a retiree who receives the new SB when it comes into effect, although the taxback rate will be more severe than that of the OAS. Recall that the SB will not be taxable income but that the amount of the SB will be income tested. In the income range over which an individual will be eligible for the program, an additional $1,000 of other income will lead to a 20 percent, or $200, reduction in her SB. If the new limits reduce her RPP or RRSP retirement income, they will also reduce the cut in the SB.

If, for example, those limits reduce her pension income by $1,000, her SB will be $200

larger than it would be otherwise. A $1,000 loss of RPP or RRSP pension less the $200 gain in the SB will leave her a net $800 worse off.

Only a small number of Canadians will be affected by the integration of the reduced RPP/RRSP limits and the net increase in their OAS benefits, and the net increase in their SB will be even smaller. The reason is that most people with middle or low income will not have their RPP/RRSP programs affected by the new limits, so the income-testing effect of the clawback will be unaffected too. Only individuals or couples with income more than about one and a half to two times the average wage will have their RPP or RRSP programs reduced. Not many of them now qualify for net OAS benefits that are substantial, and even fewer will qualify for any SB. But some overlap will still exist.

The CPP/QPP and the RPP and RRSP Limits

No decision had been announced about the Canada or Quebec Pension Plans at the time of writing. Thus, I can offer only speculations about the relationship of changes in them to the RPP and RRSP changes introduced by the 1996 federal budget. Some points seem probable, nevertheless.

Of the many complex options being discussed for changes in government pension programs, a frequent proposal is to increase contributions beyond the previously agreed schedule. In 1996, the contribution rate, divided equally between workers and their employers, was 5.6 percent of earnings between a basic exemption of $3,500 and a maximum of $35,400. Under federal-provincial agreements, the joint contribution rate is scheduled to increase gradually over the next 20 years, reaching 10.1 percent of the earnings base in 2016. While enormous differences in detail exist, the consensus of the CPP/QPP reform discussions envisages some increase in the earnings base, the contribution rate, or both by more than previously agreed, even if benefits are unchanged.

The effect of the reduced RPP/RRSP limits and increased contributions to the CPP/QPP would be to squeeze publicly aided retirement income programs from both ends. Consider a typical employer-based defined-benefit program in which the CPP and non-CPP elements are integrated and the employer and employee share equally in making contributions. Whatever is required to meet the CPP contributions has the first claim on total annual contributions. The balance goes into the employer-based pension program. If, for any given rate of total contributions, more is required to meet the CPP tranche, less is left for the employer-based program.

As an example, consider a Nova Scotia high school teacher with a 1996 salary of $60,000.[34] He and the employer each contribute 8.75 percent of the salary to the pension plan, for a total of 17.5 percent of income, or $10,500. The joint 1996 contribution to the CPP was $1,786.40, leaving $8,713.60, or 14.52 percent of income, to go to the employer-based pension program. For each of the employer and employee, the total contribution was $5,250: the CPP contribution of $893.20 and the contribution to the employer-based program of $4,356.80.

Now suppose the CPP contribution base had remained the same but the joint contribution rate had been 10 percent of eligible earnings. The joint contribution to the CPP would have been $3,150 — that is, $1,575 each for the employee and the employer.

Assume also that the CPP benefits were unchanged at a maximum of 25 percent replacement of the average wage. If the total 1996 contribution of $10,500 was unchanged, the amount left over for the employer-based pension program would have been a contribution of $7,400, a reduction of $1,313.60, or 15.1 percent. The non-CPP contribution would have been reduced to 12.3 percent of salary.

The smaller contribution could not purchase as large a non-CPP pension. The CPP benefit being the same, the total pension benefit from the contribution rate of 17.5 percent of payroll would have been reduced. This result

would have occurred even if the contribution limits for RPP and RRSP programs had not been reduced as proposed in the 1996 budget.

As the earlier analysis showed, however, that pension freeze could actually make the contribution limits binding during the decade through 2005, even for a $60,000 earner, if inflation rates average 3 percent or more a year. The teacher would see a reduction in total pension contributions as a percentage of income.

Under these circumstances, the postulated increase in CPP contribution rates would have to be met out of smaller total pension contribution rates. The resources left for the employer-based pension would be squeezed by both increased CPP contributions and reduced total pension contribution possibilities.

The bottom line is that, even if the reduction in RPP and RRSP limits does not affect a person because his income is below the effective limits, increased contributions to the CPP/QPP would reduce his total retirement income unless he offsets the effect by increased other saving. If the reduced RPP and RRSP limits do affect the person, they will interact with the likely CPP/QPP changes to squeeze his future pension from both sides. Incomes do not have to be all that high before the new limits bite. For many Canadians, sustaining their retirement income prospects at conventional retirement targets will require even greater saving effort outside their RPPs, RRSPs, and the CPP/QPP.

Overall Effects: National Saving and Government Finance

What effects will the 1996 changes in Canadian retirement programs have on national saving, economic growth, government finance, and the distribution of income and wealth? To explore these issues thoroughly would require another large and complicated analysis, a task beyond this Commentary (especially so because of the missing link: decisions regarding the CPP/QPP). I can, however, offer a few preliminary suggestions, looking first at private saving and then government saving.

Private Saving

For the new SB, the taxbacks (loss of benefits and increased PIT) will be more severe than under the OAS/GIS system it replaces. This severity, even for people at modest income levels, will provide an increased disincentive to other saving (RRSP and other programs). Its strength can only be judged by experience, but the direction is toward decreased private saving (see Box 3).

As for RRSPs and RPPs, this Commentary has already argued that the tax-relief incentives for such programs are being decreased for enough people to have the effect of reducing aggregate saving within these programs. The more generous carryforward of RRSP contribution entitlements will offset that reduction, but to an uncertain degree and likely not completely. Moreover, because of some overlap between reduced OAS or SB benefits and reduced RPP/RRSP limits for upper-middle-income people, some individuals will be losers from both ends, receiving smaller net benefits from the SB than the OAS and being bitten by the reduced RPP/RRSP limits.

Since both RPPs and RRSPs are important parts of national saving programs, if the budget measures reduce them, that portion of national saving will fall too.

One of the difficulties in assessing the effects is that Canadians do not now use all the available tax privileges for saving for their retirement. A substantial proportion could be in RPPs but are not, and a large number do not use the room available to them for participation in RRSPs (though it appears that the use is increasing). The extended carryforward privileges for RRSP contributions could increase the use of available room considerably, particularly as people become more aware of their underpreparation for retirement.

Yet, even making considerable allowance for underutilization of RRSP room under the existing tax system, I believe that, for hundreds of thousands of Canadians, the 1996 changes will lead to actual, rather than potential, reductions of RPP and RRSP benefits.

To what extent may these changes be offset by increases in other saving for retirement? It is likely that Canadians, particularly those with middle and upper-middle income, will partially offset the 1996 budget's reductions in their retirement plans by increasing their other saving. The first line of adjustment will likely be the use of unused room for RRSP contributions. This tactic will not be adequate for many Canadians. Even if they make full use of the tax privileges for their RPP and RRSP contributions, their target retirement income program may exceed what these vehicles can provide.

Some additional outside saving is also likely; how much will depend on individuals' retirement targets and their concern for wealth and for their spouses and children. The yet-to-be-made decisions regarding the CPP/QPP will also be crucial to these effects.

Overall, I expect other saving to offset reduced private saving in RPPs and RRSPs partially, but not enough to sustain net private saving.

Public Saving

What about public or government saving? Replacing the OAS/GIS system with the SB will provide some net government saving. One can argue that the effects of the reduced limits on RPP and RRSP tax deferrals will result in net increases in PIT receipts. The replacement of programs that defer taxes by those that do not (marginal replacement of RPP/RRSP programs by outside savings programs) will also increase PIT receipts. It seems likely, therefore (before considering macroeconomic effects), that government saving will increase — more exactly, government dissaving will decrease — as at least a partial offset to decreased private saving.

I judge, however, that the increases in government saving will be smaller than the reductions in private saving, and thus national savings rates will be smaller. But because of the uncertainty about the CPP/QPP, any surmises about the effects on Canadian economic growth and the balance of payments are, for the moment, in limbo.

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Conclusions

Canadians with average income or less will be the net beneficiaries of replacing the OAS/GIS by the SB. The reform is admirable in many ways, but it is not perfect. Some nasty notch problems need attention, and the fit of the SB to other programs for elders should be reexamined. Even for a person of average income, any additional outside income will lead to a combination of additional PIT and a benefit reduction (the net taxback) that will be rather large. The family basis of measuring entitlements remains a delicate issue.

People with average income will not be affected much by the reduced RPP/RRSP contribution limits. However, their net income could be reduced if CPP or QPP contributions are increased.

The budget changes' impact on middle- and upper-middle-income individuals and couples will be heavy and cumulative. At an income not all that high, the decreased RPP and RRSP limits will cut in to decrease the scope for pensions that would meet conventional retirement goals. For many people in and just beyond the upper-middle-income ranges, the reductions in their prospective pensions will be actual, not just possibilities.

Moreover, except for elders who can take advantage of grandparenting provisions, the new SB will provide smaller benefits than the OAS/GIS system did, even with the latter's clawback. Their marginal and average PIT rates, when federal and provincial taxes and surtaxes are factored in, are large. And because of the way in which contribution room is determined, they will have less scope for RRSP participation than many people consider to be fair.

Each element of these changes is understandable and appears to be reasonable. But when Canadians consider the whole package, they may have serious doubts about its fairness and effectiveness.

Paradoxically, the measures will likely reduce private saving just when many people are advocating a much larger saving program in the CPP/QPP. Will total national saving be increased when all the changes are in place? And will an increase in government-mandated saving be consistent with programs that will likely reduce private saving? No one can be certain of the answers until the whole package of changes is known.

Box 3: *Possibilities of Huge Changes in Private Retirement Savings*

In this *Commentary*, I have concluded that the changes in the retirement income system introduced by the 1996 federal budget will likely induce large changes for many Canadians. Since my paper was drafted, other useful analyses have appeared. Because of the detailed knowledge and considerable experience of its author, a paper prepared by W. Paul McCrossan for the Canadian Real Estate Association, entitled *Senior's Benefit Undermines Private Retirement Saving*, deserves particular attention. McCrossan argues that

> the Senior's Benefit will have a profoundly negative impact on Canadians who have saved for their retirement. It will impose punitively high "effective rates of taxation" on seniors who have saved for their retirement income outside the Senior's Benefit....a regrettable consequence of the heavy clawback is the disincentive this will present to private retirement savings by Canadians in moderate income brackets.

McCrossan then sets out some of the effective tax-avoidance measures Canadians may use to try to protect themselves from the changes in the retirement income system.

Overall, it seems likely that many thousands, probably hundreds of thousands, of Canadians (and their employers and unions) will have to make major changes in the structure of their preparations for retirement and in the management of their affairs when they become elders.

Notes

1 An increase in contributions compared with benefits in the CPP/QPP programs may be required to put them on a sound basis. Such changes are not argued here, nor need they be. What matters for this paper is that, in an integrated CPP/QPP and RPP program, without increases in *total* employee and employer contributions, increases in CPP/QPP contributions reduce the room an individual has for the RPP portion of the program.

2 David Slater, "Reforming Canada's Retirement Income System," *Canadian Business Economics* 4 (Fall 1995): 55.

3 See, for example, Ontario Fair Tax Commission, *Fair Taxation in a Changing World* (Toronto, 1993).

4 See William B.P. Robson, *Putting Some Gold in the Golden Years: Fixing the Canada Pension Plan, C.D. Howe Institute Commentary 76 (Toronto: C.D. Howe Institute, January 1996). See also the testimony to the Canada Pension Plan consultations provided by Dick Martin of the Canadian Labour Congress, Monica Townson, Keith Patterson, Robert Brown, and Michael Walker.*

5 *I am personally on record as in favor of improving the four-tier Canadian retirement system — of fixing the current system rather than replacing any major part of it (see Slater, "Reforming Canada's Retirement Income System," pp. 47–58); Learned Societies' meetings, St. Catharines, Ont., June 1996). Manageable and equitable, if major, changes could be made. I still believe that reform of the existing structure is preferable to replacing the CPP/QPP with mandatory individual retirement savings accounts. Radical proposals do, however, deserve careful analysis and consideration, but with all their warts as well as their beauty spots showing.*

6 *It is my understanding that the diagnosis of the problems of the OAS/GIS and the design of the replacement SB (and changed allowances) has been heavily influenced by the work on these subjects in recent years by the Caledon Institute of Social Research. See, particularly, Ken Battle, "A New Old Age Pension" (paper presented to the Conference on Reform of the Retirement Income System, School of Policy Studies, Queen's University, Kingston, Ont., February 1, 1996).*

7 *See, for example, Ontario Fair Tax Commission, Fair Taxation in a Changing World*; and Canada, National Council of Welfare, *A Pension Primer* (Ottawa, 1996).

8 Canada, *Tax Expenditures, 1995* (Ottawa), p. 26. Tax expenditures are estimates of what a government might collect in revenue currently if it did not provide deferrals and other relief. The measures of tax expenditures are often exaggerated and misleading. They do not take account of behavior that changes when taxes are changed. They exaggerate what revenue would be raised by their removal. The various tax expenditures cannot be added together.

9 Provincial PITs were about 58 percent of the federal PIT. Thus, provincial tax expenditures were about 58 percent of federal tax expenditures.

10 An alternative source for measures of income distribution is *Taxation Statistics*, which is available with 1993 data. They show that, of nearly 20 million taxfilers in 1993, about 13.5 million had taxable returns. (Taxfilers have to be individuals, not families, which accounts for the larger number of units in *Taxation Statistics* than in the Statistics Canada report, which reports on families, except for individuals who are unattached.) The mean income of assessed taxable returns in 1993 was $37,098, which can be compared with the 1994 Statistics Canada combined mean for families and unattached individuals of $44,382. The difference is mainly due to the number of two- (or more) earner families reported in the Statistics Canada survey and the number of individual taxfilers in *Taxation Statistics* (where, reflecting the many people who file only to claim tax credits, the lower-income groups were larger than those in the Statistics Canada measures). The consensus among statisticians is that the Statistics Canada data, though not perfect, are more reliable indicators of Canadian income distribution than *Taxation Statistics*.

11 For example, in the face of Canada's "gray power," the Mulroney government had to abandon its proposal to reduce the program's indexing (inflation protection).

12 Canada, *The Seniors Benefit: Securing the Future* (Ottawa, March 6, 1996), p. 25.

13 Ibid., p. 27.

14 Ibid., p. 28.

15 In order to provide estimates of the SB in 2001 and to compare those amounts with what would have been available under the old OAS program, the government had to make some working assumptions. First, it needed inflation projections. The government, with the Bank of Canada, has a policy commitment for 1996 and 1997 to a target rate of inflation of 2 percent per annum, plus or minus 1 percent. No specific policy commitment exists beyond that time, though an objective of price stability has been stated in general terms. The Department of Finance apparently used an average rate of inflation of 1.5 percent per year for the 1998–2001 period.

Second, indicating the net benefits under the old and new programs required assumptions about the federal and provincial PITs. The department assumed that the 1996 federal PIT structure and rates would continue and estimated that provincial income taxes would average 58 percent of the federal income tax.

16 Canada, *The Seniors Benefit*, p. 67, note to table 1.

17 Ibid.

18 At age 65, average life expectancy is about 18 years. Thus, on average, the person will need to receive an annuity of $2,580 a year for 18 years. If the annuity is

indexed at the average inflation rate and the nominal interest rate is also so indexed, the two indexations will offset each other. Thus, the present value of the annuity can be based on $2,580 a year. At a 4 percent rate of discount, the present value is about $32,000.

19 Canada, *The Seniors Benefit*, p. 28.

20 Ibid., p. 29.

21 One anomaly in the system is that the limits do not apply to senior federal government officials, a situation some people regard as unfair.

22 It is generally felt that the calculation is based on a rather generous pension program, such as that of federal public servants. For many private sector defined-benefit programs, the factor used is regarded as too large; its application thus overvalues the RPP and the PA, resulting in less RRSP room than is appropriate.

A useful evaluation of the calculation is given in Canadian Institute of Actuaries, *Troubled Tomorrows* (Ottawa, 1995).

23 As of late 1994, the actuarial profession expected that the limit for 1995 would be $15,500, indexed to the average wage thereafter. Subsequently, the limit for 1995 was set at $14,500.

24 Granted that $200,000 in RRSP assets is more than a typical person in this income range would have accumulated by age 45. But the principle this case illustrates is the same for a person who has accumulated much smaller sums by that age. In general, the smaller the RRSP contribution limits for calculating taxable income, the more an individual will have to rely on other saving to achieve any given retirement income target. Also, the smaller the accumulation of assets by age 45, the larger must be the saving thereafter, in or out of an RRSP, to meet a given retirement income target.

25 Two cases arise. In the first, neither tax concessions for contributions nor tax deferrals of investment income take place. In a pure stand-alone acquisition of a CSB, for example, contributions are not deductible. Interest on the bond is paid and taxed yearly even though it is not collected until maturity. On withdrawal, neither the capital nor the income is taxable. Comparable arrangements should be available for other outside savings programs that can be used in retirement saving. In the second case, no tax relief is given for contributions, but investment income is not currently taxed on an annual basis. For this case, when the resources are withdrawn, the return of capital should not be taxed, but the interest income becomes taxable. An example is a fairly common type of annuity contract, though many other annuities do involve double taxation.

26 Anomalies appear in the taxation of RRSPs too. For a single person who dies just before becoming eligible to begin RRSP or RRIF withdrawals, the total value of the accumulated fund is immediately subject to the PIT, for the year of death, at the deceased's top marginal tax rate.

27 Canadian Institute of Actuaries, *Troubled Tomorrows*.

28 Canada, Department of Finance, *The Budget Plan* (Ottawa, March 6, 1996), pp. 49–50.

29 Ibid., p. 50.

30 Canada, *Taxation Statistics*.

31 Canadian Institute of Actuaries, *Troubled Tomorrows*.

32 Canada, *Taxation Statistics*.

33 The 1996 budget freeze on RPPs is initially a little less severe than for RRSPs, but the two programs will be brought into closely comparable treatment between 1996 and 2005. For both of them, the tax-deferral privileges will apply to incomes up to a bit less than twice the average wage.

34 This calculation is based on work I did in 1992 as a consultant on the Nova Scotia Teachers' Pension plan.