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FISCAL POLICY

Saving the Future:

Restoring Fairness to the Taxation of Savings

Jack M. Mintz and
Thomas A. Wilson

In this issue...

Canada's retirement-savings system is outdated, uncompetitive relative to its US counterpart and needlessly restrictive. Meanwhile, inflation has eroded the real value of dollar limits on registered retirement savings plans to the point where the ceiling is now lower than in the mid-1970s.

The Study in Brief

Canada's current retirement tax system is outdated, uncompetitive in comparison to its US counterparts and needlessly restrictive. Inflation has steadily eroded the real value of the limits on retirement savings to the point where they are lower than they were in the mid-1970s. While some amendments in the 1990s improved access to the retirement system, many other rules were tightened, reducing the benefits of tax-assisted retirement savings plans.

This *Commentary* makes several recommendations to improve the tax treatment of registered pension plans (RPPs) and registered retirement savings plans (RRSPs). It recommends that RRSP contribution limits should be raised to $17,500 from $13,500 in 2003, at a minimum, with full indexing in the following years. It also calls for a restoration of annual percentage limits to 20 percent of income from the current 18 percent.

The study argues that there should be better opportunities for lifetime averaging of income, including allowing taxable withdrawals from an RRSP to be used to create additional room for contributions. Withdrawals from registered pensions should also be used to create future RRSP room. The age ceiling at which RRSPs must be annuitized, or converted to registered retirement income funds, should be raised to 73 from 69 years, based on current expected lifetimes of Canadians. Measures should also enable taxpayers to split RPP withdrawals between spouses for tax purposes.

As well, income averaging should be reintroduced to eliminate the discrimination imposed by the progressive tax system against those taxpayers with fluctuating incomes. The age credit should be increased to eliminate the overlap of the guaranteed income supplement clawback with personal income tax rates.

These are measures the federal government should consider as it prepares its budget for the coming fiscal year.

The Authors of This Issue

Jack M. Mintz, is CEO and President, C.D. Howe Institute, and a professor at the J.L. Rotman School of Management, University of Toronto.

Thomas A. Wilson is the Area Co-ordinator for Business Economics at the J.L. Rotman School of Management, and Senior Adviser to the Institute for Policy Analysis, University of Toronto.

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The federal government's treatment of pension and retirement savings has played a significant role in Canadian tax policy for several decades. With its latest reforms, undertaken in the 1990s, the government intended to improve the ability of Canadians to save for retirement purposes, whether using registered pension plans (RPPs),[1] or registered retirement savings plans (RRSPs). However, while some changes improved the system, the policies have not kept up with inflation and flexible working arrangements for many Canadians. In fact, the current tax treatment of retirement savings for many taxpayers is more restrictive today than in earlier years.

Indeed, the current retirement savings system is outdated, uncompetitive in comparison to its US counterpart, and needlessly restrictive. Although the government has several times increased the dollar limits on RRSPs, inflation has steadily reduced the real value of these limits to the point where they are now lower than they were in the mid-1970s. If the limits were deflated by a wage index instead of a price index, the deterioration would be even greater.

The tax treatment of pension benefits in Canada penalizes businesses, universities and other employers who offer reasonably competitive compensation packages for high-skilled workers. In light of these drawbacks, we set out several reforms designed to improve the effectiveness and fairness of the program.

This *Commentary* is focused on registered pension plans and retirement savings plans currently available in Canada. Kesselman and Poschmann (2001) proposed another approach — tax-paid savings plans. While we would also endorse this type of plan, which would be especially helpful to lower-income Canadians, we have decided to focus this paper on the existing system.

Rationale for RPPs and RRSPs

RPPs and RRSPs aim to enable taxpayers to accumulate resources for retirement by deducting from taxable income contributions made to RPPs and RRSPs. The income earned within these registered plans is tax exempt, but withdrawals of the plans' principal and accumulated income are fully taxed.[2] Interest expense on borrowed funds to finance the acquisition of RRSP assets is not deductible from taxpayers' incomes.

RPPs and RRSPs, therefore, relieve from taxation accumulations of wealth for retirement purposes. When Canadians pay tax on earned income, they can earn additional income from savings without attracting additional tax. Compared to

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1 RRPs can be either defined benefit plans, where pensions are related to past earnings, or defined contribution plans, where pensions are paid from accumulated funds.

2 With pension plans and RRSPs, the tax saving from contributions is equal to the tax paid on withdrawals, once accounting for the time value of money when tax rates are constant over time. If the effective tax rate in the future is higher (lower) than the tax rate at time of contribution, the time value of taxes paid is positive (negative) on savings.

most other investments, where returns are subject to tax, the RPPs and RRSPs are therefore provided more favourable tax treatment.[3]

The current regime of RPPs and RRSPs is consistent with the "expenditure" approach to taxation. Because consumption is the difference between income and savings, an expenditure tax is one that applies to income net of contributions to registered savings plans. The effect of the expenditure approach is to eliminate the discriminatory impact of income taxes between savers and consumers. Otherwise, savers pay income tax not only when they earn income from their work, but also when they earn capital income from their savings, which were designed to provide consumption in future years. By contrast, consumers pay tax only when income is earned and, over time, they pay less than savers who have similar incomes. As part of the expenditure approach, a person does not pay tax on income received from savings because taxes have already been paid on earnings. The expenditure approach also implies that interest expenses on debt used to finance investments are not deductible.

The government, however, imposes limits on the *degree* to which Canadians can earn capital income exempt from taxation. The retirement system enables Canadians to accumulate sufficient wealth on a tax-free basis to provide a pension or annuity of no more than a given level. A common guideline for pension adequacy is 70 percent of average earned income before retirement. "Final year average" defined benefit plans typically use a three- or five-year average of the highest earnings of the individual. Under a final-year average defined-benefit plan, with a two percent annual benefit accrual rate, this would be achieved after 35 years of service.

Consumers pay tax only when income is earned and, over time, they pay less than savers who have similar incomes.

However, unlike the United States, where the Treasury imposes penalties on taxpayers withdrawing funds prior to retirement, the Canadian system permits individuals to access their RRSP savings at any time. For this reason, the RRSP system has provided an opportunity for Canadians to average, on a limited basis, their tax base over their lifetime. Because personal income tax rates rise with income, individuals with fluctuating earnings can face higher rates of tax over their lifetime, compared to those with stable income. Contributions to RRSPs made during years of high income reduce the tax base, while withdrawals during periods of low income would increase taxable earnings. Since the federal government eliminated income averaging when it flattened some marginal tax rates in 1987, RRSPs are one of the few remaining vehicles that enable taxpayers to average fluctuations in their tax base over time.

The Existing Treatment of Savings under the Personal Income Tax

The personal income tax (PIT) system in Canada is essentially a hybrid. While ostensibly a tax on annual income, several features of the PIT shift it towards a consumption base. Since imputed rental income and capital gains on principal

3 Investments in owner-occupied principal residences and other consumer durables like automobiles are also provided favourable tax treatment. Although there is no deduction provided for investments in these types of assets, no tax is applied to "imputed rental income" and any capital gains earned on principal residences is exempt from tax. For an elaboration of these points, see the Meade Report (Institute of Fiscal Studies 1978) and US Treasury (1977).

residences, on houses and other consumer durables are not subject to tax, and mortgage interest is not deductible, these elements of consumer expenditure are essentially taxed on a consumption basis. More importantly, a number of provisions in the *Income Tax Act* allow for tax-exempt savings. Elimination of annual taxes on capital gains in retirement savings plans results in this income being taxed on a consumption basis.[4]

RPPs may be either of the defined-contribution type, where the pension depends on the value of the assets accumulated within the plan, or of the defined-benefit type, where the pension is related to average, or final average, salary and years of service. A third type of plan, the deferred profit savings plan, is of lesser importance and is roughly equivalent to the defined-contribution RPP.

At present, contributions made by, or on behalf of, an individual to these plans are subject to annual limits of 18 percent of the previous year's earned income or $13,500, whichever is less. Contribution limits to RRSPs are reduced by contributions made to deferred profit savings plans and RPPs, with special pension adjustments[5] for defined-benefit RPPs. The government lowered the RRSP limit from $14,500 to the current level in 1996 and said the ceiling will not be raised before 2003.

Employer contributions to defined benefit plans are limited by actuarial requirements related to the funding of future pension benefits. Employee contributions to these plans are deductible within specified limits.[6]

However, for defined-benefit plans the key limits are the annual and lifetime pension-benefit accruals. At present, defined-benefit pension accruals are limited to the lesser of two percent per year of service, or $1,722.22. The annual pension-benefit accrual is the amount by which an individual's pension is increased by a year of service. The $1,722.22 cap effectively limits the maximum salary on which benefits can be accrued under a two percent per annum defined-benefit plan to $86,111. There is currently no lifetime limit on these accruals. These pension limits have not been significantly changed since 1976.[7] In 2001, the maximum defined benefit pension after 35 years of service was only 1.9 times the average industrial wage. In 1976, this pension was about five times the average industrial wage.

Another tax concession for retirement savings is the $1,000 pension-income credit. This measure, when combined with the age credit, helps to reduce the overlap between the clawback of the guaranteed income supplement (GIS) and the PIT. Unfortunately, as documented in Wilson (1997), a considerable overlap of the GIS clawback and the PIT remains, with punitive effective marginal rates of tax on pension income as a result.

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4 In the case of RPPs, employer contributions are also deductible against the employer's income (with earnings from these contributions also exempt from tax).

5 The PA for a defined benefit RPP is normally calculated as nine times the pension benefit accrual for the year, less $600.

6 These limits are nine percent of the individual's total annual compensation or $1,000, plus seven percent of the member's pension credit for the year, whichever is less. [CCH (2001) *Canadian Pension and Retirement Income Plan*, 2.]

7 The limit was increased to $1,715 per year in 1976. The small increment to $1,722.22 was put into effect with the 1991 Pension Reform.

Two other important provisions provide tax relief for savings. Registered education savings plans defer tax on the accumulations of income (such income is included in the student's taxable income once attending a qualifying institution) with a substantial grant to the plan, usually resulting in a subsidy towards this form of savings. Furthermore, savings for a principal residence via tax-free RRSP withdrawals result in a negative effective tax rate on investments in housing. These withdrawals are subject to a $20,000 limit per individual. Furthermore, any funds withdrawn must be paid back into the plan over a 15-year period, or be taxed.

The $500,000 capital-gains exemption for farmers and shares of qualifying Canadian-controlled private corporations represents another measure that can be viewed as providing consumption treatment for a form of savings. Farmers and small business owners who save through reinvesting in their businesses escape tax on up to $500,000 of realized capital gains. Although designed to aid small businesses, the exemption applies to shares in *all* Canadian controlled private companies, including large corporations. These capital gains exemptions are not targeted towards retirement savings; consumption financed through such capital gains effectively escapes taxation.

A Comparison with the United States

Although Canada's tax system provides a greater degree of flexibility, the US plans are more generous.

Canadian employers frequently compete for skilled workers by offering a compensation package that includes pension benefits. The competitiveness of the package can affect hiring, especially for mobile skilled workers in business, universities and health care. Employees who have competing offers from Canadian and US employers will be influenced by the pension benefits provided by them.

The US provides several types of tax-assisted plans for retirement. The most important are employer-provided 401K, 403(b) and 457 plans under which individuals can currently contribute up to US$11,000 as a deductible expense from income. Contribution limits will rise to US$15,000 by 2006. Individuals over 50 will be able to make additional contributions of as much as US$5,000 by 2006. Contributions to profit sharing or defined contribution plans are deductible to an annual maximum of $40,000, or 25 percent of up to $200,000 in compensation. Recent changes to US legislation provide for more portability among plans, though some restrictions still remain.

Although Canada's tax system provides a greater degree of flexibility to workers, the US plans are more generous — especially for senior salaried workers — because of their much higher limits. The US system therefore puts Canadian companies at a disadvantage in competing for high-skilled workers in North American labour markets.

Specific Features of the Tax-Transfer System and Effective Tax Rates

Neutral tax treatment of savings on a consumption basis would require that the effective marginal tax rate on consumption in each year be the same. With fluctuating or rising incomes, this is clearly impossible to achieve with a tax on annual income — or on annual consumption — at progressive rates. Averaging provisions would mitigate this problem.

As discussed above, an annual tax on income penalizes future consumption via the double taxation of savings. As earnings on savings outside of designated plans are taxed, future consumption financed by these savings is subject to a higher rate of tax than current consumption. This effect is mitigated if the individual is in a lower marginal rate bracket after retirement.

However, clawbacks of various transfer payments and tax credits tend to raise effective marginal rates after retirement. In addition to the GIS clawback, there are clawbacks of the age credit and the goods and services tax (GST) credit, as well as the clawbacks of old age security (OAS) pensions.

Clawbacks of the GIS and the GST credits are based on family income and affect marginal rates of lower-income and moderate-income pensioners. The clawback of the age credit is on an individual-income basis and affects middle-income pensioners in the $27,000-to-$51,000 range. The clawback of the old age security pension is on an individual basis and affects marginal rates for incomes between about $55,000 and $90,000.

As a result of these clawback provisions, many Canadians find themselves with *higher* effective marginal rates after retirement than before. Their effective tax rates on savings relative to consumption would be increased, worsening the non-neutral treatment of savings under the tax-transfer system. Furthermore, provincial supplements to the GIS, and a number of means-tested, in-kind benefit programs exacerbate this problem for lower-income seniors.

Family Income vs. Individual Income

The Canadian PIT system is designed to be primarily a tax on individuals. Spouses with low, or zero, income are recognized with non-refundable credits and children by the refundable "child tax benefit" — a transfer payment which is clawed back on the basis of family income. As noted, GST credits and the GIS are also clawed back on the basis of family income.

Certain credits — the age credit, charitable-contribution credits, pension credits and education and tuition credits — are transferable between spouses.

In general, income splitting is not permitted and complex attribution rules are designed to prevent it. However, there are two notable exceptions related to retirement income. First, spouses may elect to split their CPP/QPP pensions. Second, individuals may allocate part or all of their RRSP contributions to spousal plans. However, there are no such income-splitting provisions for RPP pensions.

Because of these features, the Canadian tax-transfer system is neither a completely individual nor a family one; again, it is a hybrid.

Has Canada been Moving away from a Consumption Base?

The Canadian PIT system has long been a hybrid, based on both consumption and annual income. However, the system has changed over the years, partly because inflation has eroded limits and partly because of governments' tax and pension policy initiatives.

With the exception of the initial effects of the 1991 pension reforms and the more recent establishment of the lifetime carryforward of unused RRSP

contribution room, several policy initiatives since the tax reform of 1971 have generally moved the PIT system away from a consumption base.[8]

Early Restrictions

The restrictions imposed on access to the retirement savings system go back to several policies adopted in the 1970s and 1980s. Over time, the system became less favourable to retirement savings because of:

- The government's failure to index pension and RRSP contribution limits when indexing was introduced in 1973. Without indexation, inflation steadily eroded the real value of these limits. Similarly, the failure to index pension accruals under defined-benefit pension plans has eroded the real value of potential pension-plan savings.
- The elimination in 1981 of income-averaging annuity contracts, shifting the PIT base towards annual income. Income annuity-averaging contracts enabled taxpayers to forward average qualified income for up to 15 years with term-certain annuities and lifetime forward average with life annuities. Qualified income included major sources of fluctuating income, as well as capital gains.
- The 1987 tax reforms included measures that moved the PIT system towards an annual income base — in particular, by eliminating a $1,000 investment-income deduction and general averaging.

As a result of the 1981 and 1987 measures, averaging was eliminated for most taxpayers — limited averaging remained for farmers and fishermen.

The 1991 and Subsequent Measures

Even when changes were intended to improve access to tax-assisted retirement savings, they sometimes fell far short in achieving this objective, largely because of revenue considerations. In particular, the 1991 Pension Reforms were designed to "level the playing field" for contributors to RPPs and RRSPs. Prior to these adjustments, RRSP annual limits for non-participants were $5,500 (before 1986) and $7,500 (1986–1990) for taxpayers who did not participate in RPPs. This amount was inadequate to finance retirement income as generous as that provided by RPPs.

Further, a major improvement to the RRSP system was introduced in 1991. Prior to that year RRSP contributions for a year had to be made within 60 days of the end of the year; any unused RRSP contribution "room" was lost. In 1991, unused RRSP contribution room could be carried forward for seven years. In 1996/97, this seven-year carryforward was replaced by an indefinite timeframe. This important reform represents one step towards lifetime averaging for RRSP contributions.

The government initially designed the 1991 Pension Reform to raise RRSP limits to $11,500 and then by $1,000 a year until reaching $15,500 in 1995, when

8 The pension adjustment was another helpful amendment, restoring contribution room to RPP members who received low termination benefits upon quitting a plan.

Table 1: ***RRSP Contribution Limits 1973–2001***

Year	Percent of Earned Income Limits	Absolute $ Limit		Absolute Limit in Constant 2001 Dollars *(not in RPP)*
		Not in RPP	In RPP[b]	
1973	20	4,000	2,500	16,595
1974	20	4,000	2,500	14,956
1975	20	4,000	2,500	13,513
1976	20	5,500	3,500	17,277
1977	20	5,500	3,500	15,996
1978	20	5,500	3,500	14,682
1979	20	5,500	3,500	13,453
1980	20	5,500	3,500	12,213
1981	20	5,500	3,500	10,862
1982	20	5,500	3,500	9,803
1983	20	5,500	3,500	9,261
1984	20	5,500	3,500	8,879
1985	20	5,500	3,500	8,540
1986	20	7,500	3,500	11,179
1987	20	7,500	3,500	10,713
1988	20	7,500	3,500	10,296
1989	20	7,500	3,500	9,807
1990	20	7,500	3,500	9,361
1991	18[a]	11,500	11,500-PA[c]	13,590
1992	18	12,500	12,500-PA	14,555
1993	18	12,500	12,500-PA	14,289
1994	18	13,500	13,500-PA	15,407
1995	18	14,500	14,500-PA	16,198
1996	18	13,500	13,500-PA	14,847
1997	18	13,500	13,500-PA	14,610
1998	18	13,500	13,500-PA	14,466
1999	18	13,500	13,500-PA	14,220
2000	18	13,500	13,500-PA	13,842
2001	18	13,500	13,500-PA	13,500

Source: Canadian Tax Foundation.

a After 1990, the limit of 18 percent relates to the previous year's income.

b "In RPP" prior to 1991 relates to an individual who is a member of an RPP to which his/her employer contributes. After 1991 it refers to an individual who is a member of an RPP.

c PA refers to the "Pension Adjustment," which is the dollar amount contributed to money purchase plan RPPs and an equivalent amount for defined benefit RPPs based on a complex formula. Up to 1995, the PA is adjusted so that members of an RPP have at least $1,000 of contribution room for RRSPs.

they would be indexed. In subsequent federal budgets, limits were frozen and then rolled back to $13,500 in 1996. Currently, the proposed limits are $13,500 for 2003, $14,500 for 2004 and $15,500 for 2005, when they will be indexed.

The 1991 measures also redefined earned income to exclude pension benefits and other forms of retirement payments and eliminated the transferability of pension income into RRSPs. The latter measure was mitigated by a transitional provision allowing $6,000 annual transfers to spousal RRSPs until 1994.

Further Restrictions

In recent years, other measures have served to limit retirement savings. In 1996, the government eliminated rollover provisions, which enabled retirement allowances to be transferred into RRSPs. In the same year, the age at which RRSPs must be annuitized, or converted to Registered Retirement Income Funds (RRIFs), was lowered in two steps over two years from 71 to 69.

Contribution Limits and the Impact of Inflation

The evolution of the RRSP system since 1973 is summarized in Table 1. Although RRSP dollar limits have been increased several times in the past, inflation has steadily reduced the real value of these limits. As a result of non-indexation of the limits, the real value of the ceiling for 2001 is lower than the limits of the mid-1970s. If the limits were deflated by a wage index instead of a price index, the deterioration would be even greater.

Although the pension changes of the early 1990s initially restored the real value of the limits to that of the mid-1970s, the rollback and freezes of the nominal limit

Table 2: ***RRSP Contributions 1985–1999*** *($millions)*

Year	Total Income	RRSP Deductions Amount	RRSP Deductions As Percent of Income	RRSP Limits[a]
1985	307,552	6,672	2.17	5,500 *(20%)*
1986	327,712	7,920	2.42	7,500 *(20%)*
1987	353,261	9,024	2.55	7,500 *(20%)*
1988	393,389	10,600	2.69	7,500 *(20%)*
1989	431,845	11,938	2.76	7,500 *(20%)*
1990	455,074	10,626	2.34	7,500 *(20%)*
Average 1986–90		10,022	2.55	
1991	465,694	13,371	2.87	11,500 *(18%)*
1992[b]	473,434	14,784	3.12	12,500 *(18%)*
1993[b]	484,068	17,500	3.62	12,500 *(18%)*
1994[b]	526,976	19,285	3.66	13,500 *(18%)*
Average 1991–4		16,235	3.32	
1995[b]	509,883	21,163	4.15	14,500 *(18%)*
1996[b]	530,073	23,757	4.48	13,500 *(18%)*
1997[b]	558,460	25,347	4.54	13,500 *(18%)*
1998[b]	577,068	26,460	4.59	13,500 *(18%)*
1999[b]	625,417	26,595	4.25	13,500 *(18%)*
Average 1995–9		24,664	4.40	

Source: *Taxation Statistics for 1985–1999,* table 2, Canada Department of National Revenue.

a Absolute dollar limits with percent of income limitations in parentheses. Note that, after 1990, the percent of income limitation is based on the previous year's income.

b "Total income" is adjusted to exclude "tax exempt income"in order to be comparable to data for prior years.

at $13,500 for the period since 1995 has reduced the real limit by 17 percent.

Relative to the original objective of a limit of $15,500 in 1995 with subsequent indexing, today's $13,500 limit is 22 percent lower in real terms that it was in the mid-1970s. Had the government not imposed the freeze and rollback and had it indexed on schedule, the limit in 2001 would have been $17,314.

Other features of the pension measures of 1991 actually reduced the RRSP contribution room for many taxpayers.

Individuals whose contributions were limited by the percent of income had less contribution room after the reforms. The measures lowered the percentage limits to 18 from 20. In addition, after 1990 the limits for a year were based on the previous year's earned income.

The reforms also lowered RRSP contribution room for many RPP participants. Prior to 1991, members of RPPs whose employers contributed to their plans could add up to $3,500, less their own RPP contributions. After the changes, RPP members' contribution room was limited by the dollar RRSP limit, minus the Pension Adjustment. Initially, the PA was changed to leave at least $1,000 of RRSP room, but this measure was eliminated when the RRSP limit was rolled back to $13,500 in 1996.

Summary

The present PIT system in Canada is more focused on an annual income base than the PIT system of the mid-1970s. Averaging has been eliminated and RRSP contribution limits are generally lower relative to income. Inflation steadily eroded allowable pension accruals under defined-benefit RPPs. One particular innovation has relaxed some of the restrictions discussed above, the carryforward of unused contribution room that provides more flexibility to taxpayers. However, inequities and inefficiencies remain in the system.

Reforming the PIT System

We believe that two principles should guide the reform of the PIT system. First, whether income, consumption or a mixture is the base of the tax, taxation should not be based on an annual measure. Ideally, lifetime averaging should be implemented. Second, the tax base should be shifted towards consumption, in order to mitigate the divergence of effective rates on current and future consumption.

The most important set of reforms that we recommend relate to the RRSP/RPP system. The various contribution limits within the system should be increased and the system should be moved to a full lifetime basis. Other measures could also help reduce tax penalties on savings. Implementing these reforms would alter the incidence of taxes across age cohorts. Seniors would likely face higher effective rates over the transition period and some transitional tax relief might be required to offset increased tax burdens.

Improving Contribution Limits

As noted, real contribution limits today are lower than they were in 1976 and lower than they would have been had the government followed the original pension reform blueprint. Specifically, the government could make several improvements to provide greater incentives for retirement savings:

- At a minimum, RRSP contribution limits should be raised to $17,500 for 2003, with full indexing in the years following. This would move the limits on to the schedule originally set out in the 1991 Pension Reform. However, consideration should be given to higher RRSP limits. A ceiling of $18,300 would approximately restore the RRSP limit to its 1976 position relative to average labour income.
- Similarly, the government should substantially increase pension accruals under defined-benefit RPPs, in line with the increases in RRSP limits.
- In addition to the increase in absolute dollar limits, the annual percentage limit should be restored to 20 percent of income. Taxation officials should consider increasing the percentage limit further to 30 percent of income, the value originally recommended by the Economic Council of Canada. Increasing the contribution limits would move the PIT system further towards a consumption base.

Improving Life-Time Averaging

While increased limits are important, the system should also be modified to place it on a lifetime basis. The establishment of indefinite carryforwards for unused RRSP contribution room was a first step towards lifetime averaging. It is time to take the remaining steps that are required for complete lifetime averaging for RRSPs and RPPs. These are:

- Taxable withdrawals from an RRSP in a year should create additional future RRSP contribution room. With the indefinite carryforward of contribution room, this provision is simple to administer.
- Government should enable taxpayers, whose earned income in a year is in excess of the amount that generates the maximum RRSP contribution, to carry back or forward to create additional RRSP contribution room in years when earned income is below the RRSP maximum limits.
- Consistent with this lifetime treatment of RRSP contributions and withdrawals, taxpayers should be able to contribute pension payments from RPPs to RRSPs — i.e., pension "withdrawals" from RPPs would create future RRSP contribution room in the same way as withdrawals from RRSPs. The establishment of a lifetime earnings-based RRSP/RPP system will introduce more complexity, but modern information technology can easily deal with this.
- The age limit at which RRSPs must be annuitized, or converted to RRIFs, was lowered from 71 to 69 in the federal budget of 1996. This measure, perhaps driven by fiscal requirements, is the opposite of what demographic trends would indicate, since life expectancies, at age 70 in 1996, were almost two years longer than in 1976. At a minimum, the age limit should be restored to 71, but we would argue that, with current life expectancies, 73 would be a more appropriate age limit. Raising the age limit is particularly important for women, whose life expectancy at age 70 is about five years longer than that of men.
- As discussed earlier, income splitting between spouses is generally forbidden, with the two exceptions of CPP/QPP pension and spousal contributions to RRSPs. These measures enable RRSP participants to effectively split income with their spouses. At present, however, RPP participants cannot split pension income. This inequity can be resolved by permitting RPP pensions to be shared under the same rules as CPP/QPP pensions.

Restoration of Income Averaging

The lack of general averaging provisions in the Canadian PIT penalizes taxpayers with fluctuating earnings relative to those with stable, or gradually increasing, incomes. This tax penalty will be highest for those who undertake risky activities and for those who spend a long period in education and training.

Although the proposed reforms to the RRSP/RPP system will enable it to be used for income averaging, this use of retirement savings is limited and does entail the cost of foregone earnings within these retirement accounts.

The former income-averaging annuity contracts (IAAC's), originally proposed as a general averaging device by the Carter Royal Commission, should be reinstated. However, these revamped income-averaging annuities should be general in scope and not restricted to particular sources of income.[9]

9 To prevent the abuse of the IAAC system, borrowing costs incurred to finance the acquisition of IAACs should not be deductible. Note that any deferral of tax under the IAAC system is...

Because income-averaging annuities only enable individuals to forward average their earnings, they should be supplemented by a general backward-averaging provision as well. Backward averaging over a five- or seven-year period would allow individuals to average their incomes over past years and mitigate the effects of annual progressive rates. Backward averaging is particularly important for young professionals early in their careers.

Rationalizing the Clawback System

Clawbacks of transfer payments and tax credits can face pensioners with higher effective marginal tax rates after retirement than before. As shown by Wilson (1997), the overlap of the clawback of the GIS and the PIT generates very high effective marginal rates for lower-income seniors.

Towards the other end of the income distribution, the clawback of old-age security typically augments effective marginal tax rates by eight-to-ten percentage points. The clawback of sales-tax credits and age credits raises effective marginal tax rates by five percent and three percent respectively for middle-income seniors.

This clawback system will inevitably involve some distortions of effective marginal rates for some taxpayers. Short of abolishing these clawbacks, which is beyond the scope of this paper, we should focus on mitigating the most egregious distortion — namely, the overlap of the 50 percent GIS clawback with the PIT. This problem can be remedied by increasing the age credit so that there is no overlap of the GIS clawback with the PIT. The income threshold for the clawback of the age credit can be lowered to partly offset the revenue cost of this measure.

There is a serious concern that Canada's taxation of savings will compromise Canadians in their ability to save for the future.

Conclusions

The retirement-savings system under the Canadian personal income tax has been eroded by inflation over the years. Although the Pension Reform of 1991 was designed to improve the situation, subsequent policies have exposed the system to further erosion. In addition, other policy changes have limited rollovers, lowered the age of conversion and eliminated averaging, moving the Canadian income tax system back towards an annual-income basis.

Canada's tax treatment of retirement raises two serious concerns. The first is that taxation of savings will compromise Canadians in their ability to save for future purposes, especially at a time when demographic changes in society will lead to a significant enlargement of the aging population "bubble," supported by a non-growing working-age population. The second is that Canada's treatment of retirement savings is now less competitive than that in the United States, thereby affecting salary negotiations for high-skilled, mobile workers who are offered competing jobs in both countries.

Note 9 - continued

...compensated by the taxation of future interest accruals within IAAC payments. As was the case in the past, such backward averaging could be implemented automatically by the CCRA when it is favourable to the taxpayer. However, with modern tax software, individuals should be able to check how backward averaging would affect their tax payments.

To remedy this situation, we recommend that retirement savings limits be restored to the track originally proposed in the 1991 Pension Reform, with concomitant increases for pension accruals under defined-benefit pension plans. We also recommend that the retirement savings system be shifted to a lifetime averaging basis. Other changes that should be implemented include the restoration of averaging and modification to the clawback system for transfer payments.

The federal government's planned late-February budget offers an optimal opportunity to introduce just such reforms.

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