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Communiqué

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Government policies penalize retirement saving by low-income Canadians, says C.D. Howe Institute study

Federal and provincial tax and transfer policies effectively confiscate the retirement savings of low-income Canadians, says a *C.D. Howe Institute Commentary* released today. It urges numerous steps to fix the problem, ranging from new retirement savings accounts that would provide tax-free income to seniors, to lower clawbacks in means-tested programs such as the Guaranteed Income Supplement (GIS) and provincial drug plans

The study, entitled "The Dark Side of Targeting: Retirement Saving for Low-Income Canadians," was written by Richard Shillington, Principal of the consulting firm Tristat Resources and one of Canada's foremost experts on issues affecting low-income Canadians.

Shillington documents how programs intended to raise the living standards of the less-well-off elderly end up subjecting their recipients to very high effective marginal tax rates — sometimes over 100 percent. He shows how clawbacks — such as the 50 percent reduction rate that applies to GIS benefits and to various provincial top-ups to the GIS — can reduce seniors' incomes by a full dollar for every dollar of income they receive from their retirement savings. For seniors who receive dividend income, each dollar of income from retirement savings can trigger a clawback exceeding one dollar. Even for seniors outside the range of 100 percent clawbacks, the stacking of income taxes on top of GIS reduction rates typically produces effective tax rates that are higher in retirement than they were during working life. For many of these people, saving in a pension plan or RRSP is a mistake.

Shillington argues that not only is the current system unfair to modest- and low-income Canadians, of whom most are unaware of the pitfalls, but that discouraging retirement saving harms Canadians generally.

To solve this dilemma, Shillington makes two types of recommendations. First, he urges reform of current targeted benefits to address some of their most perverse effects and generally to reduce clawbacks to less punitive levels. The calculation of GIS benefits, in particular, needs reform, he says, but reducing effective marginal tax rates will require better coordination among a range of provincial and municipal programs.

Second, Shillington notes that well over a million Canadians with incomes under $20,000 contribute to employer-sponsored pension plans or RRSPs, and that many of these people would ultimately be better off saving in other forms or not at all. Accordingly, he argues that governments need to explain more clearly to low- and modest-income Canadians how the retirement income system works. He also recommends a new type of pension plan aimed at helping those Canadians avoid the consequences of saving in inappropriate forms. Such a plan would provide no tax relief for contributions (when low-income participants typically face relatively low tax rates) but grant relief on distributions (when their tax rates would typically be much higher).

If governments are unwilling to act, Shillington concludes, volunteer organizations and the financial services industry should undertake an educational campaign aimed at low-income Canadians.

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For further information, contact:

Richard Shillington (613) 692-1551
Bill Robson; Shannon Spencer (media relations),
C.D. Howe Institute
phone: (416) 865-1904; fax: (416) 865-1866;
e-mail: cdhowe@cdhowe.org;
Internet: www.cdhowe.org

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C.D. Howe Institute
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Communiqué

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Selon une étude de l'Institut C.D. Howe, les politiques gouvernementales sont préjudiciables aux Canadiens à faible revenu

Les politiques fiscales et de transfert du gouvernement fédéral et des gouvernements provinciaux s'accaparent l'épargne de retraite des Canadiens à faible revenu, affirme un *Commentaire de l'Institut C.D. Howe* publié aujourd'hui. Ce dernier propose diverses mesures qui régleront le problème, telles que de nouveaux comptes d'épargne-retraite qui fourniraient un revenu exonéré d'impôt aux personnes âgées et des dispositions de récupération plus modestes en fonction des ressources pour des programmes comme le Supplément de revenu garanti (SRG) et les programmes d'assurance-médicaments.

Intitulée « The Dark Side of Targeting: Retirement Saving for Low-Income Canadians » (« La face cachée des prestations ciblées : l'épargne de retraite des Canadiens à faible revenu »), cette étude est rédigée par Richard Shillington, directeur de la société d'experts-conseils Tristat Resources et l'un des principaux spécialistes des questions afférentes aux Canadiens à faible revenu.

M. Shillington explique comment les programmes conçus pour améliorer le niveau de vie des personnes âgées moins bien nanties finissent par imposer des taux marginaux d'imposition réelle très élevés, dépassant parfois 100 %. Il montre de quelle manière les dispositions de récupération — comme le taux de réduction de 50 % qui s'applique aux prestations de SRG et aux diverses prestations provinciales complémentaires à celle-ci — peuvent réduire le revenu des personnes âgées d'un dollar pour chaque dollar qu'elles puisent dans leur épargne de retraite. En fait, dans le cas des personnes âgées qui reçoivent un revenu de dividendes, chaque dollar de revenu provenant de leur épargne de retraite peut entraîner une récupération qui dépasse un dollar. Et même pour ce qui est des personnes âgées qui n'entrent pas dans la fourchette de récupération de 100 %, l'accumulation des impôts sur le revenu ajouté au taux de réduction du SRG produit généralement un taux d'imposition réel qui dépasse celui auquel elles étaient assujetties durant leur vie professionnelle. Pour bon nombre de cas, mettre de l'argent de côté par le biais d'un régime de retraite ou d'un REER est donc une erreur.

L'auteur souligne que non seulement le système actuel est-il injuste envers les Canadiens à revenu faible ou moyen — et beaucoup d'entre eux sont ignorants du piège — mais qu'en décourageant l'épargne pour la retraite, on cause du tort aux Canadiens en général.

M. Shillington propose deux ensembles de recommandations pour résoudre le dilemme. Il suggère en premier lieu une réforme des prestations ciblées pour éliminer certains des effets les plus iniques et réduire les dispositions de récupération à des niveaux moins punitifs. Le calcul des prestations de SRG a particulièrement besoin d'une réforme, affirme-t-il, mais la diminution des taux marginaux d'imposition réelle exige une meilleure coordination d'une vaste gamme de programmes provinciaux et municipaux.

De plus, explique M. Shillington, plus d'un million de Canadiens dont le revenu est inférieur à 20 000 $ cotisent à des régimes de retraite d'employeur ou à des REER; or, la plupart ferait mieux d'épargner d'une autre manière ou de ne pas épargner du tout. Par conséquent, il soutient que les gouvernements devraient expliquer plus clairement aux Canadiens à faible et à moyen revenu comment fonctionne le système de revenu de retraite. Il recommande également un nouveau type de régime de retraite visant à aider cette catégorie de Canadiens à éviter les pièges de certaines formes d'épargne. Un tel régime n'offrirait aucun allégement fiscal pour les cotisations (lorsque les participants à faible revenu ne se verraient assujettis de toute façon qu'à un taux d'imposition relativement faible), mais accorderait un allégement sur les prestations (lorsque le taux d'imposition serait généralement plus élevé).

Si les gouvernements ne sont pas prêts à agir, conclut M. Shillington, ce sont les organismes bénévoles et le secteur des services financiers qui devraient entreprendre une campagne de sensibilisation des Canadiens à faible revenu.

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Renseignements : Richard Shillington 613 692-1551;
Bill Robson, Shannon Spencer (relations avec les médias),
Institut C.D. Howe
téléphone : 416 865-1904, télécopieur : 416 865-1866;
courriel : cdhowe@cdhowe.org,
Internet : www.cdhowe.org

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The Dark Side of Targeting:

Retirement Saving for Low-Income Canadians

by

Richard Shillington

Canada's income support system has significantly reduced poverty rates among the elderly, but it continues to penalize low-income Canadians who try to save for their retirement. Under current rules on income testing, any money they save for retirement simply reduces their eligibility as seniors for income, health care, and social support. Yet thousands of low-income Canadians, unaware of the way the system works, continue to try to save for retirement in ways that disadvantage them.

For example, many middle-income Canadians use registered retirement savings plans (RRSPs) as a tax shelter, but RRSPs are of little value for low-income Canadians and can actually reduce their assets. Most low-income seniors would, in fact, be better advised to purchase a home (since most programs are not asset tested) or to invest where they can outside an RRSP.

What is now needed is a policy debate about the savings disincentives for low-income Canadians. That discussion should include changing the income definitions of the Guaranteed Income Supplement to remove its perverse treatment of dividends; developing tax mechanisms so that low-income Canadians receive tax assistance for their retirement savings similar to that enjoyed by middle- and high-income Canadians (perhaps through a mechanism similar to the Roth Individual Retirement Account used in the United States); and coordinating federal, provincial, and municipal government programs with respect to the income testing of social programs to avoid perverse effective tax rates. Finally, if governments and policy planners remain unwilling to tackle the perversity of the current system's administrative rules, then volunteer organizations and the financial services industry should undertake an educational campaign aimed at low-income Canadians.

Main Findings of the Commentary

- Canada's income assistance for seniors starts with Old Age Security (OAS), a taxable entitlement (just over $4,885 annually in 1998) that is almost universal, which is clawed back from individuals with incomes of roughly $53,215 and over.
- Seniors who are less well off (for example, singles with income of less than $16,520 *including* OAS benefits in 1998) can receive the Guaranteed Income Supplement (GIS), which in 1998 amounted to a little more than $5,805. Eligibility is tested against *family* income, and benefits are reduced by 50 cents for each dollar of non-OAS income.
- Many provinces provide GIS top-ups for the poorest of seniors (for example, singles with non-OAS income of less than $2,000). These benefits are also clawed back at 50 cents on each dollar of non-OAS income. Thus, recipients face an effective taxback of 100 percent of extra income.
- The definition of income used by the GIS and the provincial top-up programs creates pitfalls for low-income seniors. For example, for taxable seniors it includes the *grossed-up* value of dividends, so that they are, in effect, taxed back at 62.5 percent (50% × the 125% gross-up).
- The bizarre effects of the GIS taxback and the phase-out rules for other income-tested benefits interact with the income tax brackets to produce a complex marginal rate structure for the one-third of GIS recipients who must pay tax. The combined effect is that the highest effective rates fall on Canadians who have the lowest incomes — often women and older seniors.
- Some low-income Canadians make great efforts to save for retirement via the usual vehicles: registered retirement savings plans (RRSPs), unregistered investment accounts, pension plans, and home ownership. A little arithmetic reveals that they are unlikely to benefit from the tax advantages of RRSPs and pensions. Indeed, if they encounter a 75 percent effective tax rate in retirement, participation in such plans can leave them significantly worse off.
- Saving in a retirement account, tax sheltered or not, presents another trap for low-income Canadians who have to turn to social assistance. The eligibility rules require liquidating such assets.
- Home ownership does not generally affect eligibility for social assistance, but increasing property taxes and purchase prices make it impractical in most urban areas.
- The array of provincial health care and social supports also complicates matters. Eligibility for most is income tested, and for some it is asset tested. Given effective tax rates of 50 to 100 percent for low-income seniors, such testing of programs usually means that the consequence of a lifetime of prudent saving is a minimal increase (or no increase) in disposable income and perhaps ineligibility for needed help.
- Despite the potential traps of the current system, low-income Canadians can obtain little information on how best to prepare for retirement. If governments and policy planners remain unwilling to tackle the perversity of the administrative rules, volunteer organizations and the financial services industry should undertake an educational campaign.

Canada's current system of income support has done an admirable job of reducing the proportion of seniors who have incomes below Statistics Canada's low-income cutoffs — from 34 percent as recently as 1980 to 19 percent in 1996, although poverty rates for single seniors remain very high at about 45 percent (Canadian Council on Social Development 1999). Yet success judged by anti-poverty criteria does not erase failure against other criteria, such as fairness and rewards to savings.

The system now in place ensures the majority of seniors a relatively comfortable retirement but makes it virtually impossible for low-income seniors to improve their retirement income. Their savings attempts are hardly rewarded at all. Under the current rules, any money they may have saved for retirement simply reduces their eligibility for income, health care, and social support. As the Canadian Chamber of Commerce notes:

> For Canadians at low income levels the system says "do not save — public programs will provide you with a minimum income in retirement that you will not be able to significantly augment through your own savings efforts." (Canadian Chamber of Commerce [n.d.], 2.)

One might ask why anyone should care. After all, low-income seniors are assured a tolerable standard of living, and the significant savings disincentives are important only if people know about them. The problem is one of equity and social desirability. I can imagine embarking on an educational campaign to suggest that low-income Canadians "smarten up" and stop even trying to save for retirement because their efforts are counterproductive. If the campaign were even partially successful, the result would be a lower savings rate and harm to society.

No one has started such a revolt. Thousands of low-income Canadians continue to save for retirement in ways that disadvantage them. Given the paucity of their income, this savings effort must require a substantial sacrifice, yet, unknown to them, the major beneficiaries are governments.

As I demonstrate below, Canada's system of tax-subsidized retirement incentives and protections assists middle- and higher-income Canadians, but for lower-income seniors the effect of income testing support generally more than offsets the tax benefits and often punishes those who would have saved for retirement.

One would expect that this obvious unfairness would be sufficient motivation for Ottawa to take remedial action. Yet it apparently continues to hope that low-income Canadians will save for their retirement despite the disincentives.

Consider that the past decade has seen several policy debates related to retirement: the discarded proposal for the Seniors Benefit, which would have reduced the demographically related cost increases for Old Age Security (OAS); the increase in Canada and Quebec Pension Plan (QPP/CPP) contributions; and the increase, rollback, and freezing of contribution limits to registered retirement savings plans (RRSPs). During each of these debates, experts acknowledged that the current tax and transfer scheme provides low-income Canadians with little or no reward for any retirement savings they may manage. Yet neither government nor the policy community has given much attention to remedying the situation.

Thus, the primary intention of this *Commentary* is to motivate a policy debate about the savings disincentives for low-income Canadians. Because the system is very complex and remedies require further research, policy analysis and program changes, and the coordinated efforts of three levels of government,

I would like to thank, for very useful comments and suggestions, Bill Robson, John Richards, and Malcolm Hamilton.

I concentrate on the problems that exist. Remedying them would include:

- Modifications to the income support system to eliminate perverse effective tax rates and anomalies in the operation of the Guaranteed Income Supplement (GIS). This repair would include removing the various financial pitfalls into which seniors can stumble and encounter effective tax rates exceeding 100 percent. Part of the adjustment could include designing vehicles for low-income Canadians that would relieve their retirement saving from double taxation.
- A campaign to explain to low-income Canadians how best to improve their retirement income — by, for example, saving through buying a principal residence and investing outside RRSPs and private pensions.

The paper begins by explaining the operation of OAS/GIS and, in particular, the idiosyncrasies in the income definition used for the GIS. It demonstrates the exclusion of low-income Canadians from tax assistance for retirement savings. It then discusses the compounding of the problem by the income testing of provincial income, health care, and social support. Finally, it describes recent aborted reform proposals (the Seniors Benefit and those contained in the 1998 federal budget) and considers educating low-income Canadians about their current best choices in retirement planning (surely a good way to begin repairing the system).

The policy discussion I call for must address the balance between imposing disincentives and using very high marginal tax rates to target programs and hold down their cost (see Box 1). For seniors, the evidence below suggests that income testing has gone so far as to create perverse outcomes.

This circumstance should make people uncomfortable. For those who want government programs that encourage self-reliance and who desire a culture that encourages a savings and investment mentality, the current arrangements are a problem since they do not reward such behavior. Further they tell low-income Canadians to relax: after a lifetime of struggle at the margins of the economy, governments will ensure that your standard of living at retirement will not drop; in fact, some will see an increase in their standard of living when, at age 65, welfare is replaced by OAS/GIS. The rules also ensure that, as Davies puts it, it is "financially unattractive for many low-income Canadians to save much for retirement" (1998, 18).

Income Support for Seniors

Income assistance for seniors can be thought of as comprising several programs in each of three tiers: (1) public income support; (2) public income replacement; and (3) private income replacement.

In the first tier are:

- The OAS, a taxable support-level benefit that is an entitlement based on age (along with citizenship and residency). Traditionally, it has been seen as the universal basic support, although benefits are clawed back from individuals with income of more than $53,215.
- The GIS, a program tested against family income that provides maximum benefits to low-income seniors. Benefits are reduced by 50 cents for each dollar of non-OAS income.
- The Spousal Allowance, a program similar to the GIS, for individuals ages 60 to 64 who are widowed or married to GIS beneficiaries. (Curiously, low-income single seniors are eligible for support if they are widowed, but not if they are never married or divorced. The relationship between

Box 1: *Marginal Tax Rates and Targeting*

The circumstances of low-income support for seniors can be characterized as a tolerable living guarantee with very high effective marginal tax rates.

The phrase "marginal tax rate" is the economist's designation of the proportion of income paid to government on the last dollar of income. An example familiar to most Canadians results from the graduations of the federal personal income tax. An individual whose taxable income is less than $29,590 pays 17 percent of it to Ottawa. If his taxable income is $29,600, he pays 26 percent of that extra $10, and his marginal rate is 26 percent.*

All income support programs encounter a basic tension: the tradeoff between adequacy and marginal tax rates (and work/saving disincentives associated with the latter). Any reduction in the marginal tax rate decreases targeting, drastically increases support levels, and is expensive unless support levels are generally reduced.

In the extreme, the choice is between programs that are "universal" (where there is no direct income testing, although benefits are usually taxable) and expensive and those that are targeted (that limit benefits to the most "deserving"). The latter are less expensive but they discourage saving and employment.

The obvious example of a highly targeted program is social assistance, or welfare, which tends to have 100 percent marginal tax rates in order to concentrate benefits on those most in need. Such a high taxback makes it very difficult for families, particularly those with children, to work their way off welfare.

* The term "effective tax rates" includes the combined effect of income tax rates and the reduction rates associated with income-tested transfer payments.

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marital status and economic need is not self-evident.)

The second tier is the public pension plans, in which participation is mandatory:

- The CPP/QPP provides a basic pension for all retired Canadians who have been employed. The basic level of support is about 25 percent of average pensionable earnings.
- The CPP/QPP also provides death, disability, and survivor benefits.

The third tier is tax-assisted retirement savings. It comprises:

- RRSPs, which offer an opportunity for retirement savings plus tax advantages in several forms: deductibility of contributions, deferral of taxes owing on the contribution and income earned in the plan, and the tax rate at withdrawal, which, for many Canadians, is lower than the tax rate at the time of contribution. But the GIS ensures that, for low-income Canadians, the tax rate when funds are withdrawn is generally higher than at the time of contribution.
- Private pension plans, which offer the same tax advantages as RRSPs — and the same disadvantage for low-income Canadians. It is worth noting that, although these plans are often called voluntary, a worker's terms of employment may require participation.
- Deferred profit-sharing plans, in which low-income seniors are unlikely to have participated.
- Registered retirement income funds (RRIFs), which allow retirees to manage their invested funds and the money removed from that account.

Table 1 demonstrates several points. First, Canadian seniors are guaranteed tolerable incomes. For example, a single senior without any CPP/QPP or other source of income is guaranteed $10,692 ([$407.15 + $483.86] × 12) from the federal government. The same indi-

Table 1: *Benefit Levels for Federal Seniors' Programs, January 1998*

	Monthly Maximum Rate	Annual Income for GIS Cut-Off: Excluding OAS	Annual Income for GIS Cut-Off: Including OAS
		(dollars)	
OAS	407.15	—	—
GIS			
Single	483.86	11,634	16,520
Married to a pensioner	315.17	15,149	24,921

Notes: Eligibility for the GIS depends on income from sources other than OAS. This analysis ignores the CPP/QPP (maximum monthly retirement benefit is about $750).

vidual is also often eligible for provincial government benefits in the form of income and health care support.

Of course, given the relative generosity of the federal programs alone, they are expensive. As shown in Table 2, 3.7 million recipients share $22.5 billion. By comparison, for the Child Tax Benefit, roughly 6 million children share about $6.0 billion.[1]

Table 1 also reveals that GIS recipients are not a narrow, low-income fringe of seniors. The program extends to seniors with incomes of about $16,000 for singles and $25,000 for couples. Consequently, many GIS recipients also pay income tax.

Table 2: *OAS/GIS/Spousal Allowance Beneficiaries and Gross Benefits, 1998*

	Number	Annual Amount
	(thousands)	*($ millions)*
OAS	3,700	17,409
GIS	1,400	4,790
Spousal allowance	100	380
Total		22,579

Source: Based on statistical information provided by Canada, Department of Human Resources Development.

The GIS and Effective Tax Rates

The reduction rate of 50 percent associated with the GIS is not the only tax rate its recipients face. The total effective tax rate is often higher since low-income seniors may also be involved with other support programs.

One such program is the GIS top-up, which exists in each province west of Quebec and is a highly targeted provincial income guarantee for the poorest of seniors. Ontario's, for example, is available only to senior individuals and couples with non-OAS income of less than $2,000 or $4,000, respectively.

The marginal tax rate for the GIS top-up typically brings the effective tax rate of these seniors to 100 percent. To illustrate, a senior with an additional $1,000 of earned income has her GIS reduced by $500 and her provincial top-up reduced by an *additional* $500.

Overall, my modeled estimate is that about one-third of all GIS recipients — about 25 percent of singles and 50 percent of couples — pay income tax.[2] The implication is an effective tax rate of at least 75 percent for those paying income tax and receiving the GIS.[3]

Basic Marginal Tax Rate Structure

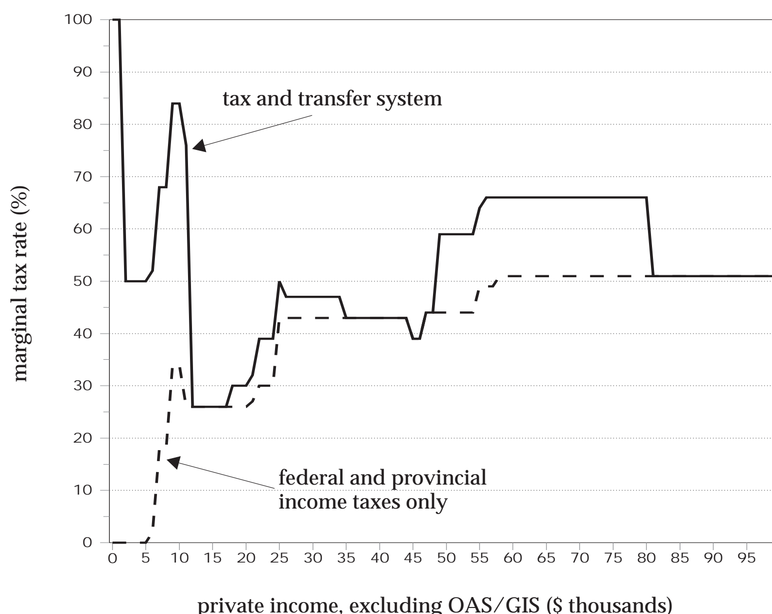
The interplay of the basic income tax structure and the different phase-out rules for various income-tested benefits — the GIS, the GIS top-

1 Based on data provided to the author by Human Resources Development Canada.

2 Analysis based on the Social Policy Simulation Database/Model (SPSD/M), from Statistics Canada. The results are my responsibility.

3 That is, 50 percent taxback + 17 percent federal personal income tax + 8 percent assumed provincial personal income tax. One advantage of the proposed Seniors Benefit was that, by incorporating OAS, currently a taxable transfer, into the nontaxable Seniors Benefit, it would have removed much of the overlap between the income-tested GIS and the income tax system.

Figure 1: ***Marginal Tax Rates on the Tax and Transfer System, Single Senior, Ontario, 1998***



up, the goods and services tax (GST) credit, and then the OAS — produces a complex marginal tax rate structure that is pictured in Figure 1. The lower line there traces the increases in the tax rate due to the tax's three brackets. The upper line includes the impact of the income-tested supports.

Notice the striking pattern. The income tax rates themselves increase with income — a progressive structure — but the effective marginal tax rates associated with income support decline. The combined effect is that the highest effective rates fall on those with the lowest incomes.

Income Definition for the GIS

The primary reason for this pattern of effective tax rates is the definitions of income the various programs use.

The GIS relies on income tax concepts for the basic information used to determine eligibility. Although this approach has the virtue of simplicity, it can lead to perverse results.

Moreover, although the income concept used to determine eligibility for the GIS is similar to that used for income tax, some important differences exist. Income for GIS purposes is net of contributions to the CPP/QPP and employment insurance (EI), as well as the employment expense deduction (although the latter was eliminated from the income tax system some time ago). But it includes dividends and capital gains as reported on the tax form.

The GIS's treatment of income from dividends is a particular anomaly that should be corrected. The personal income tax system works on the principle that, since corporations pay dividends out of after-tax earnings, they should be taxed at a lower rate in the recipients' hands.

The *Income Tax Act* implements this tax preference by first grossing up reported income and then providing a special credit. Thus, $1,000 of dividend income is reported as $1,250 of income (grossed up by 25.0 percent), but it generates a dividend tax credit of $167 (13.3 percent of $1,250). The combined effect is that dividends are overstated in reported income but ultimately taxed at a lower rate.

This method of treating dividends may be reasonable for the personal income tax but not for the GIS, which is administered on the basis of a definition of income that uses the *grossed-up* value of dividends. Thus, a senior who receives $1,000 of dividends has an apparent non-OAS income of $1,250, and his GIS benefit is reduced by $625 (50 percent of $1,250).

Effectively, dividends are taxable at a preferential rate for seniors who are not GIS recipients and at a higher, close to confiscatory, rate for GIS recipients. About 66,000 GIS recipients are subject to this perverse treatment of divi-

dend income, according to administrative data from Human Resources Development Canada.

The same data suggest that about 8,000 GIS recipients collect dividends but have such low total income that they are eligible for provincial GIS top-ups (where they exist). These programs use the federal GIS income definition. The implication is that, for the individuals involved, the effective tax rate, already 100 percent on earned income, is actually 125 percent on dividend income.

The federal government recently proposed changes in the treatment of dividends for the GIS. For recipients who do not pay income tax, only 75 percent of dividends would be included in income (like the treatment of capital gains). The proposal does not, however, extend this remedy to GIS recipients who pay income tax. The consequence would be that taxable GIS recipients would still face a rate of at least 70 percent on dividends.[4]

In contrast to its treatment of dividends, the GIS handles capital gains much as the income tax does. Only 75 percent of the cash value of a capital gain, net of capital losses, is included in GIS income. Thus, capital gains have a much smaller effect on the GIS than dividends.

The Pitfalls for Seniors

Most low-income seniors, like most low-income younger Canadians, are not sophisticated investors and do not access professional advice on retirement planning. Indeed, for many seniors, the time for planning and adjustment is past; they cannot now rearrange their affairs.

Thus, programs to aid them should be designed in such a way that the penalties for ignorance are minimal — that no pitfalls or traps could unfairly disadvantage an unwary senior. In other words, it is particularly important that programs for seniors be clear, simple, and easy to understand.

The current system, typified by the bizarre treatment of earned income, dividends, and capital gains for the GIS, clearly fails these criteria.

Savings

The GIS's treatment of investment income — income from savings — exemplifies the quandary. Even quite-low-income Canadians do attempt to save for retirement. In 1995, about 350,000 individuals with income under $20,000 contributed to private pensions and about 912,000 contributed to RRSPs (see Table 3). The average amounts were not great, but most must have required a sacrifice on the part of individuals at these income levels.

Although not all individuals with income under $20,000 are potential GIS recipients (some, such as students, have low income only temporarily), contributions to RRSPs and pensions by future GIS recipients are clearly not rare events.

But are such contributions in their makers' self-interest?

RRSPs

Table 4 compares the results for a low-income Canadian of saving inside and outside an RRSP. Specifically, the analysis computes the return from investing $1,000 at age 45 for someone in a 25 percent income tax bracket.

Outside an RRSP, the $1,000 grows to $2,276. The 5.6 percent nominal rate of return (3.5% + 2.0% — the difference is due to rounding) falls to 4.2 percent (75.0% of 5.6%) because of the annual taxation of returns at 25.0 per-

4 The proposed change, a step in the direction of correcting some anomalies for all GIS recipients with dividend income, was prompted by the demutualization of several insurance companies. As these companies become private, many thousands of Canadians, including low-income seniors, will receive proceeds, some as dividends and some as a capital gain.

Table 3: *Retirement Savings, 1995*

	Income < $20,000	All Incomes
	Number of Contributors *(thousands)*	
Pensions	351	3,651
RRSPs	912	5,728
	Contributions *($ millions)*	
Pensions	157	6,926
RRSPs	1,469	21,163

Source: Canada, Department of National Revenue, *Taxation Statistics*.

cent, but the resulting $2,276 is not income for GIS purposes and therefore is fully available to the senior.

Inside the RRSP, the investment enjoys the well-known advantages of providing a tax deduction, which can be reinvested, as well as a tax-free rate of return. The $1,000 grows to $3,942 at retirement, all of which is taxable and included in income for the GIS. The amount available depends on the individual's tax rate at retirement. If the effective tax rate is 50 percent, the amount available is $1,971, slightly less than the amount available from the investment outside an RRSP. But if the recipient has an effective tax rate of 75 percent, the amount available falls to $936, substantially less than the funds available from an investment outside an RRSP and, indeed, less than the original $1,000.

In other words, the high reduction rate for the GIS can offset the tax advantages of RRSPs.

The actual results depend, of course, on the age at investment as well as on the inflation rate and real rate of return. Generally, if real rates of return are about 3.5 percent and inflation is modest, an RRSP is preferred until the contributor is in his or her mid-thirties; with real rates of return of 6.5 percent, the edge continues into the mid-forties.

Other advantages of investing outside an RRSP are worth mentioning but not central to the discussion here: the invested funds are not subject to limitations on foreign content, and they can be cashed in to minimize the tax burden and need not be converted to an annuity or RRIF.

On the other hand, funds invested outside an RRSP do not have the provisions of an RRSP to facilitate spousal income splitting. (Spousal RRSPs usually provide some tax advantages by moving some income at retirement from the higher-income to the lower-income spouse.) The fact that the GIS is tested against family income while the tax system is based on individuals complicates the analysis, but some of the tax advantages of income splitting are denied to GIS recipients.

Private Pensions

The analysis of GIS recipients' having saved in an RRSP also applies to their saving in a private pension plan (whether it has defined contributions or actuarially fair defined benefits). The tax system does not favor these vehicles for retirement savings for future GIS recipients because their effective tax rate will be at least 50 percent and often over 75 percent.

Indeed, some contributors to a pension plan may be worse off than contributors to an

Table 4: ***Impact of a $1,000 Investment at Age 45***
(2.0% inflation, 3.5% real rate of return)

	Outside an RRSP	Inside an RRSP
Invested amount *($)*	1,000	1,333[a]
Nominal rate of return after tax *(%)*	4.18	5.57
Amount at age 65 *($)*	2,267	3,942
Amount subject to income testing and taxation *($)*	—	3,942
Amount available after income testing and taxation at 50% *($)*	2,267	1,971
Amount available after income testing and taxation at 75% *($)*	2,267	986

[a] The tax deduction associated with the RRSP is also invested. A taxpayer who invests $1,333 is entitled to a deduction of $333.

RRSP because the former may not have the choice of opting out of the pension plan. Their employment contracts thus compel them to save in a way that is not to their advantage.

Alternatives

If the tax advantages of RRSPs and private pensions do not operate effectively for low-income Canadians, then policymakers should explore alternatives. To begin the discussion, one could consider provisions of a vehicle such as the Roth Individual Retirement Account used in the United States. Contributions are not deductible, but the fund grows tax free and the proceeds attract no tax — treatment that is comparable to what Canada currently gives capital gains in a principal residence and funds in a registered educational savings plan.

Such a mechanism would provide limited financial rewards, but one can argue for an early tax-assisted savings scheme because it helps people develop a valuable saving habit.

It would also address a psychological concern about current disincentives to save. Many people would argue that saving should be assisted because it is a "virtuous" activity that reduces dependence on government and encourages a self-reliant attitude. A population with a broadly based saving and investing mentality offers advantages to the economy and to political life. If we want low-income Canadians to save for retirement, we should at least ensure they will be rewarded for it.

Social Assistance

The operation of the GIS (and top-ups) ensures that any retirement saving done in RRSPs will be taxed at a very high rate. Yet this complaint understates the problem. It does not include the way in which applicants for social assistance or residence in some long-term care facilities have all their RRSP income confiscated.

The possibility of any future need for social assistance gives low-income Canadians one more reason not to save for retirement. To understand this, consider how social assistance is typically needs tested:

- Ownership of a modest home does not generally affect eligibility for social assistance.
- Assets in a private pension or a locked-in RRSP do not affect eligibility.
- An RRSP or investment account renders a family ineligible while funds remain in it.

One can understand the reason social assistance is needs tested. Yet policymakers should not ignore the message sent to the increasing number of Canadians in precarious employment sectors: save for retirement in an RRSP or an investment account that is not locked up and you could be forced to liquidate it if you turn to social assistance.

Thus, low-income Canadians with savings in their home or a pension plan are somewhat protected if they must turn to social assistance. Yet these protections are often not practical or sufficient. Owning a home may be feasible, despite increasing property taxes in many provinces, in small towns or rural parts of Canada, but few low-income city dwellers can afford the cost. And some Maritimers are not protected if they seek the GIS top-up or long-term health care.

Pension plans are not widely available with the types of jobs that are increasingly prevalent for low-income Canadians. Where they do exist, they provide little or no tax assistance, as already described.

Provincial and Municipal Support

The analysis thus far has not considered health and social support for seniors that is operated by provinces and sometimes by municipalities, such as public drug plans, meals on wheels, subsidized housing, long-term care,

and home care/home support. These programs are usually income tested, and sometimes asset tested, but that is where the common characteristics end.

Given effective tax rates of 50 to 100 percent for low-income seniors, further income testing of support programs is tempting fate. Almost inevitably, such rules put seniors in a position where the consequence of a lifetime of prudent saving is a minimal increase, or no increase at all, in disposable income. Any additional income increases the cost of a health care or social support (home care or nursing home care) or makes the individual ineligible for programs such as public drug plans.

The issue of how income is defined to determine eligibility is important. Does a program use family income or individual income? Does family income include the income of children living with the beneficiary? Is the applicable figure total income, net income, or disposable income? To add to the complexity, some programs are asset tested, using various definitions of assets that may or may not include the home. These circumstances are so complex that perverse outcomes are virtually guaranteed.

The pileup of effective marginal tax rates creates a pattern in which the highest rates are at low incomes and hence are more likely to be experienced by women and older seniors. As well, income testing at high rates for long-term care also ensures that, as seniors age and require greater care, their marginal tax rates increase.

In such a system, with income support already taxed at, or even over, 100 percent, further income testing for health care and social support seems excessive.

Recent Federal Initiatives

Two recent, aborted federal initiatives — the Seniors Benefit and certain 1998 budget provisions — illustrate that Ottawa is still unaware of the need to address the issue of savings disincentives.

The Seniors Benefit

The Seniors Benefit failed when middle-income seniors rebelled against the punishing effective tax rates and disincentives to save that low-income seniors currently experience.

The Seniors Benefit was proposed to curb the increasing cost of income support for the elderly. The associated policy papers did not address the current system's savings disincentives for low-income Canadians. Rather than exploring ways to reduce those disincentives, the proposal was to enlarge the income range over which high marginal tax rates would operate.

Many analysts opposed the combination of OAS and the GIS in the Seniors Benefit because it would have mixed and confused entitlement and income support objectives.[5] The experience with the child benefit suggests that such a muddled program — neither fish nor fowl — tends to lose any focus on horizontal equity and to increase marginal tax rates to target benefits to meet anti-poverty criteria.

That the debate did not address the retirement savings disincentives for low-income Canadians — and, in fact, would have extended them — suggests that the Ottawa mindset is some way from recognizing the need to reduce existing disincentives.

The 1998 Federal Budget

The 1998 federal budget included a provision that received no media attention but that illus-

5 The shift to family income definitions for the Seniors Benefit was welcomed by those who give priority to anti-poverty goals (who argued that it is wasteful to support the wife of a retired bank president), and opposed by those who advance an entitlement foundation for support for seniors (arguing that spouses should be supported due to their age, regardless of their high-income partners; targeting is handled by the income tax system).

trated a continuing political urge to increase the targeting of benefits — despite having already reached, in many cases, effective tax rates of 100 percent.

The budget proposal included some valuable provisions on the timing of GIS applications, but it would also have changed the income definition for the GIS to increase the program's targeting. The change would have eliminated certain items currently deducted from income before GIS eligibility is calculated, including contributions to the CPP/QPP and EI and an employment expense deduction. A senior would have faced the prospect of having her GIS eligibility determined on the basis of income before payroll taxes, rather than after them as is currently the case. These changes would have affected those with an employed spouse under age 65. Officials at Human Resources Development Canada estimated that the changes would have affected about 42,000 Canadians and saved the federal government $14 million.

Had this proposal been implemented, some GIS beneficiaries would have faced effective rates that stacked taxes on the GIS and the GIS top-ups (amounting to 100 percent) and then the payroll taxes.

Given the known disincentives to saving for low-income Canadians, one might ask why Ottawa was interested in further increasing effective tax rates for GIS recipients. The minister of finance withdrew the proposal because of its "unintended consequences."[6]

The clear conclusion is that the federal government sees more room for targeting. It does not yet recognize that it has reached — and passed — the limit.

Retirement Planning and Low-Income Canadians

Several recent reports refer to the existence of savings disincentives for low-income Canadians (Davies 1998; Canadian Chamber of Commerce [n.d.]; Slater 1997; 1998). Yet the data suggest that many thousands of Canadians are saving in ways unlikely to be advantageous.

As long as most government support is not asset tested, a rational strategy for retirement savings for these individuals would consider the advantages of home ownership, particularly since the proceeds of a reverse mortgage are not income for the purposes of eligibility for the GIS. And savings should not go into an RRSP.

To whom should such information be addressed? And who should undertake such information?

The Audience for Education

The discouraging circumstances I have described apply primarily to the 38 percent of seniors who are now GIS recipients. But because the income available in retirement usually depends on decisions made in previous years, the main target of any educational effort should be younger or middle-aged people who can expect to face these confiscatory tax rates. Identifying them with precision is impossible, but I can point out that low-income Canadians are more likely than others to become GIS recipients later.

The Educators

Where should low-income Canadians obtain information on retirement planning? They are not going to get it from professionals. Even if they are willing to turn to accountants, my own informal survey suggests that those who give tax advice know nothing about how the GIS operates or about programs such as the GIS top-ups or the secondary effects of income on eligibility for provincial drug programs and the charges for long-term care and home care.

6 After I made a presentation to the House of Commons Finance Committee.

Neither is sound advice likely to come from the media, despite the articles and advertisements so ubiquitous in January and February as the RRSP contribution deadline draws near. Media analyses simply ignore the special circumstances of low-income Canadians.

One can understand why accountants focus on well-to-do clients and why investment firms want comfortable Canadians to understand the advantages of RRSPs. One can also understand why the media, which sell advertising to investment firms, find time and space to explain the logic of tax-deferred investments. It is harder to understand why Canadian governments do not accept some responsibility for helping low-income Canadians to realize the long-term consequences of their financial decisions.

Governments are, however, loath to spend tax dollars on advertising their failures. So, if they are unwilling to design a retirement savings system that deals with low-income Canadians in a rational and fair way, the educational campaign should be taken up by volunteer organizations and the financial services industry as a whole.

Conclusions

Canada has failed to design a retirement savings system that deals with low-income citizens in a rational and fair way. Canada has also largely failed to advise those with low income how they should prepare for their retirement and how the administrative rules affect them. This situation should be rectified.

The current tax and transfer rules are understood by only a few technical experts. Confronting the current retirement dilemmas of low-income Canadians would bring governments little political windfall, but they should address this issue anyway.

RRSPs are perhaps Canadians' most familiar tax preference. Middle-income Canadians see them as the one tax shelter available to them. What is unknown outside a small circle of experts is that RRSPs are of little value for low-income Canadians and can actually reduce their assets.

Given the tax and transfer system's current characteristics, the disincentives to saving in an RRSP will remain. Most low-income seniors would be better advised to purchase a home (since most programs are not asset tested) or to invest where they can outside an RRSP.

Recall that the continuum of targeting ranges from universality, which is expensive but does not increase marginal tax rates, to highly targeted programs, which minimize costs but create earnings and savings disincentives. I believe we have gone too far in the direction of targeting income benefits.

This paper is meant to initiate a discussion of measures that could remedy the current situation. That discussion should include the following:

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- changing the income definitions of the GIS to remove its perverse treatment of dividends; the current proposals are only a partial solution;
- developing tax mechanisms so that low-income Canadians receive tax assistance for their retirement savings similar to that enjoyed by middle- and high-income Canadians (perhaps through a mechanism similar to the Roth Individual Retirement Account used in the United States);
- coordinating federal, provincial, and municipal government programs with respect to the income testing of social programs to avoid perverse effective tax rates; and
- publishing educational material on the effects of various savings strategies for low-income Canadians, such as saving in a home and inside or outside an RRSP.

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