Certified General Accountants Association of Canada

Issue in Focus

51 and Counting – Is It Time to Remodel RRSPs?

By Elena Simonova and Rock Lefebvre

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Executive Summary

Registered Retirement Savings Plans (RRSPs) are arguably the most recognized and widely used retirement savings vehicle available to Canadians; however their popularity has been noticeably declining over the past decade. This would not be a reason for concern if the coverage provided by the publicly managed pension system and/or employer-sponsored pension plans had been expanding. But that has not been the case.

As a public policy instrument, the RRSP program was designed to influence behaviour through tax incentive. In this context, one of the reasons for decreasing popularity of the program may be the diminishing ability of the tax incentives to motivate individuals' decisions. In the following pages, CGA-Canada sets out to examine how the tax incentives embedded in the RRSP methodology have changed over the past decade and the concomitant ability to influence the level of RRSP contributions. As the following pages reveal, it can reasonably be conceded that:

> ***The decline in RRSP contribution and participation rates*** over the past decade occurred despite the positive changes in certain of socio-economic factors that create strong preconditions for individuals to be willing and to have the means to participate in the RRSP program more extensively.
>
> ***Propensity to capitalize on RRSP tax incentives have noticeably decreased over the past decade;*** particularly so for middle and high income Canadians and more so in western Canada. However, provincial and income variations in the tax incentives have not translated into equivalent differences in the RRSP contributions. As such, RRSP tax incentives seem to play a limited role in influencing people's behaviour.
>
> ***RRSP tax incentives are not strong enough to motivate households to use the RRSP savings vehicle more extensively than non-pension financial assets***. In fact, to the contrary, some groups (i.e. low and middle net worth quintiles) are more inclined to save outside of RRSPs devices despite the large magnitude of unused and available contribution room.

Taken together, these assertions lead us to question the ability of the RRSP program to influence household behaviour to the extent necessary and to serve in the accumulation of adequate private pension savings. It further leads us to wonder if it may be timely to develop an improved or alternate public policy approach to hearten private pension saving. It may simply be time for an approach that relies on natural human inertia wherein the initial enrolment into a private pension plan is compulsory but a time sensitive choice to opt out is available. Such an innovation may be particularly important during the current economic uncertainty when limited financial resources of households are called upon to meet diverse, often conflicting priorities.

Introduction

Retirement income, and the savings upon which that income is generated, has become a source of anxiety for many over past decades. Those participating in employer-sponsored defined benefit pension plans are subject to risk that the plan is underfunded or under-performing. Those with defined contribution plans run a risk of outliving their savings or experiencing erosion of those resources by market fluctuations and inflation. Individuals without employer-sponsored pension plans are subject to the greatest pressure among all; having to fully assume retirement planning. These worries are often compounded with uncertainty around the adequate savings amount and the optimum means of accumulating it. Although Canada can boast of a sound public pension system, its coverage allows for only modest living standards and it has yet to be seen if government might be tempted to change the provisions once the fiscal pressures of the aging population begin to crest.

Although these anxieties may be high, it seems that there is only one single component which is under the direct control of the individual. That is the amount of personal pension savings that people are willing to place. RRSPs may arguably be the best known and popular private pension savings vehicle currently in existence in Canada. With over $100 million spent on advertising during the RRSP season,[1] there is little reason to be unaware of the benefits and basic workings of an RRSP. However, the popularity of RRSPs has not been immune to the eroding propensity of individuals to save - the trend that has become particularly apparent over the past decade. The tendency to use RRSP funds prior to retirement, the decreasing frequency of contributions, and the amplifying unused RRSP room have been well documented.

It is useful to remember that the very need to have RRSPs is largely determined by such variables as the prospect of the publicly managed pension system, the availability and extent of coverage by an employer-sponsored pension plan, the level of job security and, of course, the levels of personal income and net worth. In this context, the fact that only 31% of those eligible, made RRSP contributions in 2007 and only 6% of the available contribution room was used[2] may well be interpreted that individuals do not see a need for additional private pension savings. The declining trend in the occupational pension plans complemented by a fairly stable benefit level offered by the public pension system may imply the contrary: the 'space' to be filled by private pension savings is widening. Research showing that Canadians may not have saved enough for their retirement[3] further confirms that the importance of private pension savings has not diminished.

1 *You May Think You're Ready to Retire, but Are You Really?* Kingston Whig-Standard (ON), Thursday, December 4, 2008.
2 Statistics Canada (2008). *Registered Retirement Savings Plan Contributions,* The Daily, Wednesday, November 5, 2008.
3 See, for instance, Statistics Canada (2001). *The Assets and Debts of Canadians – Focus on Private Pension Savings,* Catalogue no. 13-596-XIE; Canadian Institute of Actuaries (2007). *Planning for Retirement: Are Canadians Saving Enough?*

The contradictory tendencies associated with an increasing need for private pension savings, a high level of awareness of the RRSP program and its relatively low and declining use, may also suggest that the core element of the RRSP program – the tax incentives – are no longer shaping individuals' behaviour to the desired extent. In assessing this hypothesis, we first consider the recent trends in RRSP contributions and the factors that were expected to exert upward pressure on RRSP contributions. This is followed by the analysis of the changing levels of tax incentives associated with RRSPs and their capacity to influence levels of RRSP contributions. The paper closes with some concluding thoughts intended to highlight the more salient aspects of our findings and possible options for future policy development.

How RRSPs Have Fared in Recent Years

In 2008, the RRSP celebrated its 51st birthday. The program was first introduced in 1957 to equalize the tax advantages for individuals saving for retirement through personal savings plans with those participating in employer-sponsored pension plans. Over the past five decades, the RRSP program has undergone a number of considerable modifications making it potentially more flexible and attractive to intended users. Among the most significant changes introduced was permitting of unlimited carry forward of unused contribution room, allowing spousal RRSP contributions, and restoring to an extent, contribution ceilings eroded by inflation. Other, not less important modifications include equalizing tax assistance between RRSPs, Registered Pension Plans (RPPs) and Deferred Profit Sharing Plans (DPSPs), introduction of the RRSP Home Buyers' Plan and the RRSP Lifelong Learning Plan, and increasing the maturity age of RRSP accounts. Not surprising then, annual RRSP contributions, expressed in 2007 dollars, increased from a mere $0.54 billion in 1965 to $34.1 billion in 2007.[4]

While the long-term trajectory of the growth in RRSP contributions appears to be in itself impressive, a closer look at its dynamic over the past two decades reveals a worrisome trend. After nearly 40 years of persistent growth,[5] the RRSP contribution rate[6] peaked at 5.2% in 1997 and has been experiencing a declining trend since. The RRSP participation rate[7] has also been waning after reaching 32.6% in 1997 (Figure 1).

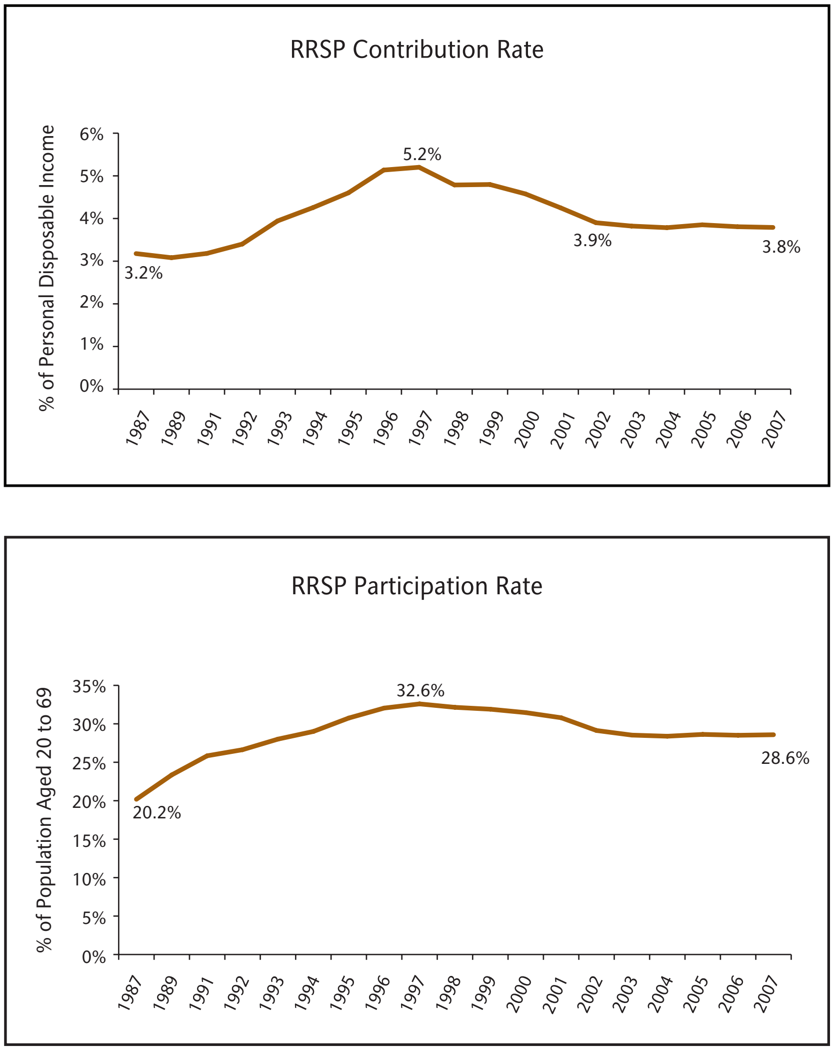
4 Based on CANSIM Table 111-0039 and Fougère, M. (2002). *RRSP Savings and the Aging of the Baby Boom Generation,* Canadian Tax Journal, Vol. 50, No. 2; CGA-Canada computation.

5 Based on Fougère, M. (2002). *RRSP Savings and the Aging of the Baby Boom Generation,* Canadian Tax Journal, Vol. 50, No. 2, Figure 5.

6 RRSP contribution rate is measured as a share of RRSP contributions in household disposable income.

7 RRSP participation rate is measured as a proportion of RRSP contributors in total population aged 20 to 69. The choice of the reference age group is based on the fact that 99.4% of all RRSP contributors fall in this age category (Source: Canada Revenue Agency, Income Statistics 2008, Interim Table 4; CGA-Canada computation).

Figure 1 – RRSP Contribution and Participation Rates, 1987-2007



Source: Statistics Canada (2003). *Canada's Retirement Income Programs: A Statistical Overview (1990-2000)*, Catalogue no. 74-507-XIE; Statistics Canada (2000). *Pension Plans in Canada*, Catalogue no. 74-401-XIB; Canada Revenue Agency, Income Statistics 2007, Historic Table 1; CANSIM Tables 111-0039 and 380-0019; CGA-Canada computation.

Regulatory changes that took place within the considered timeline can hardly provide the full explanation for these trends. For example, a number of the regulatory changes introduced during the years when the RRSP contribution rate was rising (i.e. 1987-1997) may be viewed as limiting the opportunities for contributing to RRSPs. For instance, contribution limits were frozen and even rolled back during the 1990s, and the initially scheduled increase of the limit to $15,500 by 1995 was not achieved until 2004. Moreover, most opportunities to transfer income from RPP and DPSPs, and rolling over of retiring allowances into RRSPs were also eliminated during the 1990s.

In turn, regulatory changes introduced during the declining years of RRSP contributions (i.e. 1998-2007) made provisions of the RRSP program more liberal. For instance, limits on holding foreign securities in RRSP accounts were increased from 10% in 2000 to 30% in 2001 and full elimination in 2005. The contribution limits grew at an annual average rate of 9% between 2003 and 2007, and the list of qualified investments that can be held in RRSPs was extended in 2007 to include most of investment-grade debt and publicly-listed securities.

What are the Reasons for Worry?

By itself, the declining popularity of the RRSP program may not be problematic. For instance, if pension assets outside RRSPs would rise or the proportion of already retired would significantly increase, it may well be expected that the need in RRSP savings would be diminishing. However, if we look at the developments in certain socio-economic factors over the past decade, the common logic may suggest that the use of the RRSP program should have been levitating. Four such factors have been identified: RPP coverage, changing age composition of Canadians, labour demand and income dynamic. The paragraphs that follow consider these factors in more detail. To do so, the two time periods emphasized above will be characterized as the 1990s (1987-1997) episode and the 2000s (1998-2007) episode.

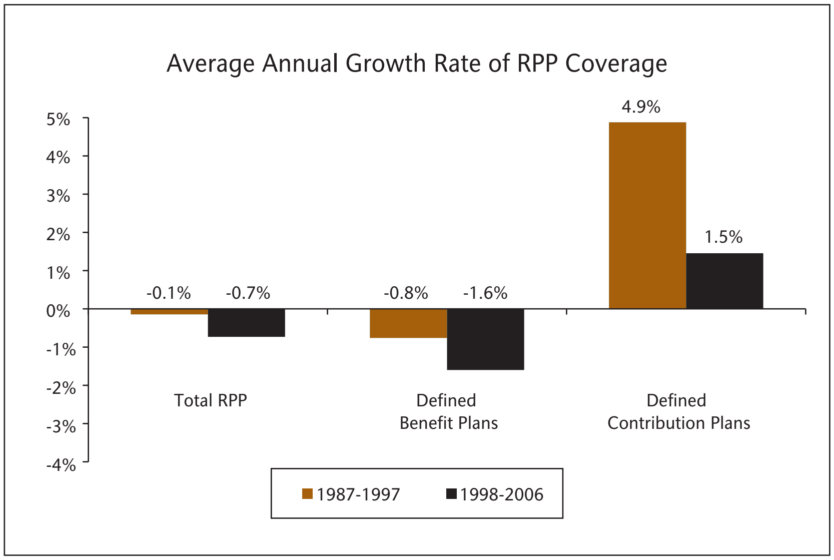
***Decreasing RPP Coverage*[8]**

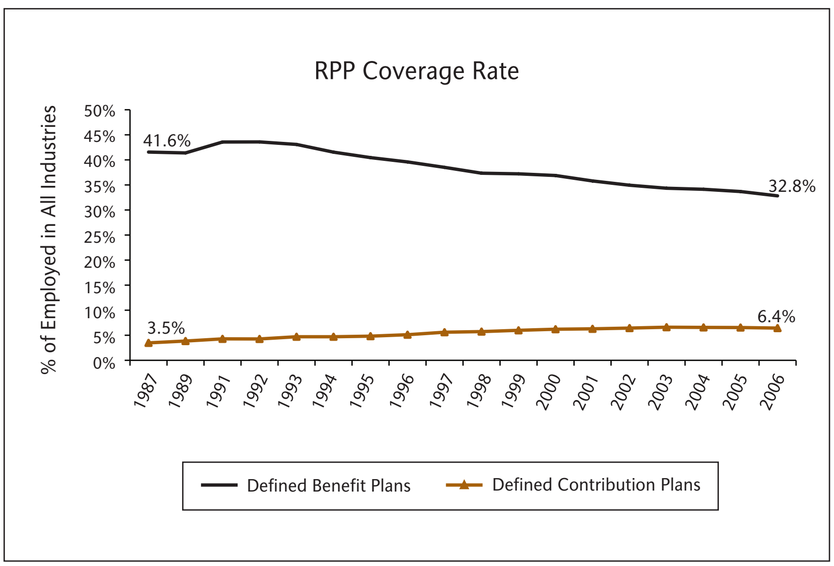
RPPs are retirement benefit programs provided by employer or by union sponsors in both the private and public sectors. It is fair to assume that participation in RPPs would be a natural first choice for many individuals when it comes to private retirement savings. Employees' contributions to such plans are often supplemented by employers, contribution deductions are incorporated into payroll system easing the stress of financial discipline, and for those participating in defined benefit pension plans, most of the retirement risks (e.g. income replacement inadequacy, market fluctuation, longevity uncertainty and inflation risk) are borne by the employer and consequentially mitigated at least in some large part for the individual.

Although participation in RPPs may be attractive for many, the reality is that the RPP coverage (measured as a ratio of RPPs members to all employees) has been on a declining trend in the past 30 years gradually shifting the burden of saving for retirement to individuals. More interesting, though, is that the rate of decline in the RPP coverage has accelerated over the past decade. The proportion of employees enrolled in RPPs decreased by an annual average 0.1% during the 1990s, but accelerated to 0.7% during the 2000s (top bar chart of Figure 2).

8 Data on the number of RPPs members in the year 2007 were not available at the time of writing. Due to this, 1998-2006 statistics was used to analyze the RPP trends during the 2000s.

Figure 2 – Changes in RPP Coverage, 1987-2006





Source: CANSIM Tables 280-0012 and 282-0012, CGA-Canada computation.

The two distinct types of RPPs – defined benefit and defined contribution – deserve separate consideration, particularly because their dynamic has been opposite. During 1987-2006, defined benefit plans continued their long-term decline whereas the proportion of employees participating in defined contribution plans was on the rise; however this upward drift was too weak to offset the drop in defined benefit plans (bottom graph of Figure 2). In both cases, though, the trends deteriorated over the past decade. In the 2000s, the fall in defined benefit plans was more pronounced averaging 1.6% per year compared to only 0.8% during the 1990s. In the case of defined contribution plans, the coverage grew at a much slower pace of 1.5% per year in the 2000s compared to a strong average annual growth of 4.9% during the decade prior to that (top bar chart of Figure 2).

According to Statistics Canada,[9] individuals with income above $30,000 and with no RPP coverage have higher likelihood of participating in the RRSP program. As we have seen above, the proportion of Canadians not covered by employer-sponsored pension plans has been increasing with an accelerated pace in the past decade. This was also accompanied by an increasing share of individuals with income above $30,000. For instance, individuals with no RPP coverage and income above $30,000 accounted for 31.3% of all tax filers in 2005, up from 26.0% in 2001.[10] The combination of these two factors should have created an upward pressure on the RRSP contribution and participation rates in the 2000s.

Increased Number of Individuals Aged 45 to 64

The life-cycle framework is often used by economists to think about the intertemporal allocation of time, effort and money. The framework divides the life of an individual into three phases: (i) those typically under the age of 45 years borrowing funds to finance investments in expectation of rising income, (ii) those typically aged 45 to 64 years intent on accumulation of wealth by consuming less than disposable income, and (iii) those 65 years of age and older typically in the dis-saving or retirement phase relying on savings or pension income to finance consumption.[11] Although savings are an important element of individual financial health at any age, it is the individuals in their accumulation phase who are primarily expected to have already partially or fully paid off debt and begun to actively accumulate pre-retirement savings.

The extent to which individuals of different ages contribute to RRSPs seems to support the life-cycle framework. Our analysis shows that in 1999, the average contribution made by individuals in the accumulation phase of their life was $1,875 - a noticeably higher amount than $1,170 contributed by an average individual younger than 45 years of age, or a bare $210 contributed

9 See, for instance, Palameta, B. (2001). *Who Contributes to RRSPs? A Re-examination,* Statistics Canada, Perspectives on Labour and Income, Vol. 13, no. 3, and Palameta, B. (2003). *Profiling RRSP Contributors,* Statistics Canada, Perspectives on Labour and Income, Vol. 4, no. 1.

10 Canada Revenue Agency, Income Statistics 2003 and 2007, Basic Tables 2 and 11A; CGA-Canada computation.

11 Chawla, R. K. and Wannell, T. (2005). *Spenders and Savers,* Statistics Canada, Perspectives on Labour and Income, Vol. 6, no. 3.

by those over 65 years old. Individuals in the accumulation phase were also more likely to participate in the RRSP program. In 1999, some 38.9% of all tax filers in this age group made RRSP contributions, whereas only 31.2% of those under 45 were contributing to RRSPs.[12] Similar differences were observed throughout the 2000s as well.

As the term itself suggests, aging of the population tends to shift weights of different age groups towards older ages. Knowing that individuals in their accumulation phase tend to contribute higher amounts to an RRSP and do so more often, one could expect that the popularity of RRSPs would be rising as population aging becomes more pronounced. The age shifts that took place between 1998 and 2007 were fairly noticeable. In 1998, individuals aged 45 to 64 accounted for 34.3% of those within the RRSP contribution age,[13] whereas this proportion increased to 40.7% by the year 2007.[14] Contrary to this, the RRSP contribution and participation rates did not increase over the past decade.

Strong Income Growth[15]

Income is indisputably a very important determinant of individual's ability to make RRSP contributions. After all, it is the difference between household's income and expenditures that forms savings. As such, growth in income may create additional funds available for savings. However, it may also generate a higher need for retirement savings as the level of 'adequate' income at retirement is usually a function of pre-retirement income. Given the declining trends in RPP coverage and absence of significant changes in the public pension system, the higher income may be expected to lead to higher RRSP contributions.

Statistics Canada uses several concepts of income to report financial wellbeing of Canadians. Household disposable income shows how much money actually remains in the pockets of Canadians once tax and social insurance contributions are paid. Total income of individuals reflects the overall level of funds received from all sources, whereas market income shows the amount of money earned and is probably the closest approximation of the income used for determining RRSP contribution room. When adjusted for inflation, all these types of income grew nearly twice faster during the 2000s compared to the 1990s (Table 1). And those contended to be particularly interested in accumulating savings (i.e. aged 45 to 64) seemingly had means for that as their income grew at a much higher rate than for all Canadians.

12 Canada Revenue Agency, Income Statistics 2001, Basic Table 4; CGA-Canada computation.
13 RRSP contribution age is defined as 20 to 69. See footnote 7 for more details.
14 Based on CANSIM Table 051-0001, CGA-Canada computation.
15 Data on income of individuals for the year 2007 were not available at the time of writing. Due to this, 1998-2006 statistics was used to analyze the income growth during the 2000s.

Table 1 – Real Income of Individuals – Average Annual Growth Rate, 1987-2006

	1987-1997	1998-2006
Household disposable income	1.3%	2.8%
Total income of individuals		
20 years and over	1.6%	2.9%
45 to 64 years	3.1%	5.1%
Market income of individuals (excluding retirement income)		
20 years and over	0.9%	3.0%
45 to 64 years	2.7%	5.5%

Source: CANSIM Tables 202-0407 and 380-0019, CGA-Canada computation

It is well known by now[16] that low and moderate income Canadians have little incentive or ability to save for retirement. Modest disposable income leaves little room to contribute to RRSPs, whereas income-tested public retirement benefits impose high marginal effective tax rates on RRSP withdrawals. The decreasing proportion of individuals having low income should then be transpiring into a growing proportion of those having both means and motivation to contribute to RRSPs. The proportion of those with annual income under $30,000 (in constant 2006 dollars) decreased from 61.6% in 1998 to 56.4% in 2006.[17] However, neither this nor the upward trends in the overall household income translated into higher rates of RRSP contribution and participation.

Low Unemployment Rate

Unemployment is also an important factor that may affect the level of RRSP contributions. It could do so by not only reducing individual's ability to save in the year with income instability, but also by reducing the RRSP contribution room in the year that follows. It is fair to assume that the higher the unemployment rate and the longer the duration of unemployment, the lesser is the individual's capacity to contribute to RRSP. And, vice versa.

The unemployment statistics show that the 2000s were a fairly favourable time for savings with unemployment averaging 6.5% compared to a much higher level of 8.9% during the 1990s (Table 2). The labour market prospects for those in the accumulation phase of life were

16 See, for instance, Kesselman, J. and Poschmann, F. (2001). *A New Option for Retirement Savings: Tax-Prepaid Savings Plans,* C.D. Howe Institute, Commentary No. 149; Shillington, R. (2003). *New Poverty Traps: Means-Testing and Modest Income Seniors,* C.D. Howe Institute, Backgrounder No. 65.

17 Based on CANSIM Table 202-0402.

particularly good - their unemployment rate averaged at just 5.5% over the 2000s. The duration of unemployment has also been shorter during the 2000s.

Table 2 – Unemployment, 1987-2007

	1987-1997	1998-2007
Unemployment rate (average for the period)		
20 to 69 years old	8.9%	6.5%
45 to 64 years old	7.2%	5.5%
Average duration of unemployment, weeks	21.6	16.3

Source: CANSIM Tables 282-0002 and 282-0048, CGA-Canada computation.

As earlier revealed, the year 1997 marked a turning point from the steadily amplifying long-term growth in the RRSP contribution rate, into its noticeable decline which persisted even despite the presence of certain factors that could increase the possibility of RRSP expansion. This may suggest that the declining popularity of the RRSP program is not a temporary phenomenon which will vanish in the near future, but rather a sign of secular changes in the environment that affect the basic elements of the RRSP program.

In broad and simplified terms, the decision to contribute to RRSPs may be viewed as a two-step process: first, the individual would need to give a higher priority to savings over consumption and second, the individual would need to choose saving in RRSPs over saving outside of RRSPs. For the latter, tax incentives could play a particularly important role given the fact that the list of eligible investment vehicles available to RRSPs have grown to include much of the financial instrument market. Let us now turn our attention to the consideration of the changes in the core component of the RRSP program - the tax incentives it offers.

Erosion of Tax Incentives

RRSP is a form of the tax-assisted savings vehicle and its underlying assumption is that the deferral of taxes reduces the tax burden on savings, increasing thus, the incentives to save. The contributions made to an RRSP are tax deductible and income earned within RRSP is exempt from taxation during the time the funds remain in the plan. Cash withdrawals, though, are treated as ordinary income and are taxable in the year of withdrawal. As such, changes in federal and provincial tax rates and surtaxes may represent important elements in encouraging or discouraging individuals to contribute to RRSPs.

Over the past decade, several significant changes have been introduced to personal income taxation at both the federal and provincial levels. In Budget 2000, the federal government announced a number of structural changes to the personal income tax system aiming to reduce the tax burden on individuals. The measures included restoration of the full indexation of the tax system, increasing the amount of income individuals could earn tax-free, reducing the middle income tax rate, increasing amounts of income at which the middle and top tax rates begin to apply, and eliminating the federal surtax.[18]

At the provincial level, the early 2000s witnessed an introduction of a new income tax calculation method – "Tax on Income" or TONI. Prior to 2001, all provinces except Quebec set their tax rates as a percentage of the Basic Federal Tax using "tax-on-tax" method of calculating income tax. The new income tax calculation method (i.e. TONI) provided provinces with the opportunity to establish income tax brackets and rates independent from the federal income tax rates. In addition to these reforms, both levels of governments continued introducing minor adjustments to tax rates and amounts of tax credits during the 2000s.

To identify the combined effect of these changes, we compared the level of marginal effective tax rates in 1998 and 2007 – the timeframe that coincided with the declining trend in the RRSP contribution rate. The marginal effective tax rate is generally defined as the percentage of an additional dollar of income that has to be paid in taxes. In the context of RRSPs, it can also show the proportion of the first dollar contributed to RRSP that will be returned to the individual as a tax refund.

18 Department of Finance Canada (2000). *Budget 2000: Five-Year Tax Reduction Plan*, p. 9.

When analyzing marginal effective tax rates, the main pitfall lies in the fact that the tax treatment of an individual depends greatly on the individual's distinct economic and social character. This mainly relates to the province of residence, level and the source of personal income, age, marital status and number of dependents. This creates a large number of possible variations in income tax treatment, even for two apparently similar individuals.

In order to mitigate this pitfall, the analysis was conducted for a single individual aged 65 or younger with no dependents. The age limitation was chosen based on the fact that 97.5% of all RRSP contributors are younger than 65.[19] The 'single individual no dependents' concept was adopted because approximately 40% of Canadian tax filers are likely to be treated as such by the tax system. This group is formed by single individuals (estimated 20.7% of tax filers under 65 years of age), but also by those living in dual-earner families with no children (estimated 18.9% of tax filers).[20] Three income levels were considered to approximate for different income groups: $30,000 represented lower income Canadians, $60,000 approximated middle-income individuals and $150,000 reflected high-income individuals that would be subject to the highest income tax bracket.

As seen from Figure 3, the magnitude of changes in marginal effective tax rates varies significantly depending on the level of income and the province of residence of the tax payer.[21] For lower income individuals, marginal effective tax rates did not change much between 1998 and 2007. The largest decrease was observed in British Columbia (from 25.6% in 1998 to 20.7% in 2007) whereas in Nova Scotia this income group experienced the biggest increase in the tax burden (top graph of Figure 3).

Middle-income Canadians were the most advantaged among the three income groups as they experienced a noticeable reduction in their marginal effective income tax rates across all provinces. Those residing in Saskatchewan benefited the most with their marginal effective tax rate dropping more than 10 percentage points. In turn, mid-income Nova Scotians saw an only modest reduction in their marginal effective tax rate. It decreased from 42.5% in 1998 to 38.7% in 2007 (middle graph of Figure 3).

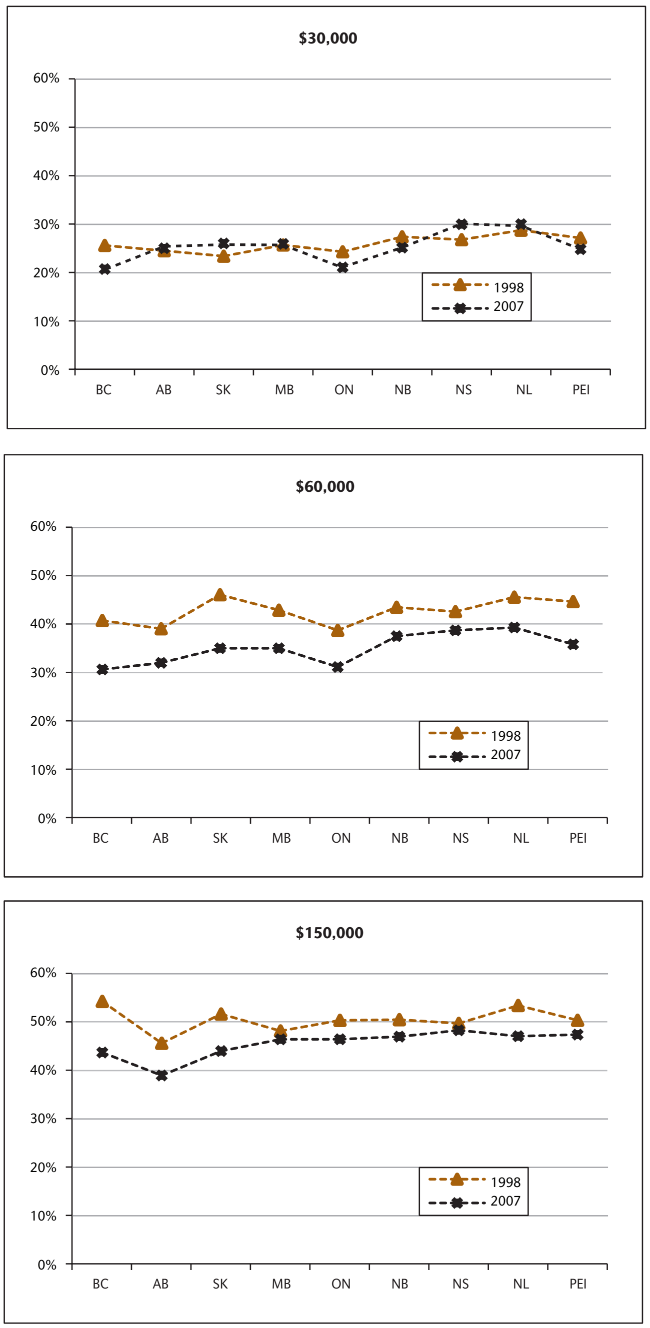
The picture for high income individuals was somewhat mixed across provinces. In the western provinces and Newfoundland and Labrador, top earners noticeably benefited from the changes in the tax system, while in other provinces they primarily maintained the 1998 status quo (bottom graph of Figure 3).

19 Canada Revenue Agency, Income Statistics 2008, Interim Table 4; CGA-Canada computation.

20 Based on CANSIM Tables 111-0011, 111-0012 and 111-0020; CGA-Canada estimates.

21 For the purpose of this paper, the provincial comparison includes provinces that use the same method of calculating tax on personal income as does the federal tax system.

Figure 3 – Marginal Effective Income Tax Rates, Single Individual with No Dependents and Annual Income of..[22]



Source: General Income Tax and Benefit Package 1998 and 2007 (available at http://www.cra-arc.gc.ca/formspubs/t1gnrl/llyrs-eng.html), CANSIM Table 326-0021, CGA-Canada computation.

21 The income levels in Figure 3 are expressed in 2007 dollars. When computing marginal effective tax rates for 1998, the income levels were adjusted for inflation to allow for a proper comparison.

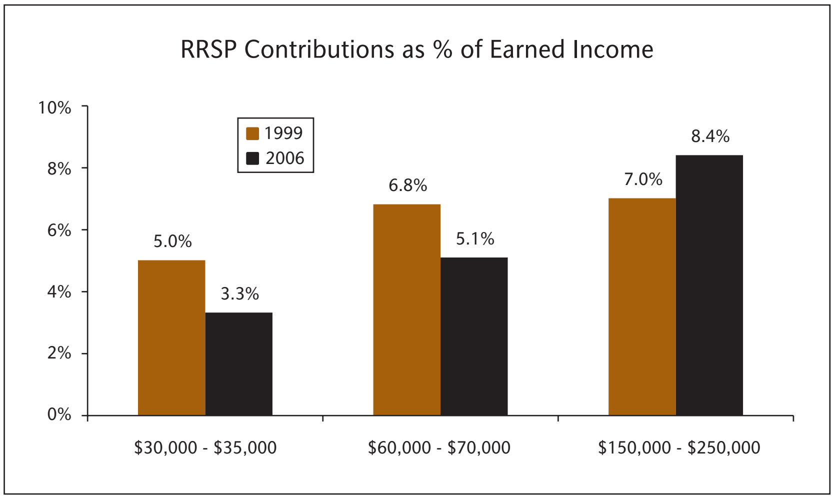
Do Tax Incentives Matter?

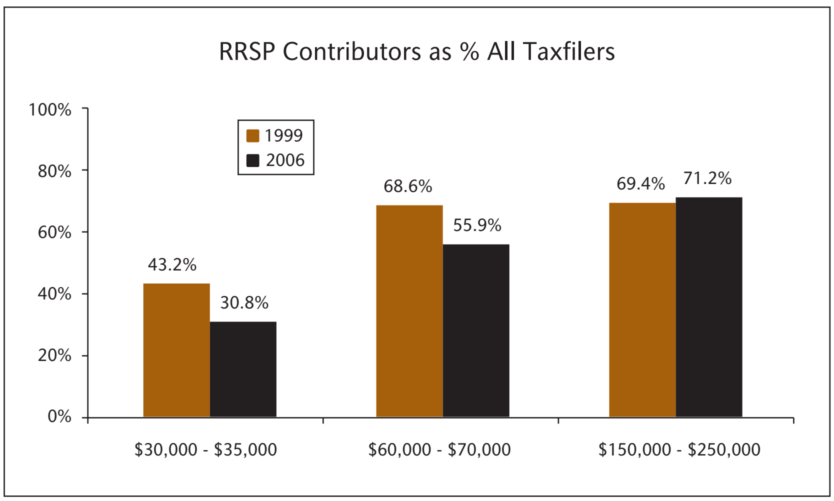
The above analysis suggests that over the past decade the tax incentives for contributing to RRSPs have declined significantly for middle-income Canadians across all provinces and for high income individuals in western Canada. In turn, tax motives for lower income taxpayers did not materially change in any province. It is tempting to assume that the differences in the magnitude of tax incentives should be reflected in the provincial dynamic of the RRSP contribution and participation rates. For instance, the decline in RRSPs may be expected to be more profound in British Columbia, where the marginal effective tax rate noticeably declined for all income groups. In Nova Scotia, though, the decline should be less profound as the marginal rates remained almost unchanged over the past decade. However, this was not the case: between 1998 and 2007, the RRSP contribution rate declined, on average, by 2.3% annually in British Columbia compared to 3.3% in Nova Scotia.[23] In other provinces, no particular relationship between the level of decline in tax incentives and the speed of weakening in RRSP contributions was observed either.

Likewise, changes in attitudes to RRSPs within each income group do not seem to follow the changing tax incentives. Taking the dynamic of the marginal effective tax rate as a guiding trend, one may presume that middle-income (and, to some extent, high-income) Canadians would have become less eager to make RRSP contributions whereas lower income individuals would have maintained their RRSP participation relatively unchanged between 1998 and 2007. As seen from Figure 4, the level of RRSP contributions and the RRSP participation rate indeed went noticeably down for middle-income tax filers. However, for low-income Canadians, the drop was even deeper whereas top earners increased their participation in the RRSP program.

23 Based on CANSIM Tables 111-0039 and 384-0012; CGA-Canada computation.

Figure 4 – RRSP Contributions by Different Income Groups, 1999 and 2006



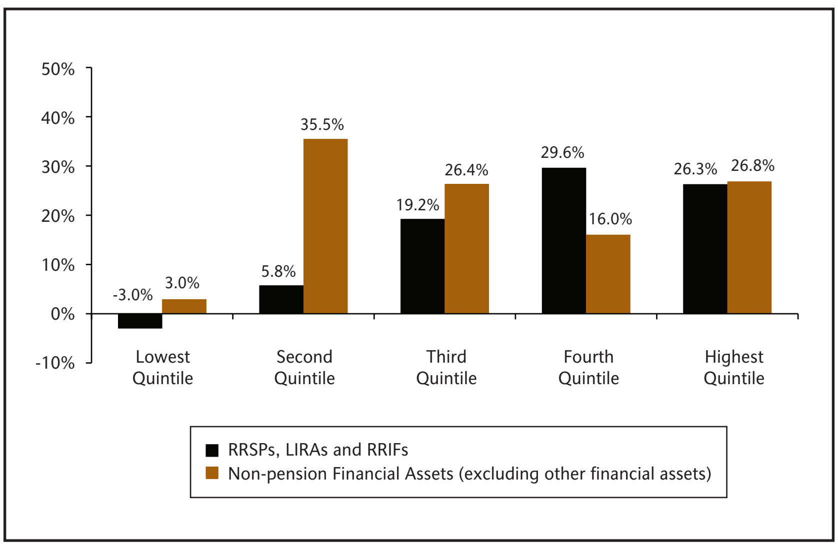


Note: Earned income includes income from employment, commissions, business income, professional income, rental income, income from farming and fishing.

Source: Canada Revenue Agency, Income Statistics 2001 (Basic Table 2) and 2008 (Interim Table 2), CGA-Canada computation.

Further indirect evidence that tax incentives provide insufficient stimulus to attract RRSP savings is the dynamic of non-pension financial assets. The accumulated unused RRSP contribution room is probably the fastest growing element of households' financial accounts. Reaching a record 55% of household disposable income in 2007, the unused RRSP contribution room allows plenty of 'space' for benefiting from the tax advantages offered by RRSPs. And yet, non-pension financial assets such as bonds, stocks, mutual and investment funds, income trusts and deposits in financial institutions grew by 25.3% between 1999 and 2005 – a rate very comparable with the 25.9% of growth in RRSPs, LIRAs and RRIFs.[24] Moreover, individuals in the lowest, second and third net worth quintile showed strong preferences for investing outside of RRSPs. For these groups, the value of non-pension financial assets increased (in real terms) at a much higher rate than the value of assets allocated in RRSPs, LIRAs and RRIFs (Figure 5).

Figure 5 – Change in Value of Selected Household Assets, 1999 to 2005 (Adjusted for Inflation)



Source: Statistics Canada, Survey of Financial Security 1999 and 2005, available at http://www40.statcan.ca/l01/cst01/famil115a-eng.htm. CGA-Canada computation.

Summing up the discussion, the following points deemed to be important. First, the RRSP contribution and participation rates have been declining since 1998 even though changes in a number of socio-economic factors could have been a strong driving force for boosting RRSP

24 Based on Statistics Canada, Survey of Financial Security 1999 and 2005, available at http://www40.statcan.gc.ca/l01/cst01/famil109-eng.htm

investment. Second, the tax benefits of participating in RRSP has noticeably decreased over the past decade, particularly so for middle and high income Canadians and more so in western Canada. However, changes in RRSP contributions did not replicate the changes in the tax incentives. Third, the tax incentives do not seem to be strong enough for households to use the RRSP savings vehicle more extensively than non-pension financial assets. Contrary, some groups (i.e. low and middle net worth quintiles) are more inclined to save outside of RRSPs although a large amount of unused contribution room is available. All this leads us to questioning the ability of the RRSP program to influence people's behaviour in the desired collective way, i.e. to encourage private pension savings among all Canadians.

Closing Comments

Prior to the 2008 financial crisis and economic downturn, we tended to worry relatively less about the declining savings rate. Housing equity was expanding within double-digit rates, economic fundamentals were strong, and the stock market was seemingly making up for what we failed to put aside as conventional savings. However, this attitude has quickly become a remote and long forgotten past as the financial turmoil has been unfolding. Housing sales have experienced their biggest plunge since the 1980s, the stock market has lost nearly 40% of its value, and public pension system, employer-sponsored pension plans, and individuals' savings are unable to remain immune to this. Although having a larger amount of savings would not shelter the individual from unfavourable economic shocks, simple math would show that 60% of a larger amount is always greater than 60% of a lessened amount.

The downward trend in the RRSP contributions discussed herein relates primarily to the pre downturn 'good times' associated with strong economic growth and stable financial markets. Now, that we enter the economic recession which some describe as the hardest and longest since the Great Depression, many Canadians will be facing challenges of job insecurity, low interest rates and murky prospects of business growth. None of these factors is a great help in accumulating personal pension savings. Moreover, many may face the threat of losing the employer-sponsored pension plans due to the increased rate of corporate bankruptcy.

Unfortunately, the economic crisis does not alter the rules of nature, particularly those governing aging, and the need for private pension savings will continue to persist. As individuals' responsiveness to tax incentives offered by the RRSP program appears to be weak and is not straightforward, it may be reasonable to consider a new, more assertive approach of encouraging private pension savings. The approach that relies on people's natural inertia where the initial enrolment into a private pension plan is compulsory but an option to opt out within a limited period of time is available. Some of the OECD countries have already considered this policy option. The KiwiSaver plan recently introduced in New Zealand is one example. The United Kingdom and Ireland are likely to follow this lead in the near future.[25]

Financial education and awareness programs may also be useful; however a new approach may be required in order to achieve positive results. Conventional measures seem to have created a fatigue and adverse reaction among Canadians 59% of whom already "hate being told they aren't saving enough for retirement."[26]

The truth of the matter is that RRSPs represent a good deal for Canadians. As a financial strategy, they can undeniably be made to work. As a policy instrument, there is undeniable room for improvement.

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