Asset-Building and Fairer Tax Treatment of Savings

Submission to the Department of Finance by SEDI (Social and Enterprise Development Innovations), December 2003

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Introduction

SEDI (Social and Enterprise Development Innovations) is a national charitable organization dedicated to enabling poor, unemployed and under-employed people to become self-sufficient. We take a variety of leading-edge social and economic approaches to this goal in areas such as policy development, project management, information exchange, capacity building, public education and research. SEDI was formed in 1986 as a small provider of self-employment training for low-income people. Today SEDI works with a network of 100 partners in more than 40 communities in every region in Canada to increase self-sufficiency for disadvantaged Canadians through self-employment, asset-building and initiatives for youth with barriers and persons with disabilities. We envision a society where there are no barriers to prevent Canadians from realizing their full economic and human potential. We want to see social, cultural and economic supports that enable people to learn, take risks, invest wisely and participate in the economic mainstream. Our partners include leading private sector corporations, foundations, community-based organizations and policy research organizations in Canada and abroad. SEDI's expertise has been recognized by the Organization for Economic Cooperation and Development and by the World Economic Forum.

SEDI has prepared this submission to the Department of Finance Canada in response to the Department's invitation to take part in informal consultations on the tax treatment of savings. In the 2003 federal budget, the Government of Canada indicated that it would conduct a review of representations made on the tax treatment of savings and examine whether introducing Tax Pre-Paid Savings Plans (TPSPs) could be a useful and appropriate mechanism for providing another savings vehicle for Canadians.

Asset-Building and Canada's Asset Gap

Since 1996, SEDI has led the development of the asset-building field in Canada. Asset-building is an emerging area of social policy and practice. Its core idea is that to overcome poverty, opportunities to save and invest in a better future are as critical as income. Savings and assets can leverage new income, open new opportunities for education and development, enable productive risk-taking and can build social capital by enhancing inclusion and participation. Savings can also provide a safety net, for example to cushion the climb out of poverty or to prevent deprivation in case of income losses. When individuals have access to assets and to supportive services they are better equipped to manage life transitions and to build and maintain self-sufficiency. A growing body of evidence from Canada, the US and the UK suggests that when provided the right supports, low-income accountholders *can and do* save.

SEDI has designed and secured funding for the single largest demonstration of Individual Development Accounts in the world. Funded by HRDC at a cost of approximately $32 Million, *learn*$ave, is already starting to yield some of the best data on asset-building. More than 4,600 low-income adults, including social assistance recipients, are enrolled in the project that helps them save for education, training or to start a small business. Project participants are saving an average $55 per month ($1.8 million total), generating a further $165 in matching credits ($5.3 million total)[1]. Already, 335 participants have converted their savings into investments totalling approximately $530,000 in education, $48,000 in skills training and $144,000 in microenterprise development. The Social Research and Demonstration Corporation will begin releasing a series of research reports on the project later this fall.

International governments and bodies have acknowledged the value of asset-building. Delegates from the OECD have participated in an international conference, co-hosted by SEDI and have published reports to encourage further dialogue among OECD members on savings and asset-building. The World Economic Forum has held a workshop dedicated to asset-building during its Fall 2003 meeting in Geneva and has put asset-building on the agenda for its annual meeting in Davos. Federal legislation in the US now supports hundreds of local asset-building projects and asset-based programs are now the fastest growing domestic social expenditure in the US. The UK government has moved quickly and decisively to establish asset-building as the "third pillar" of the social welfare system in Britain. SEDI believes that asset-building offers a new and much-needed avenue toward increased social inclusion and shared economic security in Canada.

Canada has a gross and persistent gap dating as far back as 1970 between those with savings and assets and those without. The poorer 50% of Canadian households own less than 6% of all personal financial assets (Statistics Canada, 2001). Between 1984 and 1999, the median net worth of the wealthiest 20 percent of Canadians increased 39% while the net wealth of the poorest 20% of Canadians actually fell.

[1] Data are current to December 2003 and are from the project's Management Information Software.

Opportunities for asset development are imbalanced in Canada to such a degree that low-income Canadians:

- are two and a half times less likely to own their home than high income Canadians (CMHC, 1992);
- have twice the national debt-to-asset ratio (Statistics Canada, 2001);
- are almost twice as likely to work in a low-skilled job compared with the Canadian average (CCSD, 2000); and
- are almost twice less likely to report any contributions to an RRSP than middle income Canadians (CCRA, 1999).

But what does this mean in terms of real financial security for Canadian families? A recent report by Steve Kerstetter offers some interesting insights. One rough measure of financial security, he notes, is to examine the proportion of financial assets a family has in relation to its total income (Kerstetter, 2002). In cases of unexpected hardship like losing employment, this measure gives some sense of how long a family could sustain themselves at the same level of consumption by liquidating their savings to replace lost income. Kerstetter finds that the poorest 20% of Canadian families had an average after-tax income[2] of $18,698 and average financial assets of only $1,974 which would replace only about 5 weeks of lost income at the same level. Not surprisingly, one third of these families also reported falling 2 months or more behind on a bill, mortgage, rent or loan payment during 1998. The next quintile had an average after-tax income of $30,803 and $9,187 in financial assets, enough to replace only 16 weeks of income at the same level. By comparison, the wealthiest 20% of Canadian families had sufficient financial assets to replace 218 weeks of income at their current levels. Considering that their average after-tax incomes were only $62,518 this concentration of wealth and the financial security that goes with it is astounding.

At least some portion of this maldistribution of wealth must be attributed to federal income tax and program expenditures. As noted in the Department's background document, the Government of Canada already supports private savings and asset building through a variety of tax expenditures including deductions on RRSP contributions and foregone taxes on many capital gains and RESP contributions. However, the impacts of these investment disproportionately goes to wealthier Canadians. The poorest 40% of Canadian families own less than 3% of all RRSPs or other registered plans, 1% of all mutual and investment funds and only 7% of all non-financial assets, including real-estate, housing, vehicles and valuables, (Kerstetter, 2002).

There is currently only one on-going universal program expenditure whose aim is to increase individual savings. Since 1998, the Government of Canada has also provided a 20% annual Canada Education Savings Grant (CESG) to families who save in an RESP towards their children's post-secondary education. A recent evaluation of the CESG found that the majority of beneficiaries come from families with incomes of $80,000 and over. By the Government of Canada's own definition, these are "high income families". Strikingly, a recent Statistics Canada survey found that over 83% of children from these families would likely attend some form of post-secondary education anyway.

Worse still, means-tested benefits penalize low-income savers. There is some evidence to suggest that many lower income Canadians are actually worse off in retirement if they invested in RRSPs because of clawbacks to means-tested retirement benefits (Shillington, 2003). Means-tests are also a significant

[2] After-tax income takes into account any redistributive effects of income tax such as refundable tax credits and is therefore a better measure than pre-tax income.

barrier for those low-income families who may turn to social assistance, and many will at least once during the course of their lifetime. All provinces in Canada impose some kind of limit on the amount of assets that an applicant for social assistance benefits can have before income assistance is provided and while in receipt of benefits. There is a large range in the limits, depending on household size and the type of income benefits[3]. For example, a single employable person (facing the most stringent asset limits) in Manitoba may be required to exhaust all their liquid assets down to the last dollar before receiving benefits whereas next door in Saskatchewan the same single person could have up to $1,500 in liquid assets and still be eligible for benefits. Even though exemptions (within dollar limits) are usually made for things like equity in primary residences, vehicles and locked-in forms of financial assets, applicants for social assistance are generally required to dispose of many of the forms of assets that might otherwise help them get off social assistance faster. Once on social assistance those who may be able to build an asset, either by saving or through a windfall such as an inheritance or legal settlement, can face severe penalties and even termination of their income benefits (Stapleton, 2003).

There is already in place in Canada a system of supports to encourage the accumulation of personal stocks of capital. The problem is, the existing system works almost exclusively to the benefit of wealthier Canadians and at the expense of poorer Canadians. It doesn't appear to be by design, but rather by neglect, that almost 40% of Canadian families are virtually shut out from publicly-subsidized forms of asset-accumulation that appear to offer greater financial security than income alone. As Kerstetter puts it, "tax policies have conferred huge financial benefits on the very wealthiest people, the one group capable of fending for themselves". At the same time, means-tested benefits impose huge disincentives to saving and asset-building on low-income Canadians.

When provided the right incentives and supports, low-income persons can and do save, a fact now made clear through research on Individual Development Accounts (IDAs) in the US, Canada and the UK. Provincial governments in Canada have already shown themselves willing to amend means-tests by excluding savings in IDAs in at least 3 different programs and by enacting regulatory changes in two provinces.[4] A more comprehensive approach to social policy would include a better mix of adequate income support, social services and opportunities to save and build assets. Low-income Canadians, like other Canadians, have short-term, medium-term and long-term financial needs that even increases in income support will not be able to meet.

SEDI's Response to the Current Consultations

The Department's background paper poses 5 questions for discussion in the current round of consultations. The following section presents SEDI's response to each of these questions.

[3] Asset limits for income benefits related to disability are significantly more generous in all provinces.

[4] Temporary waivers of asset-tests have been obtained for local IDA projects in Calgary and Winnipeg. Similar waivers were obtained in 4 provinces for a national IDA demonstration project called *learn*$ave. These waivers allow IDA participants receiving or applying for social assistance to save in an IDA without including the IDA amounts in the applicable means-tests. In BC an amendment to the regulations on social assistance now exempt all asset-development programs from means-tests. Similar regulations are about to be passed in Nova Scotia.

1. Key issues in the current tax treatment of savings

SEDI has identified six key issues in the current tax treatment of savings. Our overarching concern is that there is little if any vertical equity in the current system of taxation of and incentives for saving and asset accumulation. For several structural reasons, the current range of income tax measures is not inclusive of lower-income Canadians. Any changes to improve the tax treatment of savings must place vertical equity and inclusiveness as key objectives. Those measures that are currently "universal" are not sufficiently progressive to be truly inclusive of low-income Canadians.

First, for lower-income tax payers with lower tax liability, the deductions and non-refundable tax credits that are generally used to support asset-accumulation are of far less value than to higher income tax payers. For example, the deductions for RRSP and RPP contributions are of less value as total income from all sources decreases. Non-refundable tax credits to support post-secondary education are similarly of less value as taxable income and federal income tax decrease. Those two refundable tax credits specifically targeted to lower income tax payers, the GST/HST credit and the Canada Child Tax Benefit, are aimed at meeting consumption needs rather than asset-accumulation or retention.

Second, the primary mechanism for private savings and asset-accumulation that is currently supported by the Income Tax Act is the RRSP. RRSPs can be used to support both long-term (ie: retirement savings) and medium-term (ie: adult education through the Life-long Learning Plan and home purchase through the Homebuyer's Plan) asset goals. As noted above, there are already concerns that RRSP savings may have unintended and negative consequences in retirement for low-income earners. Low-income Canadians may also want to save to purchase a house or to engage in life-long learning and may be permitted to do so through withdrawals from an RRSP under the LLP or HBP. However, RRSPs are not the most efficient or effective way to support those two asset goals for lower income earners. Furthermore, as the primary savings vehicle supported by the Income Tax Act, RRSPs are very limited in the range of asset goals that can be pursued. The United Kingdom has piloted a saving program for low-income residents called the Savings Gateway and is set to implement a universal Child Trust Fund to provide an endowment and tax-benefited savings vehicle that is locked-in until a beneficiary is 18 years of age. However, there are also concerns about the transparency, efficiency and accountability of unrestricted and publicly-subsidized savings and asset-building strategies. During the course of its early research with low-income Canadians, SEDI identified a broad, but nevertheless defined, list of savings and asset goals that low-income Canadians listed a meaningful ways to improve their economic well-being. These included: saving for a child's education, small-business development, adult education and skills training (including but not limited to post-secondary education), home purchase and affordable rental housing.

Third, RRSP contributions and/or RESP savings are often not exempt from means-tests in provincial or federal income benefits. As noted above, many low income Canadians may receive some form of social assistance income benefits at some point in their lives. The current structures of these two mechanisms do not provide adequate protection of these assets against means-tests. Based on our experience with provincial governments as part of the *learn*$ave demonstration, there does appear to be a basis for greater coordination between levels of government to ensure that lower income Canadians do not have to exhaust all of their savings and productive assets that might otherwise help them gain greater self-sufficiency. Amendments to these vehicles or the creation of a new and locked-in savings plan, such as the Registered Development Savings Plan recommended by St. Christopher House (Stapleton, 2003) and a Registered

Tax Pre-paid Plan (see discussion in next section), would provide greater and sustainable savings and asset-building opportunity to low-income Canadians.

Fourth, the current range of income tax measures that impact savings and asset development (as with most aspects of the Income Tax Act), presume a significant level of financial literacy. If a taxpayer themselves does not have an adequate level of financial knowledge to effectively navigate the maze of income tax mechanisms, middle and upper income taxpayers with the disposable income to do so can purchase this knowledge through financial advisors and personal accountants. But lower income tax payers are at a significant disadvantage. Without disposable income they cannot afford to purchase the financial advice they need. Without adequate knowledge, they cannot make informed financial and economic decisions for themselves and their families. Low-income Canadians may also face barriers including basic numeracy, literacy, language fluency and physical or intellectual disability, more frequently than do other Canadians. As a result, many lower income Canadians may unknowingly and involuntarily be excluded from existing or future tax benefits, including those benefits specifically targeted to low-income Canadians.

Fifth, the current data collected on the savings and assets of Canadians is inadequate. Regular (ie: annual) and on-going surveys of savings and assets, alongside income, should be included in the Government of Canada's statistical data collection. The annual income tax data does not allow for more sensitive analysis and on-going evaluation of the impacts of the Income Tax Act on personal savings and assets. The current available data also makes it difficult to monitor and evaluate changes to the Income Tax Act and to examine intended or unintended effects on public programs.

Sixth, based on SEDI's experience in designing and managing the implementation of the federally-funded *learn*$ave project, consideration should be given to the tax treatment of current and future projects that aim to increase the savings of low-income Canadians. Currently, the tax treatment is based on the source of funding for the project, rather than the project objectives. This results in poor horizontal equity among low-income participants who may be taking part in different pilot projects. A more coordinated and equitable strategy should be put in place to ensure that low-income Canadians who do voluntarily participate in IDAs (Individual Development Accounts) or other asset-building projects are not penalized either by incurring a higher income tax liability or by seeing means-tested benefits (such as housing subsidies) reduced by changes to their net income.

2. Improving the tax treatment of savings

SEDI recommends the following changes to improve the tax treatment of savings for low-income Canadians:

- The Government of Canada should amend the Income Tax Act and regulations to exempt savings and matching grants accumulated in recognized IDAs or similar asset-building projects from net income. Interest earned on savings in the account may be included in taxable income. This approach will result in greater efficiency and equity as the number and range of IDA and asset-building projects continues to grow in Canada.

- In partnership with provincial and territorial governments, the Government of Canada should introduce a national strategy to improve financial literacy. The strategy should also engage interested members of the private and voluntary sectors. Already the Government of Canada has made a commitment to improving national literacy, including quantitative literacy and to address the needs of the more than 40% of Canadians with low literacy skills. A similar national commitment is urgently needed to address Canada's financial literacy gap. Community-based agencies with the credibility and the capacity to serve disadvantaged groups need to be equipped to provide a range of services so that low-income Canadians can achieve greater self-sufficiency by building assets and making the best use of them.

- The Government of Canada should introduce a Registered Tax Pre-Paid Savings Plan (RTPSP), alongside existing RRSPs and RPPs, to support the longer-term retirement savings needs of low-income Canadians. Because low-income Canadians have less disposable income and are less likely to enjoy the benefits of an employer-sponsored pension plan, they are at a significant disadvantage when it comes to building assets to maintain self-sufficiency in retirement. Worse still, those low-income Canadians who do manage to make contributions to an RRSP may see those hard-earned savings penalized through means-tests in federal seniors benefits or provincial social assistance benefits. The current rate of poverty among Canada's seniors is declining but is still as high as 25% among seniors in urban areas and even higher among older women[5]. Canada Pension Plan benefits based on market income and seniors benefits levels are not adequate to keep many seniors out of poverty, particularly in urban areas where housing costs are significant. To protect RTPSP savings in the short-term from provincial welfare asset tests, RTPSPs could be locked-in while a contributor receives provincial income assistance. Intergovernmental discussions should also be started immediately toward the goal of regulatory changes to eliminate disincentives to savings in federal and provincial benefits. Like RRSPs, RTPSPs should be eligible for tax-free withdrawals (and repayments) under the Home Buyer's Plan and Life-Long Learning Plan. For the most low-income earners, a modest matching annual grant of 20% would provide incentive to save in an RTPSP. These registered plans would offer an avenue for low-income Canadians to build savings for their retirement and to invest those savings in their well-being over the course of their lives.

- The Government of Canada should introduce a national system of Children's Savings Accounts for all children receiving the Canada Child Tax Benefit. Already the Government of Canada matches the after-tax savings of parents in an eligible education savings account through the Canada Education Savings Grant. But a recent evaluation of the program has found that the program is primarily reaching middle and upper income families with greater disposable income. To create a more level playing field for low-income families, a national system of Children's Savings Accounts should be provided to all children receiving the CCTB. A modest one-time public investment of $500 provided at birth would open the account with a recognized RESP provider. To encourage the child's family, friends and community to continue contributing to the account a matching grant of 1:1 would be added annually, much like the current Canada Education Savings Grant. With modest annual contributions, the account could grow to more than $20,000 by the time the child reaches age 18[6]. Savings could be invested by young adult in his or her own future through education, training or in starting a small business. Young adults who are unable to make full use of

[5] Source: Canadian Council on Social Development, *Urban Poverty In Canada*, 2001.
[6] Figure based on annual private contributions of $350, matched by $350 annual grants, invested with an annual rate of return of 5% compounded annually over 18 years.

CESG or Children's Savings Account funds within the set time limits should be permitted to roll the funds into another asset-building account for life-long-learning, homeownership or retirement savings.

- The Government of Canada should explore other mechanisms to meet the short and medium term savings and asset-building needs of low-income adult Canadians. Investments should be made in research projects to evaluate models for increasing savings for home purchase and affordable housing. Serious consideration should also be given to proposed mechanisms to enhance asset-retention such as the Registered Development Savings Plan (RDSP; see Stapleton, 2002).

3. Options for a new tax pre-paid registered savings vehicle

As noted above, SEDI believes that the Government of Canada should introduce a Registered Tax Pre-paid Savings Plan alongside the existing system of RRSPs and RRPs, to support long-term savings for retirement. The primary objective of the RTPSP should be to provide a better vehicle for low-income Canadians to engage in long-term savings for their retirement, recognizing that the Plan would also provide benefit to other Canadians through greater choice in their retirement savings options.

The RTPSP should be marketed and administered, like other private savings vehicles, through the existing network of licensed Canadian financial service providers. However, a national financial literacy strategy should accompany the introduction of the Plan to ensure that all Canadians, particularly disadvantaged Canadians, can make informed decisions about their own participation in the Plan.

To ensure equity, RTPSPs should be eligible for the same tax-free withdrawals (and repayments) as RRSPs under the Life-long Learning Plan (LLP) and Homebuyer's Plan (HBP). Further investments in demonstration projects and research are needed to explore whether the tax pre-paid model might offer an efficient, effective and equitable mechanism to support other short or medium-term asset-building goals for low-income Canadians.

The new RTPSP should be based on the principle of progressive universalism. While it would be available to all Canadian taxpayers, it should also be structured as a progressive instrument that is more truly inclusive of lower income Canadians. To achieve this progressive universal structure, SEDI further recommends that:

- Investment income earned in a RTPSP should not be included in net income since it may result in an increase in the marginal effective tax rate to lower income taxpayers. This would represent another disincentive to saving for low income Canadians who may see a decrease in income-tested benefits such as CCTB and provincial housing subsidies.

- Based on net income, low-income taxpayers should be eligible for a refundable tax credit worth 20% of annual RTPSP contributions (less annual investment income earned) up to a set maximum (for example 20% on the first $2,000 contributed, or $400 total).

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