

Converting the RRSP/RPP Deductions into Tax Credits: Estimated Tax Expenditure Savings

RESEARCH NOTES

Greg deGroot-Maggetti
September 2003

CITIZENS *for* PUBLIC JUSTICE



Research Notes, September 2003

Converting the RRSP/RPP Deductions into Tax Credits: Estimated Tax Expenditure Savings.

Greg deGroot-Maggetti

Public and private pension plan premiums are treated differently by Canada's tax system. Premiums paid to the Canada and Quebec Pensions Plans provide a non-refundable tax credit of 16% – the lowest marginal federal tax rate on personal incomes. The credit is deducted from income tax owing. Premiums paid to Registered Retirement Savings Plans and Registered Pension Plans are deducted from income – generating a tax saving equal to the highest marginal tax rate a tax payer is in.

Providing the deduction for RRSP/RPP premiums is premised on two grounds. First, the deduction simply defers taxation that will be collected when retirees draw income from the retirement savings or private pension. Second, particularly for the RRSP, the deduction serves as an incentive to encourage people to build up private retirement savings.

For public pension premiums an incentive to encourage saving is not necessary since payment into the program is mandatory for all employees. And since premiums are only paid on the first \$39,000 in income, public pension income will not be enough to be taxed at higher than the marginal tax rate. So the credit makes sense.

However, many contributors to RRSPs and RPPs have current incomes that put them in higher tax brackets. So the deduction saves them 22%, 26% or 29% in taxes. In retirement, however, they are far less likely to draw an income in a high tax bracket. Thus, the principle of tax deferral is not symmetric. The federal government foregoes more tax now than it collects later.

The tax advantages of RRSPs and employer pensions are well known. Contributions are deductible, funds grow tax-free, and taxes are generally deferred from high- to low-rate periods in individuals' life cycle.

Shillington

An issue of fiscal fairness

Canada's asymmetric tax treatment of private pension premiums and pension incomes is one element of fiscal unfairness. This is aggravated by the fact that lower income Canadians

CITIZENS for PUBLIC JUSTICE

who attempt to save for retirement through RRSPs get little or no tax relief now while their pension income can be taxed back at rates as high as 75% – when income tax and the reduction rate for Old Age Security benefits and other seniors benefits are factored in (Shillington 2003).

Not only are upper-income Canadians the people most likely to enjoy a tax break from RRSP contributions, but they also get a proportionately higher tax break than other Canadians.... Tax credits are fairer than tax deductions because they provide the same savings regardless of which tax bracket a person is in.

National Council of Welfare

Another aspect of unfairness is that the tax deductibility of private pension savings denies the federal government revenue that could be used for other public purposes. At a time when child poverty persists, food bank lines grow, the wealth gap is widening and the income gap showing no signs of closing, it is hard to justify costly tax deductions that benefit those who are well off.

A remedy for this problem would be to turn the RRSP/RPP premium deductions into tax credits, like CPP/QPP premiums.

Estimated Tax Expenditure Savings

The National Council of Welfare estimated that in 1996 the federal treasury lost over \$2 billion in revenue by not converting the RRSP and RPP deductions into tax credits as it had done with the Canada and Quebec Pension Plan premiums. Today the figure amounts to more than \$3 billion annually.

Table 1 gives an example of the difference in the cost of providing a tax deduction for private pension contributions versus a tax credit. In this example, we take data on RRSP/RPP contributions from 1999 and apply 2002 marginal tax rates to examine the cost difference between a tax deduction and a tax credit. The difference is greater than \$3 billion.

This result provides a rough estimate, but one that gives a sense of the magnitude of the difference in cost. We should note that this is a conservative estimate. RRSP/RPP contributors with incomes above \$100,000 are taxed at 29%. But in this example a standard 26% tax rate is applied on all incomes above \$80,000. Moreover, deducting RRSP/RPP contributions from income increases the level of other tax credits – like the Child Tax Benefit – available to higher income households.

CITIZENS for PUBLIC JUSTICE

Table 1
Tax Expenditures for Deductions and Credits: An Example

1999	No. of Savers (‘000s)	Avg. RRSP & RPP Contribution	Tax Expenditure* Deduction	Tax Expenditure** Credit
\$30,000-39,999	1,609	\$3,885	\$1,375,212,300	\$1,000,154,400
\$40,000-59,999	2,263	\$6,298	\$3,135,522,280	\$2,280,379,840
\$60,000-79,999	969	\$9,647	\$2,430,465,180	\$1,495,670,880
\$80,000 +	748	\$13,201	\$2,567,330,480	\$1,579,895,680
Total			\$9,508,530,240	\$6,356,100,800

Source: Statistics Canada (<http://www.statcan.ca/english/Pgdb/labor55.htm>)

* Assuming 22% tax on incomes between \$30,000 and 59,999 and a 26% marginal tax rate on incomes above \$60,000.

** Assuming a tax credit of 16%.

Sources

National Council of Welfare (1999). *A Pension Primer*.

Shillington, Richard (2003). *New Poverty Traps: Means Testing and Modest Income Seniors*. CD Howe Institute Backgrounder No. 65.