CREDIT CRISIS MEETS RETIREMENT INCOME

If we live longer, why can't we save longer?

The Income Tax Act is squeezing seniors and their banks

WILLIAM ROBSON

President and CEO, C.D. Howe Institute

November 5, 2008

Forced liquidations - urgent cash needs that make people unwind arrangements they would rather leave in place - are a principal cause of the current financial crisis. Savers sell at a loss and financial institutions face sudden demands for liquidity, which suddenly becomes scarce. It's all the worse when the savers are Canadian retirees, the financial institutions are the banks and insurers who hold their savings, and the force behind the liquidation is arbitrary government rules.

For years, the federal Income Tax Act has made Canadians with defined contribution pension plans or RRSPs stop contributing at a prescribed age. At 71, they must annuitize, putting their assets into instruments such as registered retirement income funds (RRIFs) and beginning to take out their money. The formula forces larger withdrawals as they get older. The purpose of both rules is to accelerate tax collections. Older people cannot deduct their saving from taxable income, as other Canadians do. And bringing tax-deferred saving into income makes them pay tax and often subjects them to clawbacks of seniors' benefits.

This governmental impatience for revenue (after all, tax-deferred saving will grow and be spent either by the saver or heirs, so the taxman gets it eventually) puts many older Canadians at risk of building too little retirement saving, and of running down what they do save too fast.

The age limit for tax-deferred saving was first set at 71 half a century ago, when life expectancy at 65 was six or seven years shorter than it is now. The rules prescribing RRIF drawdowns, established in 1992, are no less inappropriate. Not only is life expectancy up further since the early 1990s, but returns on investment are way down.
Print Edition - Section Front

Section A Front Enlarge Image
The Globe and Mail

An average 65-year-old man retiring with a $100,000 nest egg in 1992 could have expected the inflation-adjusted purchasing power of his tax-deferred savings to fall to $84,000 by his expected year of death.

Since women live longer than men, the equivalent figure for the average woman would have been $65,000. People who lived longer than average would see worse depletions - but for most people, the drawdown rule did not seriously threaten adequate tax-deferred savings throughout retirement.

Today, higher life expectancy and lower returns on investment make the situation radically different. The average man retiring with $100,000 can now expect to see his inflation-adjusted nest egg fall to a mere $28,500 by his expected year of death. For the average woman, the equivalent figure is a paltry $20,900.

Dismal as these simple examples are, the real-life plight of many older Canadians affected by the financial crisis is far worse. A nest egg of $100,000 invested in the S&P/TSX index at the beginning of this year has lost almost $30,000 since then. People approaching 71 have little time to make more tax-deferred contributions, and those past that age cannot make them at all. They must try to rebuild their diminished wealth from income. This is a forbidding task when taxes and clawbacks can take half or more of their income, and when post-tax yields on safe investments are too low even to keep pace with inflation. An added insult is that the drawdowns that RRIF holders must make this year are determined by their RRIF balance as of Jan. 1 - since when much of their value has been lost.

That fact highlights another perverse effect of these policies. The credit crisis has left households and businesses around the world short of investable funds, and while Canadian firms and financial institutions are in better shape, they too are scrambling. Preventing a large part of the Canadian population from adding to their retirement saving - and, worse, obliging them to sell financial assets and withdraw cash - is intensifying the already severe pressure on banks, insurers and others. So these policies are exacerbating a crisis that has already left many retirees and soon-to-be retirees much poorer.

The good news amid all this dysfunction is that the rules creating these problems are easy to fix. The federal government could simply raise the age at which seniors must wind up their pension plans and RRSPs to 73 or 75. The reference ages in the formula governing RRIF distributions could rise by the same amounts.

If reform is on the table, Ottawa could go further and abolish age-related limits on saving and forced distributions outright. Canadians are living longer, and those who wish to continue saving should not face barriers to doing so. The wealth many seniors will be working to rebuild in the coming years is wealth the country will need as the population ages.

Whether the reform is radical or incremental, it should happen soon. Older Canadians are being forced to stop saving just when they and their financial institutions badly need each other. The rules limiting and depleting retirement saving make no sense. The financial crisis should be a spur to fixing them.