TFSAs will be ineffective, burdensome

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The new tax-free savings accounts introduced in last week's federal budget sound great, but they won't encourage much new saving, the tax reductions will be modest, and they will be an administrative hassle for all of us. The Conservatives have unfortunately chosen another neat gimmick rather than a good policy.

The objective was apparently to reduce the taxation of interest and dividend income and thereby induce people to save more. To achieve it, policymakers needed to think carefully about the incentives people already have to save, and how these would be altered by any new policy.

To think sensibly about these incentives, let's divide Canadians into three groups and then analyse each group separately. The first group includes those who either have no RRSP or who do not contribute to the limit. In the second group are those who regularly max out their RRSPs and also save less than $5000 annually into non-RRSP accounts. Finally, there are those lucky Canadians who not only max out their RRSPs but also save more than $5000 each year outside their RRSPs.

For people in group one, the new tax-free savings accounts will be irrelevant. Since they are not using their RRSPs to the full extent possible, apparently their access to special accounts has nothing to do with their lack of saving. Their low saving is instead due to their low income or their young age or their outlook that emphasises the present rather than the future. If and when they decide to save more, they won't use the new accounts – they will use RRSPs which offer larger tax benefits. Thus the new accounts won't change their saving behaviour and they will get no tax break. So for this large fraction of the population, the new policy is irrelevant. Not a great start.

For those in the second group, the new tax-free accounts may increase total saving – but not by much. Imagine you are thinking about saving an extra $1000 per year and you can earn 5% before taxes. In a non-RRSP account, the $50 pre-tax earnings would yield roughly $30 after taxes. Inside one of the new tax-free accounts, however, you get to keep the entire $50. So will the extra $20 per year of after-tax earnings lead you to save that extra $1000 rather than spend it? Maybe, but it is more likely that other things – like your age or income or outlook – will have a bigger effect on your behaviour. But some people in this group are nonetheless likely to create one of the new accounts, direct some new saving into it, and get a modest tax reduction for their efforts. The policy is looking better.

Finally, consider the third group, those who annually save more than $5000 over and above their RRSPs. Apparently, the current tax treatment of their interest earnings is not much of an obstacle to their saving. Most of them will simply create one of the new accounts and transfer $5000 each year into it from their existing non-RRSP accounts. They will get the associated tax break and they will have to endure a little more paperwork each year. But their total annual saving is likely to be unchanged; it will simply be relabelled as it moves between accounts.

So let's recap. For group one, nothing happens, bad or good. For group 2, there will be a small increase in saving and a small (but growing) tax break. Plus there is new paperwork. For group 3, there will be no increase in saving, a small (but growing) tax break, and new paperwork. After a few years, the government will point to all the tax-free savings accounts and claim the success of their program in increasing Canadians' saving, but the success will be mostly illusory for they will not have noticed the large amount of shuffling between accounts.

None of this is rocket science, and so I find it hard to escape the conclusion that the government's real objective was to modestly reduce taxes, while not really caring about the effect on saving. And I have no problem with that objective. But instead of coming right out and doing it in a sensible way, they introduced another ineffective and burdensome gimmick. There is an alternative policy which would be much easier to implement and would have broadly similar effects on taxes and saving.

Suppose the government announced that for every Canadian, the first $15,000 of interest, dividends or capital gains earned each year (outside an RRSP) would be tax free. At a 5% rate of return, this would imply tax-free earnings for all Canadians whose accumulated stock of non-registered financial assets was $300,000 or less. This would be the vast majority of Canadians. And for those lucky Canadians who have larger nest eggs, their earnings in excess of $15,000 could be taxed as they currently are. No new paperwork; just one or two new lines on our tax forms.

This alternative policy is a no-brainer when compared with the new tax-free saving accounts. The effect on total saving would be about the same, since the lion's share of any increase in saving would come from the people in group two, most of whom have non-RRSP assets less than $300,000. But the real advantage of this policy would be that any tax reductions come without the paperwork needed to create and administer new accounts. Canada's investment advisors who collect fees by creating new accounts may not like this alternative policy, but Canadians as a whole would be better off.

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