Labour Market Matters

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Special points of interest:

- RRSP contributions can cause lowered or even negative retirement savings for GIS recipients.
- Forced early retirement by 5-10 years can cut final average pay from defined benefit pensions by 24% to 45% in instances when early retirement subtracts from maximum years of pensionable service.

"[C]onsideration should be given to the government distribution of information to taxpayers, particularly as they approach retirement, about the relative benefits of RRSP and TFSA saving, with mention of the negative interaction between RRSPs contributions and GIS phaseouts"

For GIS recipients, RRSP contributions can actually harm overall retirement savings.
Image: Stuart Miles/Freedigitalphotos.net

A Common Registered Retirement Savings Plan (RRSP) Mistake

The Guaranteed Income Supplement (GIS) has contributed significantly to the reduction of senior poverty in Canada, but prospective GIS recipients should think twice at age 64 about making an Registered Retirement Savings Plan (RRSP) contribution. In many cases, the best move may even be withdrawing the whole RRSP. This is because once GIS payments start, RRSP withdrawals are subject to a GIS phaseout of at least 50 cents on the dollar – as well as surprisingly frequently subject to personal income tax as well.

To illustrate how an individual can mistakenly save in an RRSP, consider the hypothetical case of an individual who is 64, and contributes $1,000 to an RRSP for the first time. Assuming a marginal tax rate of 30%, there would be a $300 personal income tax refund associated with this contribution. With a hypothetical interest rate of 5%, this individual will have $1,050 inside the RRSP and $315 from saving the refund one year later at age 65. Suppose this individual is a GIS recipient at age 65 and withdraws the RRSP holding that year. The withdrawal will count as income for GIS purposes and will be subject to the GIS phaseout of 50%. Hence this individual will have 50% left from the $1,050 or $525 plus the $315 from saving the refund. The total of $525 and $315 totals $840 which is *less* than the original $1000 contribution. The effective rate of return on the RRSP contribution in this scenario is *minus* 16%. Saving outside an RRSP would have yielded a better return than inside the RRSP. And the same arithmetic suggests in many cases maintaining a small RRSP at age 64 (as opposed to collapsing it) is also a mistake, again because of the GIS phaseout.

How common are these kinds of errors? Previous research[1] has estimated that 32% of near-seniors have made Registered Retirement Savings Plans (RRSP) contributions in error as their asset holdings are low enough that they will *likely* be Guaranteed Income Supplement (GIS) recipients and thus their RRSP contributions would *likely* be subject to GIS phaseout. A CLSRN study entitled ***"Estimating the Number of Guaranteed Income Supplement Recipients Who Have Mistakenly Saved in Registered Retirement Savings Plans and Registered Pension Plans"*** (CLSRN Working Paper no. 119) by Michael Veall (McMaster University) reconsiders this estimate by analyzing anonymized taxfiler data to count the number of GIS recipients who *actually* were subject to phaseout on RRSP income. While his estimates are somewhat lower than those in the previous research, his main conclusion is that this issue clearly affects a very significant number of low-income seniors.

Michael Veall (McMaster University)

Tax Free Savings Accounts (TFSAs) – introduced in 2009 – greatly affect the policy implications of this research, but as they were introduced after the data period for this study, they could not be factored into the results. Given that there may be a significant number of near-seniors who are likely to be GIS recipients contributing to RRSPs when they should be investing in TFSAs; Veall suggests that consideration should be given to the government distribution of information to taxpayers, particularly as they approach retirement, about the relative benefits of RRSP and TFSA saving, with mention of the negative interaction between RRSPs contributions and GIS phaseouts. This study illustrates a case where a group not usually thought of as a prime target for financial planning could benefit greatly from such advice because of the risk that well-intentioned RRSP saving could lead to unnecessarily low or even negative returns.

[1] Shillington, Richard (2003), "New Poverty Traps: Means-Testing and Modest-Income Seniors; C.D. Howe Institute, Backgrounder #65, April.

The Timing and Impact of Cyclical downturns on Retirement Savings and Pensions

The recession of 2008-2009 had a devastating effect on the Canadian economy. Between the second quarter of 2008 and the first quarter of 2009 the Toronto Stock Exchange (S&P TSX) composite index fell 51%. Over the same period house prices fell by 6%. By themselves, these and other asset price changes over the same period reduced the average wealth of Canadian families by 11% and average retirement assets by 14%. Without the subsequent recovery in prices, defined contribution (DC) plans would have lost 27% of their value, and registered retirement assets would have dropped 26%. While the economic recovery neutralized some of the losses, not everyone benefitted equally. In a CLSRN paper entitled ***"Impacts of Cyclical Downturns on the Third Pillar of the RIS and Policy Responses"*** (CLSRN Working Paper no. 113) James B. Davies and Xiaoyu Yu (both of the University of Western Ontario) analyze unemployment and early retirement effects of recessions and find that some pension and retirement plans are more vulnerable than others in instances of cyclical downturns.

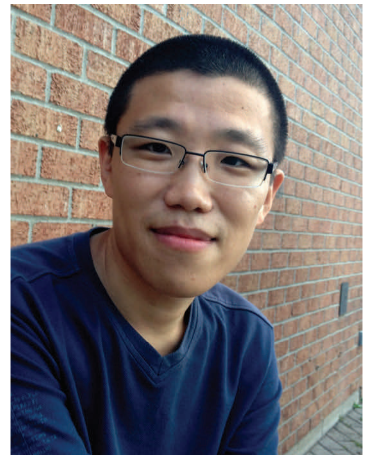
James B. Davies
(University of Western Ontario)

Using data from Statistics Canada's 2005 Survey of Financial Security (SFS) projected forward to 2008, the researchers estimated the impact of the 2008 -09 recession on the level and distribution of household wealth, including pension assets. The analysis indicated that on average, family wealth would have declined by 11% in the recession due to asset price changes alone, but then would have more than recovered, climbing 13% from the trough in 2009 to the end of 2010. Retirement assets however, would have fallen 14% and only risen 12%, not recovering fully in this period. The reason for the difference is that housing is an important element in overall wealth, and house prices more than rebounded from their 6% fall during the recession in the subsequent year, partly due to low interest rates.

While Defined Contribution pension plans (DC) are more affected by early career interruptions than Defined Benefit (DB) plans. This is because early contributions have a greater impact on DC plans due to growth compounding with time. Defined Benefit (DB) plans, in contrast, tend to be "backloaded," in the sense that benefits are augmented more quickly toward the end of the career for each additional year of work – which is also when individuals tend to earn their highest salaries. This means that a recession near the end of an individual's career or forced early retirement late in a career before an individual has hit the maximum credit for years of service in a defined-benefit plan are particularly harmful to Final Average Pay (FAP) in retirement. Indeed, the study estimates that if a typical worker is forced to retire at age 55 instead of 60 their pension pay could fall by 9.4%, and early retirement by 10 years produces an 18.0% pension hit. These effects are magnified in the "worst case scenario" where early retirement subtracts from maximum years of pensionable service. In these cases, retiring early by just 3 years can reduce pensions by 15.2%, while retiring 5 or 10 years early can cut pensions by 24.5% or 45.3% respectively.

"[I]n the 'worst case scenario' where early retirement subtracts from maximum years of pensionable service. In these cases, retiring early by just 3 years can reduce pensions by 15.2%, while retiring 5 or 10 years early can cut pensions by 24.5% or 45.3% respectively"

While stock indexes and asset prices have, for the most part, rebounded back to or beyond their pre- 2008/2009 recession levels, this study has shown that the timing of economic crises can have devastating effects on pension and other retirement income plans in certain instances. The timing of an economic downturn can have little or no effect – in cases of individuals with DB plans who continue in employment or who are forced into early retirement but have already hit their maximum pensionable years of service – or can cut DB pensions by as much as 45% in certain cases of forced early retirement. While Defined Benefit plans are often seen in a more favourable light than Defined Contribution plans, in terms of their risk characteristics, these findings are a reminder that both types of pension plan contain an element of risk in the context of economic downturns.



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Endnotes

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