



# Financial Industry Monitoring Service

In-depth analysis of developments in the Canadian and U.S. financial services industries

## Saving options for lower income Canadians

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### Table of contents

Overview .....	1
Definition of TPSPs and RDSPs .....	2
The twin rationales for TPSPs and RDSPs .....	2
Tax fairness for lower income Canadians .....	2
Stimulate more saving activity .....	4
Evaluating the merits of the two policy goals .....	4
Scope of the lower income challenge .....	4
Why don't lower income Canadians save more? .....	6
Canada's saving "problem" .....	6
Implications for other stakeholders in the debate .....	7
Benefits to middle and upper income Canadians ....	7
Financial institutions .....	8
Governments .....	8
Additional suggested reading .....	10

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### Overview

Lower income Canadians face many barriers when attempting to design a saving plan that will suit their needs both pre- and post-retirement. Aside from the obvious nature of tight budget constraints, among such barriers is the way in which the current system of taxation and social assistance programs can sometimes penalize their saving behaviour. This holds true regardless of what saving product is used by lower income Canadians, but RRSPs in particular have received considerable negative press over the issue.

Partly because of this, a new form of tax shelter named Tax Prepaid Savings Plans (TPSPs) has been proposed and discussed in the past few years. Proponents have argued that this new product, or minor variants named Registered Development Savings Plan (RDSP) and other hybrids, would do one or both of two things: address inequities in the taxation of retirement savings and income that work to the detriment of lower income Canadians; and stimulate overall saving.

Neither TPSPs nor RDSPs are likely to accomplish either of the two main objectives. On both counts, creative arguments have been employed to grossly overstate a problem and then to fix it with a very blunt, indirect, administratively costly, and relatively complex instrument that — depending on its exact form — may be overly restrictive, viewed with deep suspicion by lower income people and, ironically, be very regressive. Furthermore, the risks to federal tax coffers through inciting mass portfolio shifts away from non-tax sheltered holdings could be material especially if no (or very generous) contribution ceilings are involved as some advocate. The net benefits to financial institutions are likely to be inconsequential such that their effective marketing participation would be doubtful. The only reason they would participate is if other financial institutions offered TPSPs and this materially cannibalized other registered and non-registered products.

For a small proportion of Canadian taxfilers, however, there is a tangible problem in the way in which the tax system treats retirement saving and the way in which income- and asset-based means tests within provincial social assistance programs treat those lower income individuals who have managed to save for a variety of purposes. The outcome is such that for some people, the penalties can be much higher than for higher income individuals, while for a small portion of lower income people, saving can perversely make one worse off. Instead of compounding the problems with yet another way of fixing an imperfection in the tax system, however, serious consideration should be given to eliminating clawbacks on programs in retirement and then dealing with the implications by altering the income tax rate schedule, alongside graduated clawbacks for social assistance programs instead of the current all-or-nothing approach.

The rest of this paper explains the nature of TPSPs and RDSPs and the reasons why they have their proponents and then focuses on assessing their likely impact as well as alternatives.

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## 1. Definition of TPSPs and RDSPs

First, some straight forward definitions. A Tax Prepaid Savings Plan would allow an individual to make contributions during one's working years that are not themselves tax deductible (unlike an RRSP), but which generate investment returns that are tax-sheltered (like an RRSP). Investments held within a TPSP would be fully liquid such that withdrawals could be made at any point during working years or in retirement with impunity. Such a lack of tax penalties would not be at all contingent upon the use of any withdrawn funds, whether to purchase a major asset like a home or a car at a later date, or to save for any purpose including, but not limited to, funding retirement, paying for basic food and clothing needs, paying for a vacation, buying a boat or a TV or whatever one decides. There is debate among the proponents of TPSPs about whether contribution ceilings should exist and, if so, at what level and whether or not there should be restrictions on eligible investments that can be held within a TPSP.

For example, if you contributed \$5,000 to a TPSP that generates an average rate of return of 5% per year, no tax deduction is provided for the original \$5,000 but no tax is ever paid on the \$250 worth of investment returns earned in the first year or compounded average returns in each subsequent year.

In a very crude way, TPSPs would be similar to how a principal residence is treated for tax purposes, in which case no tax deduction is provided for the downpayment or purchase while any capital gains are allowed to accumulate tax free. Even at that, however, there are some exceptions to this argument such as tax sheltering mortgage payments and deducting expenses for a home business.

A minor variant of TPSPs, named Registered Development Savings Plans (RDSPs), has also been proposed. This product would also not offer a tax deduction on contributions and would shelter investment income. However, it is designed very specifically for lower income Canadians in that low contribution ceilings would apply, one would only be able to make withdrawals from the plan in order to fund very specific and approved expenditures, the plan would have to be depleted before retirement, and the assets held within an RDSP and any income generated within such plans would be exempt from income- and asset-based means tests that are used to determine whether one qualifies for various forms of social assistance. The latter aim to exclude RDSPs from means tests would require each provincial government to introduce such a change to provincial programs after an RDSP-type product is introduced at the federal level within the Income Tax Act.

Hybrid proposals of the two products also exist that combine a few of the characteristics. For instance, some advocate the pure form of the TPSP that includes one of the RDSP features that exempts income generated from the plan from income- and asset-based means tests used to determine eligibility for social assistance programs.

## 2. The twin rationales for TPSPs and RDSPs

Proponents of TPSPs argue that they are needed to enhance fairness in the tax treatment of lower income Canadians and to possibly stimulate greater saving activity.

### 2.a. Tax fairness for lower income Canadians

The first concern is that lower income Canadians are treated unfairly by the tax system in a way that penalizes their saving activity.

One reason is that if lower income households actually do save, then they run the risk of triggering punitive clawbacks during their retirement years if the income generated from saving results in steep rates of clawbacks on Guaranteed Income Supplements and other programs. As illustrated in chart 1, the marginal rates of taxation applied against investment income for the example of a single senior living in Ontario and filing a tax return in 2003 can climb to as high as 77% depending on the amount of investment income generated. This is because of clawbacks applied to Old Age Security benefits, the age amount of tax credit, Guaranteed Income Supplements (GIS), GST and provincial tax credits, Ontario tax reduction and sales tax credits.

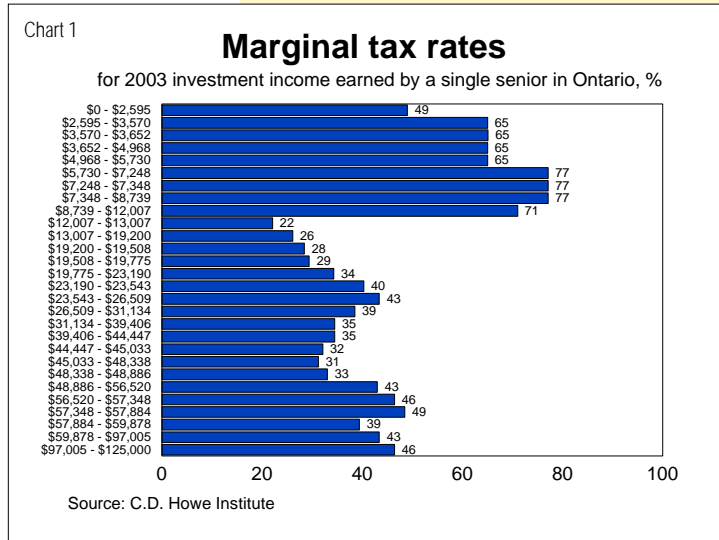
In addition, if such an individual saves for retirement through RRSPs in particular, then the up-front benefit of being able to deduct contributions from taxes is modest given low marginal rates of taxation compared to higher income contributors. What's more, if lower income Canadians do happen to generate enough saving to feed higher income in retirement than they typically earned during their working years, then this can be taxed at higher marginal rates than they paid during their working years even if assistance and benefits programs are not clawed back since they could wind up in a higher tax bracket. The overall effect is that for some, saving for retirement through RRSPs may be of little to no benefit or perhaps even make them worse off.

Secondly, lower income Canadians can be subjected to income- and asset-based means tests in order to qualify for social assistance including welfare, licensed daycare, affordable housing, or other programs. This typically means that they must demonstrate little to no earnings and that they have few if any assets. This latter requirement is typically aimed at avoiding abuse of welfare programs and other forms of assistance, such as someone drawing welfare because they have no earned income in a particular period but who may well be wealthy nonetheless. What this can mean, however, is that a lower income person spends out assets and then applies for social assistance in a way that may perpetuate the poverty cycle by ensuring little to no chance of that individual ever accumulating wealth.

This problem can also apply to an individual who comes across unexpected modest gains such as small lottery winnings or an inheritance. Asset-based means tests would force such an individual to draw down and spend such assets before being entitled to further social assistance. Critics say this ensures permanent poverty status.

Furthermore, by tightly regulating funds within an RDSP in terms of how they could be redeployed, it is thought that lower income people will be guided to make better choices with respect to what they do with their money with an eye on escaping the poverty cycle in the long-run.

It is important to note that these are not necessarily criticisms of RRSPs per se. Rather, they point out what can be the futility of saving by some lower income people regardless of the particular registered or non-registered product they use.



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## 2.b. Stimulate more saving activity

The second rationale for TPSPs and RDSPs centres on the fact that the conventionally defined personal savings rate of all Canadians currently stands at 0%, meaning that Canadians on average are saving nothing out of their paycheques. This is the lowest level in this measure of the personal savings rate in the post-war era, but not the lowest on record since the personal savings rate was negative during the 1930s when people sold off assets in order to pay for expenses that were greater than their incomes. Proponents of TPSPs argue that Canada needs more policies that encourage saving and, hence, discourage consumption in order to lift this measure of the personal saving rate.

The possible benefits could include more domestically generated savings to fund domestic investment which theory suggests could aid productivity growth and, ultimately, the standard of living of Canadians measured by personal disposable income on an inflation-adjusted per capita basis.

## 3. Evaluating the merits of the two policy goals

From a variety of perspectives explored in sections three and four, the two fundamental reasons given for advocating TPSPs and/or RDSPs are of doubtful merit. Instead, there are other, more direct policy options to explore later on in section five.

### 3.a. Scope of the lower income challenge

The first rationale for TPSPs being designed in order to address potential inequities in the tax treatment of lower income Canadians is weak. While there are, indeed, some lower income Canadians who do save and face marginal long-run upsides to doing so, they are likely a tiny fraction of the overall number of taxfilers. Furthermore, the possible inequities in their tax treatment are unlikely to be rectified by relatively complex TPSPs or RDSPs that provide weak incentives compared to the reality of plain and simple budget constraints that fundamentally limit the ability to save.

Let's start by looking at the facts on how many low-income people actually save through RRSPs in order to gauge the magnitude of the issue. As Canadians prepare to meet the deadline to file their 2004 tax returns, we can look at actual data only for the year 2003. In that year, there were 10.1 million people who earned less than \$20,000 and as a group they contributed about \$825 million to RRSPs, which was 3% of total contributions and just over \$80 per person. Out of the 535,000 Canadians within this income group that actually did make a contribution, the average was \$1,544. Overall, those who contributed represented a small 5% out of 10.1 million total taxfilers reporting annual income of less than \$20,000 and 2.4% of all 22.5 million taxfilers across all income groups. These are rather small shares of both lower income earners and overall taxfilers.

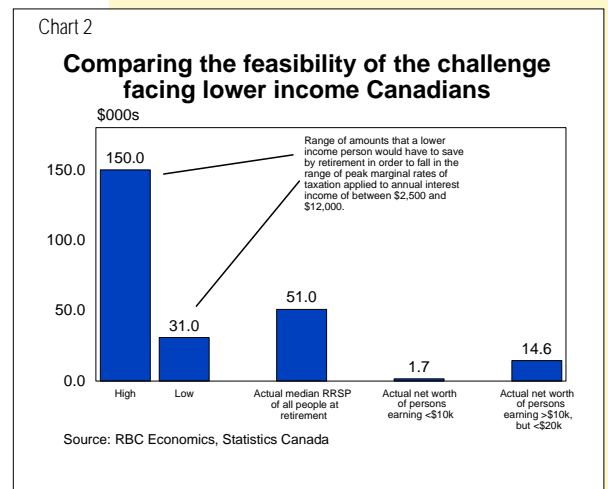
These are, furthermore, upper ceilings on estimates of how many lower income Canadians contribute to RRSPs. This is because there will always be some fraction of the population that reports lower income in a particular year but chooses to make a contribution. For example, a lower wage earner and/or part-time working person may choose to make a contribution if their spouse is a significant earner. Students and other part-time employed individuals may choose to make RRSP contributions out of limited annual compensation under the expectation that their annual income will rise in the future and that the mathematics of compounding interest are at their most powerful when people are a long way from retirement. Or a person with considerable wealth who works

part-time or little at all in a given year may wish to keep up RRSP contributions either because of a strong existing wealth position or the anticipation that earned income will be restored to higher levels in future years. In all of these cases, one may be hard-pressed to argue that they are truly of limited current or future expected means.

Most importantly, of those relatively lower income Canadians who do contribute to an RRSP, many would not contribute enough to risk incurring the peak marginal rates of taxation that are the result of clawbacks. This occurs, for the example of a single senior living in Ontario in 2003, at between about \$2,500 to \$12,000 in earned interest income. If we were to make the assumption that a person earning less than \$20,000 per year was able to contribute the \$1,544 average annual rate of contribution made in 2003 by those who did contribute and do so each and every year with the amount rising with inflation within a long 30-year period at a 5% inflation-adjusted rate of interest earned per annum, then such an individual would have about \$100,000 to invest 30 years from now in an annuity or RRIF. That amount, if invested in order to generate a fixed sum payment per year for the following 20 years in retirement, would generate annual income of about \$8000 in inflation-adjusted terms. This is smack in the middle of the peak marginal rates of taxation assuming that the tax brackets shift gradually with inflation. But, is this pace of contribution likely on such a consistent basis by the same people each year?

For that, we can turn to Statistics Canada's dated Survey of Financial Security, which is still relevant for our purposes. It showed that in 1998 the total net worth of those earning less than \$10,000 was \$1,700 and the total net worth of those earning between \$10,000 and \$20,000 was \$14,600. Furthermore, the median size of the total RRSP portfolio held by Canadians across all income groups amounted to about \$51,000 in that same year, and only 55% of taxfilers held an RRSP at all. Even among those nearing the age of retirement, about 70% have some sort of RRSP portfolio but the average size amounts to less than \$100,000. This figure itself is skewed by high income earners, so the more telling median size of an RRSP is about \$50,000 at retirement.

Lower income Canadians would have to save consistently and regularly every year and amass a portfolio of between \$31,000 and \$150,000 in order to have annual investment income of between \$2,500 and \$12,000 that is taxed at the highest marginal rates under the same assumptions we made earlier. As illustrated in chart 2, by comparison, this means that the average lower income Canadian would need to build up a portfolio by retirement that is between about two-thirds and triple the median RRSP portfolio size held at the point of retirement by all Canadians across all income groups. By further comparison, this means investing an amount in RRSPs that is between about 20 and over 80 times the total median net worth of those earning under \$10,000 and between two and 10 times the median net worth of those earning between \$10,000 and \$20,000 in order to face the range of peak marginal rates of taxation. The fact that this is highly unlikely leaves us facing the conclusion that lower income Canadians who do contribute to an RRSP and who do face material clawbacks of income support programs likely represent a very tiny fraction of taxfilers. Most lower income contributors would probably have less than \$2,500 in annual retirement investment income, taxed at marginal rates that are not terribly out of line with what is paid by higher earners. Proponents of TPSPs and RDSPs have ironically assumed that lower income earners are far wealthier than in reality.



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The overall aim here is to recognize the plight of a very small portion of the population that may itself be representative of the targeted communities of some social groups, but that there must also be a higher benchmark for a reasonableness test in order to warrant material changes to Canada's retirement income programs.

### **3.b. Why don't lower income Canadians save more?**

The inherent rationale for TPSPs as a way of providing incentives to lower income Canadians to save more, however, assumes, in part, that lower income earners do not save much because of awareness of the clawback argument. This is highly debatable, and no clear evidence has emerged that lower or higher income Canadians are aware of the many complexities involved, not least of which is the very nature of clawbacks. Compared to everything that front line bankers have to say about time spent evaluating important, but more basic, banking needs, understanding the nature of clawbacks — and the general mechanics of TPSPs — are relatively sophisticated arguments. Indeed, it has been reported by the advocates of RDSPs themselves that focus groups aimed at testing the receptiveness of lower income Canadians to TPSPs were characterized by much confusion among the participants, and leering towards the idea that how they use the money in an RDSP would be significantly restricted.

It is more likely that lower income individuals don't tend to save much because of good old-fashioned budget constraints and perhaps a lack of financial education in an increasingly complex world of investment options that can be challenging to even the most savvy investors. They have high marginal propensities to consume out of each additional dollar's worth of income. Such spending overwhelmingly goes towards basic food, clothing and shelter. This typically leaves little else to put towards other objectives such as saving for retirement.

But let's assume that modest amounts could somehow be tucked away. For example, take someone who earns \$20,000 per year and has \$1,000 to tuck away in savings. Such an individual is unlikely to want to take great risks with his or her investments and is likely to have a fixed income and liquidity bias with respect to investment choices. If such a bias yields an average annual rate of return of 3, 4, or 5% after inflation, then annual investment returns would amount to between \$30 and \$50. If the investment returns are tax-sheltered in a TPSP or RDSP, then the tax savings amount to around \$10 to \$20. Pity the poor front-line banker who, after an elaborate explanation of TPSPs and the related concepts, has to then deliver this punch line, not to mention the recipient. As such, advocates of TPSPs may be trying to be too cute by half in the sophistication of their arguments compared to more basic explanations of saving behaviour.

In summation, whereas TPSPs or RDSPs may help to get around the clawback problem in theory, their complexity will likely yield low take-up rates and they are unlikely to incite any greater saving behaviour by lower income people.

### **3.c. Canada's saving "problem"**

The second policy rationale has to do with the view that Canada has a saving problem and this is highly debatable. The conventionally defined measure of the personal savings rate is simply what people do not spend out of what they earn after all taxes and transfer payments and including employment and investment income. As chart 3 depicts, this measure is indeed quite low, but does that mean we're not saving enough?

There is much controversy surrounding this issue. For one thing, the personal savings rate is abnormally low today because households finally moved towards unleashing pent-up demand for houses, cars and other big-ticket items after the dismal first two-thirds of the 1990s and gradual pick-up thereafter. The postponement of major purchases and the ensuing release of pent-up demand is largely responsible for pushing the savings rate to such depths after it was so high in the early- and mid-1990s when interest rates, unemployment rates, and for a long time even inflation rates were high. This does not mean that Canada currently has a saving problem that requires policy intervention. Indeed, after many years in which Canadians postponed spending because of hard times in the Canadian economy, it would be odd to have public policy telling them that they should save more when they finally get around to unleashing pent-up demand.

Furthermore, the conventional definition of the personal savings rate ignores what is happening to the overall wealth position of Canadian households. A wealth-adjusted saving rate, however, which takes into account changes in asset valuations net of changes in debt and controlling for any double counting of saving, provides a very different picture. Chart 3 also shows that this wealth-adjusted measure has been volatile over the decades, but high in an average sense and with no long-run trend up or down. Clearly, households are saving not only out of their current year's income, but also with an eye on what is happening to their overall wealth positions. This would suggest that it is not at all clear that households have a saving problem that needs further policy stimulation.

Of further significance is that evidence of a saving problem affecting Canada must surely be defined on a broader level than just looking at households. Most economists would argue that saving must be evaluated from the standpoint of the nation as a whole. Presently, all levels of governments combined into one group are saving by running overall surpluses, businesses are saving through retained earnings, Canada has a trade surplus, and this all offsets a weak personal savings rate such that Canada's interactions with the rest of the world are not marked by a savings deficiency. Far from it, Canada is paying down net external debt that is owed to the rest of the world in stark contrast to the United States, which is running up liabilities to foreign investors at a rapid pace due to government borrowing and consumption that is driving a record trade deficit.

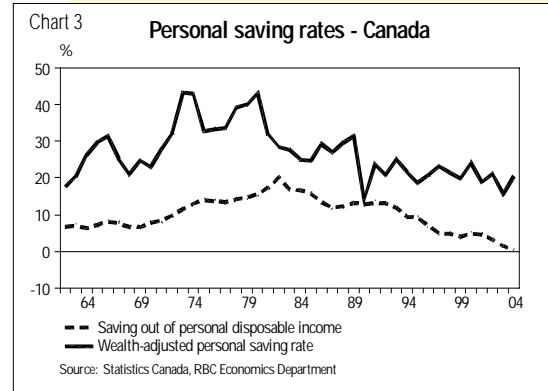
#### 4. Implications for other stakeholders in the debate

Relatively higher income Canadians, governments and financial institutions are the three other principal stakeholders in the debate and both TPSPs and RDSPs must be evaluated in terms of their impact on them.

##### 4.a. Benefits to middle- and upper-income Canadians

Whereas the need and ability of lower-income Canadians to make use of TPSPs, plus the magnitude of the incentives are all in doubt, such arguments are turned on their ears for middle- and upper-income earners. It is the relatively wealthy individuals who would be most likely to make use of such a program and they are more likely to have access to the advisors and resources necessary to gain familiarity with the program.

The magnitude of the portfolios held by upper income Canadians would make the attractiveness of the tax savings much more significant. For example, a \$1,000,000



contribution to a TPSP by a wealthy person employing the same conservative 3, 4, or 5% average annual investment return as before would yield between \$30,000 and \$50,000 a year in investment income. This would translate into enough tax savings within a TPSP to purchase a rather nice, brand new vehicle every few years. This is not likely the intent of most of the advocates of TPSPs who are concerned about the inequity in taxing retirement income earned by lower income earners. Indeed, the outcome would be highly regressive. RDSPs would limit the regressivity feature but would not eliminate it since even with just a modest contribution ceiling of, say, \$2000, it is still more likely to be used by middle income households seeking to have tax subsidized savings or purchases of consumer goods, than by lower income people.

#### **4.b. Financial institutions**

Even for financial institutions, TPSPs are unlikely to be a significantly profitable product offering if targeted to lower income earners. For one thing, the potential market size is tiny by the standards of virtually any product in the financial industry. A total of just over \$800 million in annual contributions by all people earning less than \$20,000 in 2003 compares to an overall RRSP marketplace characterized by \$27.6 billion in annual contributions. This is already a small market, but even if TPSPs were to become used by lower income people, the result would probably be to cannibalize their existing RRSP contributions, offering little to no net revenue upside.

Further, the profit margin on this business would likely be small in relation to many costs. Systems costs would take the form of separately tracking contributions and investment returns for the purpose of issuing tax receipts. Higher costs would also be incurred in order to train front-line staff on the underlying concepts and the specific nature of TPSPs so that they can relay this information to clients.

Instead, the rewards for financial institutions would come through marketing TPSPs to middle- and upper-income Canadians through high net worth channels such as private banking divisions. It is not clear, however, that this would be done in a manner that grows the size of the overall pie of investment products. Rather, growth in TPSPs would probably come at the expense of RRSPs but more importantly, non tax sheltered products. If there isn't any liquidity constraint on TPSPs and they fully shelter investment income, then after perhaps maximizing desired RRSP and pension contributions, why one would hold one penny of investments outside of a TPSP in a non-registered saving product isn't clear. In turn, this would impose systems and administrative costs on financial institutions as they deal with the zero-sum portfolio shifting.

#### **4.c. Governments**

This last argument, in turn, exposes a risk to federal and provincial tax coffers. At present, Canadians hold about \$600 billion worth of personal deposits, \$500 billion in mutual fund assets, and billions more in direct holdings of stocks, bonds and money market instruments. If even just a fraction of this were to be shifted into a TPSP, the lost tax revenue on the investment returns would be massive. In 2003, Canadians earned more than \$100 billion in investment income and there is no reason to believe that the taxes paid on this sum of money wouldn't go to zero over time as TPSPs grow in popularity (or get cancelled). Even if contributions were tied to incomes, the amounts could be very large for relatively wealthy households. That, in turn, would mean that the lost revenues would have to be made up by other forms of higher taxes or by cutting spending in other

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areas such as transfers to fund health and education spending that make up the majority of spending. This, in turn, could worsen the regressivity of TPSPs if the offsetting measures are concentrated on lower income individuals who are relatively more dependent on government services.

## 5. Other policy options

While TPSPs and RDSPs are likely poor policy options, some lower income Canadians do face material and artificial challenges when it comes to saving. It is our feeling that the end goal of improving on the equitable treatment of saving by some lower income Canadians is a laudable objective. If not done on moral grounds, then at the very least this is because not helping people break the poverty cycle that the current system of taxation and social assistance programs may force on them actually works to the detriment of social policy and some measures of the economy's performance. It is also a fundamentally perverse principle that for some lower income Canadians, the reward for long-range planning and saving is to disproportionately incur the wrath of the tax collectors and those who provide assistance to disadvantaged groups.

### 5.a. Financial education

Financial education is a clear first step, but must be done responsibly. Some proponents of TPSPs and RDSPs have advanced their ideas through bluntly targeted criticisms of RRSPs in a way that has created unnecessary confusion for such a small-scale challenge. In reality, RRSPs are the superior way of saving for retirement for the overwhelming majority of Canadians, but they may not be in the best interests of some people in certain circumstances, including a very modest number of lower income Canadians. Much of the financial planning community is already marked by the “know your client” and prudent person principles, but extending this practice across the entire financial services industry would be in the best interests of such clients. An initiative to reinforce the merits of RRSPs to the overwhelming majority of taxfilers who are saving for retirement could include cautions on which types of clients might not be well-served by RRSPs while providing simple advice and possible alternatives for lower income earners such as non-registered accounts where withdrawals are taxed more favourably as capital gains. From a policy standpoint, however, leaving it at this amounts to the undesirable message that, because of the system of taxation and assistance programs, saving by lower income Canadians is futile, so don't bother. This is why additional reforms are needed. A discussion on alternatives, however, must be divided into those that apply to recipients of social assistance programs, versus the retirement saving challenge.

### 5.b. Graduated clawbacks on social assistance

For recipients of social assistance, instead of TPSPs or RDSPs, a wider ranging debate on how to address the challenges of clawbacks is necessary. There is considerable debate on whether higher or lower clawback rates are best for the long-run welfare of lower income Canadians, but further debate and empirical research is needed. There are some instances where clawbacks are wise policies such as ensuring that affordable housing goes to the most disadvantaged, that subsidized daycare goes to those who can least afford it, or that welfare abuses by generally better-off individuals are avoided. The critical issue appears to be the all-or-nothing nature of clawback arrangements within social assistance programs whereby the minute one trips the clawback, all assistance is lost. Perhaps a graduated set of clawbacks would be best.

### 5.c. End clawbacks on retirement income and alter marginal rates

As for the retirement savings challenge, instead of adding layers of additional confusion, why not just simply address the clawback issue itself? Perhaps ending clawbacks on OAS, the GIS, the age amount of tax credit, GST and provincial tax credits and other programs could be accompanied by altering the schedule of marginal rates of taxation in order to neutralize the effect on revenues and keep a progressive system in place. The main conclusions of this paper regarding the impact of TPSPs/RDSPs are summarized in the table below.

Income level	Utilization	Negative Impact on Tax Revenue	Impact upon existing saving plans
low	low	low	low
medium	high	high	high - cannibalizes existing RRSPs/other non-registered products
high	high	very high	high - cannibalizes existing RRSPs/other non registered products

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#### Additional suggested reading

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