Double Trouble:

The Case Against Expanding Tax-Free Savings Accounts

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A longer version of this study is available at the website of Simon Fraser University's School of Public Policy

EXECUTIVE SUMMARY

The Conservative Party of Canada's proposal to double contribution limits for Tax-Free Savings Accounts (TFSA) has received inadequate critical scrutiny to date. This gap may stem from the notion that little revenues will be lost and the perception that most taxpayers would benefit. Both beliefs are erroneous.

This study finds that no case—on either economic or equity grounds—can be found for unconditional doubling of TFSA contribution limits. Over the long run, doubling TFSA limits would cost governments additional billions in annual tax revenues, put most of the lost taxes into the pockets of the already well-to-do, and reduce the overall progressivity of federal and provincial tax systems.

The great majority of Canadians would enjoy no significant benefits. In fact, they would bear the burdens of an expanded TFSA by enduring the reduced public services or bearing the increased taxes needed to offset the lost revenues.

KEY FINDINGS

First, the existing TFSA already reduces the progressivity of federal and provincial tax systems, and doubling the limits would exacerbate this bias in future years. This study finds:

- When the existing TFSA scheme matures in 40 or 50 years, the cost to the federal government is projected at up to $15.5 billion annually. This represents a sharp increase from $65 million in its 2009 inaugural year, growing to a $410 million cost in 2013.
- Provincial governments will also suffer revenue losses from the tax-free nature of TFSA balances, growing to as much as $9 billion annually when the system matures, figures that would similarly be inflated by a doubling of the TFSA limits.
- Commitment by the federal government never to consider TFSAs in the income tests for the Guaranteed Income Supplement and the Old Age Security benefits will expose the program to growing numbers of dependants and mounting costs in future decades. By 2050, annual program costs could rise by $4 billion to several times that figure.

Second, this study dispels the notion that doubling the TFSA contribution limit would be of broad benefit to the taxpaying public and would boost the economy's performance. It finds that:

- The current combined contribution limits for RRSPs and TFSAs allow ample room for the lifetime saving requirements of all workers earning up to at least $200,000 annually. With the current $5,500 limit, one could accumulate between $690,000 and $4 million depending on the rate of return; an individual with the doubled limit or a couple with the current limit could accumulate twice that amount, or between $1.4 million and $8 million.
- Usage of the current TFSA provision already displays a skew favouring individuals at higher incomes, and this bias would be accentuated and accelerated by a doubling of the contribution limits.
- The long-run benefit from doubling TFSA limits would go overwhelmingly to the wealthy; current retirees and older workers would gain over a transitional period but could be served without unconditional doubling of the limits for everyone.
- Much of the increased contributions to TFSAs would come from the transfer of taxable savings into accounts or the diversion of savings that would otherwise go into RRSPs.
- Given the weak and broken linkages between household saving and domestic business investment, doubled TFSA limits offer little prospect for improved economic performance.

In short, the proposal to double TFSA contribution limits shares and even surpasses many of the deficiencies exhibited by the government's Family Tax Cut scheme for income splitting: significant and growing loss of revenues, differentially favourable benefits for high-income households, and reducing the tax system's progressivity. But unlike the family income-splitting scheme, doubled TFSA limits will visit all of these afflictions upon defenceless provincial treasuries.

INTRODUCTION

The proposal to double Tax-Free Savings Account contribution limits is a sleeping twin of the income-splitting proposal that has garnered so much analytical study as well as media coverage and political commentary. This gap in scrutiny[1] is surprising in that the twins, whose conception dates back to the Conservative Party of Canada's 2011 election platform, are remarkably similar in their genetic deficiencies.

A doubled TFSA[2] would be heavily tilted toward high-income earners and wealth holders; its long-run cost to public revenues would be far larger than that of income splitting; it would entangle the provinces inescapably in its distributional and revenue losses; and, relative to the alternatives, it would do little to achieve its ostensible objectives. While typically described as the "big ticket" item in the CPC's electoral platform, income splitting will have to defer to its twin—the expanding TFSA, now stirring and soon to waken.

This study describes the key features and operation of the tax-prepaid TFSA provision. It investigates the distribution of TFSA usage, the impact on household savings and the real economy, and the projected long-run revenue costs for federal and provincial governments and the Old Age Security program. The study then illustrates the adequacy of current TFSA limits for the great majority of persons except for some older workers and retirees and the wealthy. From this material, the study infers the TFSA-doubling proposal's deficiencies as well as some flaws of the original scheme.

Various reforms can be undertaken to address these problems as well as provide greater TFSA access to the groups requiring it. All of this can be achieved while curbing the two main impacts –the long-run revenue costs and extreme distributional tilt—that make the proposal for doubling TFSA limits so doubly troubling. In concluding, the similar shortcomings of the TFSA-doubling and income-splitting proposals are revealed in more detail.

TFSA BASIC FEATURES AND OPERATION

Since 2009, individuals have been able to establish and make non-tax-deductible contributions to TFSAs. These accounts permitted contributions up to an initial annual limit of $5,000 unrelated to the individual's current earnings or income, and any unused part of the annual limit can be carried forward for contributions in future years. The annual limit has been indexed to inflation but increases only in $500 increments, rising to the current $5,500 figure in 2013. Funds in each TFSA accumulate free of tax on their investment earnings and withdrawals are also tax-free.

Moreover, the federal government promised at the TFSA's inception that account withdrawals and accruals would not be counted in any income-tested tax or transfer programs. It remains to be seen how long this federal immunity will last. For provincial cash and in-kind benefit programs, TFSA balances are typically counted in asset tests, but no income is attributed to TFSAs. Various features of the TFSA make it well suited for individuals to draw on for unexpected needs as well as part of retirement saving plans. Part of the motivation for the TFSA was to give lower earners a tax-efficient vehicle for saving.[3] TFSAs have become an essential part of tax planning for saving along with RRSPs and other tax-favoured vehicles and strategies (Pape 2013).

TFSA USAGE AND DISTRIBUTION

A Canada Department of Finance (2013) study provides statistics on the participation and usage patterns for TFSAs through 2011. The fact that investment earnings inside of TFSAs are indeed tax-free means that these incomes do not appear in the standard reporting of income tax statistics from the Canada Revenue Agency. However, the CRA (2009-2012) has published detailed online statistics on TFSA usage through 2012. A key and critical omission of the CRA reporting on TFSA usage is the lack of breakdowns by income of account holders, but very limited insights into these income patterns are provided in the 2013 Canada Finance study. The present paper draws on those sources and, for subsequent years, draws on limited data from a proprietary source.

Table 1 presents key aggregate and average figures for measures of TFSA participation, contributions, withdrawals, and year-end balances through 2012 and more limited measures for subsequent years. TFSA enrolment in the first year was a robust 4.8 million and rose to 9.6 million separate individuals holding accounts by 2012. By mid-2014, about 13 million TFSA accounts had been opened, with the number of distinct TFSA holders likely exceeding 10 million. Total annual TFSA contributions have risen each year, hitting $33.5 billion in 2012, which exceeds RRSP deductions of $32.4 billion in that year (Canada Revenue Agency 2014, Table 2).[4]

Withdrawals from TFSAs have also risen over time and are quite common, but they have been far outpaced by the mounting contributions. The aggregate market value of all TFSAs grew from $18 billion at year-end 2009 to an estimated $132 billion at mid-2014, which is a compound annual growth rate exceeding 50 percent.

TABLE 1: SUMMARY STATISTICS ON THE TFSA, 2009-2014

	2009	2010	2011	2012	2013	2014[c]
Number of accounts[a] (millions)	5.3	7.9	10.1	11.9	12.3	13.0
Number of individuals with a TFSA (millions)	4.8	6.9	8.4	9.6		
Total annual contributions ($ millions)	18,963	25,399	31,105	33,503		
Average contribution per TFSA holder ($)	3,918	3,701	3,718	3,491		
TFSA holders who maximized contributions (%)	64.0	39.6	30.2	23.5		
Total annual withdrawals ($ millions)	1,937	4,912	8,129	11,175		
Average withdrawal per TFSA holder ($)[d]	400	716	972	1,165		
TFSA holders who made withdrawals (%)	14.5	20.7	24.2	26.1		
Total year-end fair market value ($ millions)	18,156	40,701	62,584	87,503	108,858	131,536
Average fair market value per TFSA holder ($)	3,751	5,931	7,481	9,118		
Estimated investment income/loss[b] ($ millions)	1,130	2,058	–1,093	2,591		
Federal tax expenditure on TFSA ($ millions)	65	165	160	295	410	
Share of TFSA funds in mutual funds, equities (%)	31.0	37.4	38.9	41.0	45.1	48.6
Share of TFSA funds in fixed-term and savings (%)	69.0	62.6	61.1	59.0	54.9	51.4

a An individual may hold more than one TFSA, similar to other tax-assisted savings vehicles.

b Although TFSA holders sustained a net investment loss at the aggregate level in 2011, about three-quarters of TFSA holders had positive investment income in the year; TFSA investment income is estimated by the author using CRA data and the same method as used in Canada Department of Finance (2013).

c As at June 2014.

d Average over all TFSA holders in that year (not just those TFSA holders making contributions or withdrawals).

Sources: Canada Revenue Agency (misc. years); tax expenditure figures from Canada Department of Finance (2014, p. 16); figures for 2013 through 2014 (except tax expenditure item) and figures for all years for share of TFSA funds by asset type are from Investor Economics (2014a, 2014b).

Estimated aggregate incomes realized in TFSAs have been substantial, although the figures dipped into negative territory in 2011 because of equity market downturns. Still, even for that year about three-quarters of TFSA holders had positive investment income because they were heavily invested in more stable fixed-income and dividend-yielding assets. In the initial year, TFSA holders had their account portfolios weighted most heavily in relatively secure fixed-term and savings deposits, at nearly 70 percent.

The succeeding years have exhibited a continuing shift of TFSA balances toward greater holding of more risk-oriented equities and mutual funds, with that proportion rising to nearly 49 percent by mid-2014.[5] This shift may reflect, in part, the fact that as time progresses more lower-income, lower-wealth TFSA holders will have transferred their previous cash savings into the account. Thus, incremental TFSA contributions will come more from higher-wealth individuals who are more risk tolerant and investment savvy.[6]

Statistics on TFSA participation rates are computed relative to the total number of tax filers over age 18—the minimum age for TFSA eligibility.[7] Geographically, TFSA participation rates are highest in Ontario, Alberta, and BC, lying in the 33 to 36 percent range, and lowest in the Atlantic provinces other than Nova Scotia, falling under 21 percent. TFSA participation rates are lowest at 21 percent for the 18 to 24 year-old group in 2011; they rise to 28 percent for the 25 to 29 year-olds; and they are relatively stable for ages up to 49, but then rise significantly with higher age groups. The participation rate tops out at about 40 percent for those aged 65 and higher.

Individuals over 71 years, who cannot make further RRSP contributions and must begin their withdrawals of those funds, constituted 15 percent of TFSA holders and made nearly 20 percent of all contributions. The cited participation rates for ages 18 to 24 years are likely inflated by contributions made by well-off parents. Females accounted for 55 percent of TFSA holders and total contributions in 2011, with participation rates of 33 percent versus 29 percent for males.[8]

TFSA PATTERNS BY INCOME LEVELS

The profiles of TFSA participation and holdings by income are of particular interest for an assessment of the scheme and its proposed doubling. Unfortunately, the TFSA provision allowing a spouse to contribute to an account of the other spouse makes the official statistics suspect for those reporting low individual incomes.[9] Inter-spousal TFSA contributions are an attractive means for income splitting in cases where incomes of the spouses are divergent; inter-spousal TFSA contributions do not trigger the income attribution rules for tax that apply to most other such asset transfers. One index of how these inter-spousal TFSA transfers obscure the true income distribution of account holders is that in 2011 about 162,000 spouses and common-law partners—of which

almost 80 percent were female—made TFSA contributions that exceeded their individual incomes (Canada Finance, 2013, p. 35). With this caveat in mind, we present results for the distribution of TFSA participation and contributions by individual (not joint) incomes.

Individuals with own income below $20,000 had the lowest TFSA participation rates in 2011 at 20 percent. As noted, some of these individuals were making contributions from partners with substantially higher incomes; thus even this low participation rate is artificially inflated when benchmarking by family rather than individual incomes. Participation rates rose steadily with individual income level, peaking at 58 percent for incomes over $200,000 (p. 37).[10] Individuals with incomes below $20,000 accounted for 22 percent of all account holders and made 19 percent of total TFSA contributions; these figures fell short of their 37 percent share of all tax filers in that income range.

At the other end of the spectrum, individuals reporting 2011 incomes exceeding $200,000 accounted for about 2.5 percent of all account holders and 3 percent of total TFSA contributions while constituting just 1.3 percent of all tax filers.[11] Many top earners were constrained by the TFSA's then-current $5,000 limit and would have taken an even more disproportionate share of total contributions had a higher limit been in place.

Given the paucity of statistics on the TFSA activities by income of account holders, some insights can be garnered by examining the patterns of TFSA holders who maximized their limits. We compare account holders who maximized their contribution limits (including any carry-forward amounts) across age groups and between 2009 and 2012.

Table 2 presents these results, with the overall percent maximizing their contributions falling from 64.0 in 2009 to 23.5 in 2012. This striking decline reflects primarily the transfer of pre-existing taxable asset holdings (mostly short-term bank savings) into TFSAs, with a large share of individuals having exhausted their savings available for shifting to TFSAs by the end of this four-year period.

TABLE 2: TFSA HOLDERS MAXIMIZING THEIR CONTRIBUTION LIMITS, BY AGE, 2009 AND 2012 (PERCENTS)

	Percent maximizing TFSA contribution	
AGE RANGE (YEARS)	**IN 2009**	**IN 2012**
All (18+)	64.0	23.5
18-29	39.3	7.8
30–49	53.9	13.5
50–64	69.5	27.5
18–59	54.5	15.7
60+	81.6	38.5
65+	82.1	40.8
75+	86.2	45.8

Source: Canada Revenue Agency (2009, 2012); author's calculations.

Two elements of the patterns across age groups and over time are notable in Table 2. In each year, a steep gradient between age of TFSA holder and percent maximizing contributions arises: holders aged 60 years and up are far more likely to max out their limits. Moreover, this age gradient steepens over time; in 2009, holders aged 60-plus maxed out at twice the rate of those aged 18 to 29 years, whereas by 2012 the older holders maxed out at five times the rate of the younger holders. Again, this likely reflects the limited existing taxable asset holdings of younger cohorts available for transfer to TFSAs, and it suggests that TFSAs induced little new saving.

TFSA IMPACTS ON HOUSEHOLD SAVINGS AND THE ECONOMY

In common economic parlance, increased savings implies increased investment in the economy, resulting in higher growth, productivity, jobs, and living standards. However, this transmission chain can suffer weak connections at four distinct links when applied to tax incentives for household saving in a small open economy such as Canada's.

First, the tax incentive must raise the level of savings in the targeted type of account. Second, the savings in the targeted accounts must come from incremental new saving by households, not merely the diversion of existing assets held in taxable form or other types of tax-favoured accounts or the diversion of ongoing saving that would have occurred anyway but been held

elsewhere. Third, the additional net saving of the household sector must add to financing for the domestic business sector, not merely displace investment that would have occurred in any event from internal cash flows of firms or foreign investors. Finally, the loss of tax revenues to finance the tax incentive is a drain on national savings, and this works to offset any incremental household saving.

We next apply this sequence of economic behaviours to inquire whether the TFSA is likely to promote aggregate investment and growth of the economy. At the first stage, provision of the TFSA has unquestionably increased saving in the targeted tax-free accounts, as evidenced by the large accumulated balances shown in Table 1. At the second stage, the extent to which TFSA contributions have been savings-creating versus savings-diverting is an empirical question about household behaviour. No doubt much of the funds contributed to TFSAs would otherwise have gone into RRSPs or was drawn from existing holdings of taxable assets. We do not have direct empirical evidence on this issue, and even Finance Canada noted the possibility of savings-diversion behaviour, citing individuals "redirect[ing] their stock of existing savings to tax-assisted accounts such as the TFSA" (2013, p. 36).

In fact, economists have undertaken extensive research on the effects of tax incentives for saving, focussing mainly on the tax-deferred format.[12] Given the complexity of programs, the heterogeneity of individuals, the noise of other economic events and data limitations, the findings are diverse and even contentious. Many studies find little or no net impact of tax incentives on individual, voluntary savings behaviour; others that find a positive impact on savings for the most part yield modest estimates. For various reasons, one would not necessarily expect the savings-creation effect to be large relative to the savings-diversion effect. Providing individuals with a tax-favoured channel for saving allows them to reach any targeted level of cumulative savings—whether for a major trip, a rainy-day fund, home renovation, or retirement—with less current saving since their investment returns will be relieved of tax. In short, tax incentives for saving can actually reduce household net saving even while raising contributions to tax-favoured accounts.

The next link of the transmission chain leading to enhanced business investment and economic growth is similarly uncertain. Even if tax incentives induce households to increase their net saving, that may not translate into significant increases in business investment, given the openness of the Canadian economy to international capital flows. For large businesses that can access major capital

markets, the marginal investment project is determined by the world rate of return on investments of similar type and risk. Thus, an increase in domestic personal savings invested in Canadian equities may simply displace foreign investment to maintain the marginal rate of return at the world level.[13] Moreover, the finding that the marginal source of investment funds for large businesses in Canada is internal cash flow rather than new equity issuance weakens the linkage between household saving and business investment.[14]

Finally, tax incentives for saving carry a revenue cost to governments, and this revenue cost reduces the fiscal surplus or increases the deficit. This fiscal impact is a drain on national saving, further dampening any stimulus to domestic investment. It is estimated that slightly more than 90 percent of any additional savings at the household level is offset by lost tax revenue, so that less than 10 percent constitutes new national saving (Attanasio and Wakefield 2010, p. 677). In short, three of the four critical links required for tax incentives for household saving to have positive real economic impacts are either weak or broken.

LONG-RUN TAX REVENUE COSTS OF TFSAS

A tax-prepaid scheme like the TFSA has an interesting feature in terms of its forgone revenue cost or its so-called tax expenditure. Because the funds that an individual contributes to such an account are not tax deductible, they have fully borne tax and thus incur no immediate revenue cost. The revenue cost of the TFSA stems from the tax exemption on the investment earnings of those funds in the future, which presumably would have borne tax at the individual's ordinary rates.

The forgone revenue begins very small in the year of contribution, when little investment income arises, and grows over time with the compounding of investment returns in the account plus those on additional contributions made in future years. Accordingly, the aggregate tax expenditure of the TFSA begins very small but grows over time to be much larger. Table 1 shows official figures on the TFSA's revenue cost at a meagre $65 million in its first year but more than sextupling to $410 million just four years later in 2013.[15] The figure is projected to continue steep growth reflecting the subsequent and ongoing growth of TFSA contributions and compounding tax-free investment earnings.

One way to measure the loss of tax revenues due to the TFSA is to examine its impact on taxable investment income. Finance Canada reported that the share of tax filers reporting any taxable interest and dividend income declined from 37 percent in the two years preceding the TFSA's introduction to 33, 30, and 29 percent respectively in years 2009 through 2011 (2013, p. 42). But these are just the first three years of a tax-deferred scheme that is far from mature; it will take 40 to 50 years or longer to observe the full effects on individuals who have been able to access the TFSA for their lifetimes from age 18 onwards.

Economist Kevin Milligan (2012) has simulated the potential impact of a mature TFSA system on the proportion of families with taxable assets exceeding their cumulative TFSA contribution room.[16] With cumulative room of $200,000 (say 36 years at $5,500 per year in real terms) only 3.3 percent of families would have any taxable assets; with cumulative room of $300,000 for a couple (less than 28 years at $5,500 per year for each spouse), the figure would fall further to 1.8 percent. Even Finance Canada has projected that by 2030 the TFSA along with other tax-preferred saving vehicles will allow over 90 percent of Canadians to hold all their financial assets in "tax-efficient savings vehicles" (2013, p. 42).

Milligan's simulation exercise next estimated the revenue loss associated with a mature TFSA given its current contribution limit. Based on several assumptions, he reports a potential decline in the total federal tax base of 5.4 to 6.0 percent, and because the lost taxable income would have been taxed at a higher than average rate, this yields an estimated 10.6 percent loss of federal personal income tax revenues.[17] Translated into contemporary dollar figures, this would constitute a federal revenue cost of up to $15.5 billion based on the 2015-16 forecast income tax revenues of $145.8 billion.

On top of the federal revenue cost, one must also reckon the related revenue loss to provincial income taxes. Typically calculated at 60 percent of federal revenue, this provincial impact could range up to another $9 billion annually once the TFSA has fully matured. These figures do not consider any increase in the TFSA's current limit of $5,500 per year. Clearly, the proposal to double the TFSA limits would further boost the revenue costs to both governmental levels. Yet the increase would be less than a doubling because relatively few individuals—mainly the wealthy and some elderly—would be able to exploit all the additional contribution room.[18]

LONG-RUN COSTS OF TFSAS FOR OLD AGE SECURITY

The revenue costs imposed by the TFSA do not end with the loss of taxes on financial incomes generated within the accounts. The government's commitment to disregard TFSAs in all federal program income tests will impose significant costs for the Old Age Security program over the long run. This immunity will affect both of the Act's two main components: the income-tested Guaranteed Income Supplement (GIS) and the universally paid Old Age Security (OAS). GIS benefits are based on the claimant's income, but incomes generated within TFSAs and account withdrawals will be disregarded in this income test. Accumulations in TFSAs could over time significantly increase the number of GIS beneficiaries, benefits paid, and program costs.[19] The tax immunity of incomes generated within TFSAs will further decrease the funds recaptured from OAS beneficiaries through the benefit claw back for those with incomes above $71,000.

The Office of the Superintendent of Financial Institutions Canada (OSFI) undertakes triennial detailed actuarial projections of the OAS program's finances. Using ad hoc assumptions about future TFSA saving behaviour, the OSFI 12th actuarial report on the OAS program offers long-range forecasts of these impacts.[20] It projects the proportion of the cohort attaining age 67 in 2050 receiving full or partial GIS benefits at 30.9 percent—five percentage points higher than without TFSAs (2014, p. 78).[21] A background document to the OSFI 12th actuarial report projects that the TFSA will boost GIS expenditures in 2050 by $2.8 billion to $35.6 billion, an increase of 8.6 percent relative to the absence of TFSAs, but its "high- cost" variant indicates an annual impact as high as $8.8 billion.[22] The 12th actuarial report also forecasts that TFSAs will reduce the amount of OAS recovery tax collected in 2050 by $1.2 billion to $5.4 billion (2014, p. 77).[23] Based on these figures, the projected future annual fiscal cost of the TFSA with respect to the total OAS program could exceed $4 billion and perhaps substantially more.

Even larger GIS impacts of the TFSA have been projected by tax and pension analyst Keith Horner (2011). His model indicates that TFSAs could eventually raise GIS participation rates from the current 32 percent of seniors to more than half and expand the GIS program's total cost by as much as 84 percent relative to the absence of TFSAs.

POTENTIAL LIFETIME TFSA ACCUMULATION

For individuals who turned age 18 on or after 2009, the year that TFSAs were introduced, the potential lifetime accumulation in a tax-free account is enormous. We shall illustrate this point by taking the current $5,500 annual limit and assume that an individual makes full contributions every year for a long continuous period. We also assume that the individual invests in a diversified equity-heavy portfolio and reinvests all dividends and other income accruing within the TFSA without making withdrawals.

The long-run total real rate of return on one of the broadest measures of equities, the S&P 500 index, has been 6.5 percent over the extended period 1871 through 2012 (Rcube 2012). We compute the potential TFSA terminal balances for two periods and three real rates of return ranging from 3 percent to 8 percent. All terminal balances are shown in real dollars of purchasing power of the year of the initial TFSA contribution.

The upper panel of Table 3 shows the results for an individual making continuous annual TFSA contributions at the full limit for 52 years, such as starting at age 18 through age 69. With the current $5,500 limit, her account could accumulate between $690,000 and $4 million depending on the rate of return; an individual with the doubled limit or a couple with the current limit could accumulate twice that amount, or between $1.4 million and $8 million; and a couple with the doubled limit could achieve a terminal balance between $2.8 million and $16 million.

The lower panel of Table 3 shows the results for a shorter 42-year period of contributions at the annual limit but without using any carryover amount, such as from age 30 through 71. Terminal TFSA balances would be smaller than in the first case, but they could still exceed three-quarter of a million dollars and up to $1.8 million for an individual with the current limits, or as much as $7.2 million for a couple with doubled limits.

TABLE 3: POTENTIAL ACCUMULATED TFSA BALANCES (CONSTANT DOLLARS)

		Terminal value of fund (constant dollars)		
YEARS OF CONTRIBUTIONS	REAL ANNUAL RATE OF RETURN (%)	SINGLE PERSON WITH $5,500 LIMIT	COUPLE OR SINGLE WITH $11,000 TOTAL LIMIT	COUPLE WITH $11,000 LIMIT FOR EACH
52	3	$690,000	$1,380,000	$2,760,000
	5	$1,340,000	$2,690,000	$5,380,000
	8	$3,990,000	$7,980,000	$15,950,000
42	3	$460,000	$930,000	$1,860,000
	5	$780,000	$1,560,000	$3,120,000
	8	$1,810,000	$3,610,000	$7,230,000

Notes: Contributions are assumed at the start of each year in the specified inflation-adjusted amounts; investment earnings are accrued at the end of each year; terminal value of balances in real dollars of the initial year; the formula assumes full indexation of the TFSA contribution limit each year and ignores the lags in indexation; all figures rounded to the nearest $10,000.

$$T = \frac{X}{r}\left[(1+r)^{n+1} - (1+r)\right]$$

X = annual contribution (constant real dollars)
r = real annual rate of return
n = number of years of contributions
Source: Kesselman (2012, p. 379); author's calculations.

While $5,500 may not appear like a large sum, these examples demonstrate that over a lifetime this annual amount can yield very large accumulated balances. Even over a much shorter period, a few astute and lucky investors may accumulate large sums; one individual was reported to have a TFSA balance above $275,000 (Marr 2014). *MoneySense* magazine has been running the "Great TFSA Race" to identify individuals achieving the largest TFSA balances, and in its latest issue reported a couple who had *each* accrued over $500,000 by investing in a single penny stock (Cazzin 2015).[24]

All of the cited outcomes raise critical questions about whether TFSAs should be fully immune from all benefit clawbacks and whether TFSA accumulations should be bounded. These results also raise questions about whether there is any justification or compelling need to increase the TFSA's contribution limit from its current level—other than, perhaps, for older individuals who have limited years for making contributions.

DOUBLING TFSAS: BENEFITS FOR WHOM?

To explore the likely distribution of gains from a doubling of the TFSA contribution limits, we begin by examining the patterns of taxable investment income under current taxing provisions. The three main categories of investment income outside of tax-favoured accounts are interest, dividends, and capital gains.

Table 4 shows all these forms of investment income to be highly skewed toward very high-income individuals relative to their share of total income assessed. For example, of all returns filed for the 2011 tax year, the 0.8 of one percent with incomes above $250,000 reported 10.6 percent of all income assessed but 19.5 percent of all interest income, 38.1 percent of all taxable dividends, and 52.8 percent of taxable capital gains. The disproportionately small share of these three income types, relative to their total income shares, for lower and middle-income tax filers is explained in part by their low asset holdings and also by the fact that they already have extensive means to shelter most of their financial assets in RRSP/RPP/TFSAs.[25] The table displays the $250,000-plus filers' relatively smaller share of RRSP deductions and RPP contributions, which is explained by their occupational mix and the ceilings on those provisions.

TABLE 4: DISTRIBUTION OF INVESTMENT INCOME SOURCES AND SAVINGS DEDUCTION TYPES, 2011 TAX YEAR (PERCENTS)

ASSESSED INCOME RANGE	Loss-19,999	20,000-34,999	35,000-49,999	50,000-69,999	70,000-99,999	100,000-149,999	150,000-249,999	250,000+	ALL
Total returns	36.9	19.6	15.3	12.3	9.2	4.2	1.6	0.8	100.0
Total income assessed	8.3	12.5	15.1	17.1	17.8	11.7	6.9	10.6	100.0
Interest income[a]	9.8	14.6	13.6	13.0	12.0	9.5	7.9	19.5	100.0
Taxable dividends[b]	1.1	3.2	6.4	10.3	12.9	14.1	13.8	38.1	100.0
Taxable capital gains[c]	2.0	3.1	4.3	6.3	8.6	10.3	12.6	52.8	100.0
RPP contributions	0.6	3.5	12.2	23.5	36.2	17.2	5.0	2.0	100.0
RRSP deductions	1.1	5.0	10.8	17.4	23.1	21.0	13.0	8.6	100.0
Net federal tax	0.5	5.0	10.4	16.1	20.8	16.0	11.0	20.2	100.0
TFSA holders	22.4	20.1	18.1	15.8	12.7	6.5	2.8	1.6	100.0

a Includes bond, bank, and mortgage interest; income from trusts; foreign investment income including dividends.

b Taxable amount of dividends from taxable Canadian corporations; includes 44 percent gross-up for eligible dividends and 25 percent gross-up for non-eligible dividends; offset by dividend tax credits; foreign dividends are included with interest income.

c Taxable amounts are 50 percent of net capital gains realized in 2011.

Source: Author's calculations from Canada Revenue Agency (2013, Table 2, All Returns); last row of this table from Canada Revenue Agency (2011, Table 4).

The take-away from Table 4 is that low, middle, and even upper-middle earners (up to at least $100,000) for the most part do not have large holdings of taxable assets that would gain from many years of increased TFSA contribution room. Most of their financial wealth is already held in RPP/RRSP/TFSA forms, and the rest is held primarily in cash and savings deposits to cover cash flow and

emergency needs. A household with, say, $20,000 unsheltered in the bank and in mutual funds will have the option to shift these funds into TFSAs over several years even with the current annual contribution limits—even more so if it is a couple which already has a joint annual TFSA allowance of $11,000. In contrast, very high earners have large holdings of taxable assets that would benefit for many years from higher TFSA limits. A household having, say, $2 million in unsheltered financial investments would gain from doubled TFSA limits for its entire lifetime.

We next illustrate the extent to which *current* RRSP and TFSA contribution limits meet the retirement saving needs of individuals at various income levels.[26] These examples assume that the TFSA scheme has been in place since the individual was age 18 years to portray the operation of a mature system. Taking the terminal balances that an individual can achieve at age 65 by using the full allowable contributions, we convert these amounts into annuity payments using recent premium rates for life annuities. We consider annual earnings levels of $50,000, $100,000, and $200,000 and both male and female workers, and we ignore any benefits they might receive from OAS or Quebec/Canada Pension Plan. The results are striking: for all income levels and both genders, the net-of-tax annual incomes from annuities in retirement exceed their net annual earnings while employed—typically by a large margin. The results also demonstrate that unconditional TFSA doubling would be overkill except for extremely high earners.

TFSA DEFICIENCIES AND REMEDIES

Tax-Free Savings Accounts have served a useful purpose for many savers, but they suffered deficiencies from their inception that would be exacerbated by the doubling of contribution limits. These include:

- Although intended in part as a saving vehicle for low- to moderate-earners, TFSA take-up rates and contribution levels have been significantly tilted toward higher earners and are bound to become more skewed as the provision matures over the coming decades;
- Doubling the TFSA contribution limit would in the long run be of even more lopsided benefit to the wealthy and of limited or no benefit for the great majority of lower-, mid-, and upper-income earners who already have adequate tax-favoured contribution room;

- In the short run, TFSAs pose deceptively small federal revenue cost, which will grow exponentially to be very large drains over the long term, and the prospective doubling of TFSA limits would significantly accelerate and increase the revenue costs;
- The creation of TFSAs and their prospective doubling exert additional drains on provincial revenues that the provinces have not consciously chosen. They also reduce the progressivity of provincial income taxes in ways that the provinces have not chosen;
- Unlimited immunity from income tests on TFSA holdings regardless of their size raises false expectations and allows high TFSA wealth individuals to draw benefits intended for low-income individuals. The doubling of TFSAs would exacerbate these problems;
- The creation of TFSAs in 2009 with annual contribution limits favours younger workers who will have full lifetimes of contribution room and sharply reduces saving opportunities for older workers and retirees who have much shorter periods for making contributions;
- Despite their large long-run impacts on total tax revenues and distribution of the income tax burden, detailed statistics on TFSA usage by income level are not provided by government.

Various policy reform options can be applied to remedy the identified deficiencies of both the original TFSA provision and the proposal to double the TFSA contribution limit. The longer version of this study available at the website of Simon Fraser University's School of Public Policy canvasses several options in detail. They include reforms such as integrating TFSA and RRSP limits to allow individuals with unused RRSP contribution room to "purchase" additional TFSA room; providing additional TFSA room for older workers and retirees to compensate for their reduced number of years to make contributions; imposing dollar limits on either total TFSA contributions or total cumulative balances in each TFSA; and imposing limits on the immunity from benefit clawbacks for TFSA holdings or income accruing within TFSAs. Some of these reforms would increase the TFSA contribution room for individuals in particular situations, but none would offer an unconditional doubling.

DISCUSSION AND CONCLUSION

It is well past wake-up time for the sleeping twin of income splitting—the proposed doubling of TFSA contribution limits. Although the two display major attributes in common, once wakened, the TFSA twin will prove far more rambunctious and troublesome than the income-splitting twin, which has already received such extensive attention and critique:

- Doubled TFSAs over the long run would confer large benefits highly skewed toward top earners and wealth holders, to a significantly greater degree than the modified, capped income-splitting plan announced by the government;
- A fully mature TFSA scheme will impose far larger drains on federal tax revenues than the modified income-splitting scheme: up to $15.5 billion in annual revenue costs versus about $2 billion for income splitting; doubling of TFSAs would further increase these revenue costs;
- TFSAs will impose additional burdens on the treasuries of all provinces—including Quebec—at about 60 percent of the federal revenue cost or up to $9 billion annually and even more with doubled limits; in contrast, the income-splitting scheme is formulated as a tax credit that does not impinge on provincial revenues;[27]
- As the TFSA provision matures over future years, it will compromise the progressivity of the personal tax systems at both federal and provincial levels; even without doubled limits this TFSA impact will be more acute than that of income splitting;
- TFSAs with doubled limits would provide expanded opportunities for wealthier individuals to exploit federal income-tested benefit programs; this would pose growing burdens on moderate-income taxpayers, just as income splitting does for the great majority of taxpayers not benefiting from the provision;
- The proposal to double TFSA limits has poorly defined objectives related to individual savings and enhanced economic performance that are unlikely to be realized—similar to the muddled and conflicting rationales for income splitting.[28]

Add to all this that the unlimited immunity of even large TFSA balances from the income tests or clawbacks on benefits intended for the needy will pose growing inequities and taxpayer burdens. In fact, annual costs to the Old Age Security program could mount to $4 billion and possibly substantially more.

The current TFSA scheme has enjoyed wide participation and served the savings needs of persons in diverse situations, albeit with emerging issues that require remediation. The federal government can provide additional access to TFSAs for groups that have real need for it—especially older workers and retirees as well as individuals who have excess RRSP contribution room. Reforms can be structured so as provide maximum flexibility for most individuals without tilting the gains heavily toward top earners. But prior to implementing any expansion of TFSAs, their unlimited immunity from the income tests of federal benefit programs needs to be addressed.

Moreover, like an overdose of medicine, too much of a good thing is not always such a good thing. No solid evidence supports an unconditional doubling of TFSA limits. The proposal to double the limits for everyone would not only tilt the gains toward the highest earners and wealth holders; it would compromise both revenue levels and progressivity of federal and provincial income tax systems. And it would likely yield minimal if any gains either to individuals' retirement income security or to the economy's performance through enhanced investment.

Negligible public opposition to the proposed unconditional TFSA doubling likely can be explained by the small up-front revenue cost and the misperception that this option will benefit savers of every description. Yet, like a little baby who looks cuddly and cute, this proposed initiative would grow up to be the hulking teenager who eats everyone out of house and home.

Raising the limits for TFSA contributions without conditions and without correcting deficiencies of the current scheme would be a dereliction of fiscal responsibility. The real budgetary costs of an unconditional TFSA doubling would be incurred not by the government that institutes the change. Rather those costs would be borne by successor administrations a generation or two down the road—and by persons enduring the reduced public services or bearing the increased taxes needed to offset the revenue losses from relief enjoyed by the wealthiest.

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ENDNOTES

1 Limited previous assessment of the TFSA-doubling proposal has appeared in varied sources including Yalnizyan (2011), Kesselman (2012, 2014a), Poschmann (2012), and Cayo (2014).

2 The campaign pledge was to double the TFSA's annual contribution limit to $10,000. It is unclear whether that pledge would now translate into doubling the current $5,500 limit or the original $5,000 limit. I assume that doubling would mean an $11,000 limit, but none of this study's conclusions hinge on that point.

3 See Kesselman and Poschmann (2001a, 2001b) for the original analysis of "tax-prepaid" savings plans that spurred the later launching of TFSAs. Stapleton and Shillington (2008) stress the potential of TFSAs to benefit lower-income households. Also see Canada Finance (2008) for an official description of TFSA objectives.

4 The aggregate value of TFSA contributions exceed those for RRSPs by a large margin if one considers that, unlike TFSAs, RRSP contributions have future deferred tax embedded in them.

5 Contrasting figures on the composition of TFSAs come from a survey undertaken by the Bank of Montreal (2014): "cash" at 60 percent, mutual funds at 25 percent, and GICs at 20 percent (total exceeding 100 percent).

6 A much stronger preference of higher income account holders toward holding of equities versus cash than lower income account holders is confirmed in the UK's tax-prepaid savings scheme (HM Revenue & Customs 2014, p. 13).

7 All of the cited participation rates apply to 2011 unless otherwise noted and come from Canada Finance (2013). Many of the percentages reported in the text are based on the author's best reading of bar graphs in this source.

8 This gender differential might be explained in part by the income splitting by couples explained next in the text.

9 Donnelly and Young (2012) discuss a comparable bias in reporting of participation in the United Kingdom's similar tax-prepaid Individual Savings Account program.

10 A similar steep income gradient of participation and average balances has been observed in the tax-deferred saving program of the United States (Joulfaian and Richardson 2001) and the tax-prepaid saving program of the United Kingdom (HM Revenue & Customs 2014).

11 This general pattern of TFSA holding by income is confirmed by the figures in the last row of Table 4. For tax filers reporting incomes below $20,000 the share of TFSA holders is about half their share of all returns; for those reporting incomes of $250,000 and higher the share of TFSA holders is twice their share of all returns.

12 For major critical reviews of the extensive literature see Bernheim (2002) and Attanasio and Wakefield (2012); also the findings in Chetty et al. (2012) and Kesselman (2015) for a non-technical overview of the research findings.

13 This argument and supporting evidence draw on Kesselman and Spiro (2014). Boadway and Tremblay (2014) come to a similar conclusion about the limited impact of domestic saving on domestic investment, while Milligan (2014) argues that international capital mobility is less salient for financing of investment in smaller firms.

14 See the analysis and findings in McKenzie and Thompson (1995) and Auerbach and Hassett (2003).

15 The methodology in computing these "tax expenditure" figures is provided in Canada Finance (2013, p. 44). Some of the key assumptions are no behavioural changes (hence, no substitution of RRSP contributions for TFSAs and no impact on GIS costs) and that only one-fifth of capital gains accruing within TFSAs would be realized that year.

16 This method assumes that the individual will utilize all available TFSA room, which somewhat overstates the situation for individuals wishing to hold some readily available balances to cover cash-flow needs. However, even as a limiting bound the results are striking. For more complex methodologies, see Antolín et al. (2004).

17 Alternative more complex computation methods could consider behavioural effects such as the extent to which the provision of, or expansion of, TFSAs results in the creation of new savings versus the diversion of existing savings, but the empirical factors are unresolved; see OECD (2007). Milligan notes that his methodology understates the potential revenue loss because it ignores the tax sheltering of investment returns accumulating within the TFSAs (2012, p. 356, note 4). Also see Milligan (2011).

18 The Conservative Party of Canada's original estimates of the federal revenue cost of doubling the TFSA limits were $7.5 million and $30 million in the first and second years (2011, p. 65), which are far less than the TFSA's actual first- and second-year cost, shown in Table 1 as $65 million and $165 million, respectively.

19 Schemes to facilitate individuals' access to GIS benefits through the use of TFSAs are discussed by Chevreau (2014) and Vettese (2014).

20 The report states that its estimated TFSA impacts "should be interpreted with caution" (OSFI 2014, pp. 75, 79) because of the lack of long historical data on TFSAs.

21 The report also presents "low-cost" and "high-cost" projections for alternative assumptions about the growth of TFSA balances, yielding GIS recipient rates ranging between 27.4 percent and 37.2 percent (OSFI 2014, p. 92).

22 The 12th actuarial report presents detailed projections of the TFSA impact in 2050 on the distributions of GIS by benefit levels of recipients, but no dollar figure for the impact on aggregate GIS program cost. It also offers "low-cost" and "high-cost" figures for alternative assumptions about TFSA behaviour that would alter GIS benefits by 5.6 percent lower or 17 percent higher relative to the best-estimate scenario for 2050 (OSFI 2014, p. 97); thus, the high-cost estimate of the TFSA impact on GIS expenditures amounts to $8.8 billion ($2.8 billion + 0.17 x $35.6 billion).

23 Also in 2050, the TFSA is projected to reduce the numbers subject to OAS recovery tax by 132,000 (from 850,000 to 718,000), with 63,000 relieved of full repayment and 69,000 relieved of partial repayment (OSFI 2014, p. 76).

24 The US Government Accountability Office (2014) reported an estimated 300 Individual Retirement Accounts with balances exceeding $25 million each, but the US accounts permit types of assets such as founders' shares and non-publicly traded assets that are prohibited in the counterpart Canadian RRSPs and TFSAs.

25 For the two tabulated income classes of Loss-$19,999 and $20,000-$34,999, the shares of total interest incomes somewhat exceed their shares of total incomes. This situation might be explained by the fact that over 90 percent of the first-cited income class are non-taxable filers, and the other income class generally faces low tax rates.

26 Full details and assumptions of these illustrations are provided in the longer paper. These scenarios ignore the ability of high earners such as top managers, senior-level executives, and majority shareholders to access additional tax-deferred saving beyond the normal limits of RRSPs and RPPs via special schemes such as Individual Pension Plans, Retirement Compensation Arrangements, and Supplementary Executive Retirement Plans. See Gosselin and Laporte (2013) and Kahane et al. (2013).

27 The original CPC income-splitting proposal would have allowed the transfer of taxable income between spouses and thus have impacted income tax revenues for all provinces except Québec (which collects its own taxes). The modified version announced in 2014 operates as a tax credit and thus insulates the provinces from revenue impacts.

28 See Kesselman (2014b) for critical analysis of income splitting's inconsistent rationales and objectives.