



Economics & Strategy

The New Tax-Free Savings Account: How Popular Will It Be?

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The 2008 federal budget gave birth to arguably the most dramatic change in Canada's savings system since the introduction of the Registered Retirement Savings Account (RRSP).

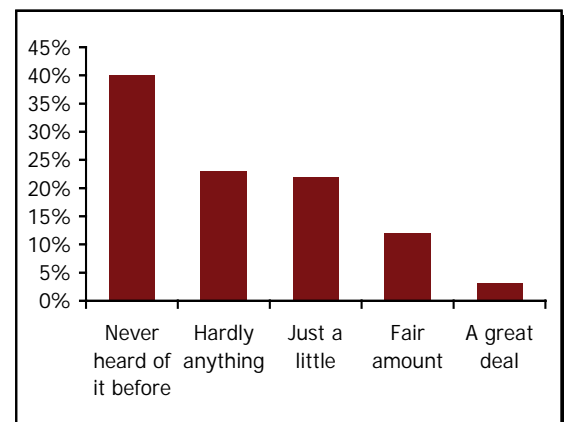
The introduction of the Tax-Free Savings Account (TFSA) will revolutionize the tax treatment regarding investments held by Canadians. And if recent surveys and the experience of other countries with similar plans are any guide, Canadians will use the TFSA much faster than currently projected. Within a short five-year span, we expect the TFSA market to mushroom to a \$115 billion market with a cumulative tax savings of close to \$2 billion.

The reality is that at this point, most Canadians have little to no knowledge of the details behind the plan. In fact, as of May 2008, a full two months after the plan was introduced, an astonishing 40% of Canadians have not even heard about the plan (Chart 1)<sup>1</sup>. Look for the knowledge gap to narrow notably as we approach January 2009 when the plan comes into effect. And what will speed up the learning curve is the fact that the plan is relatively simple, and can be easily understood by the lay person.

TFSA—How Will It Work?

The Tax-Free Savings Account is simply a tax exempt savings account which is available to any individual aged 18 and over. At this point, the maximum contribution is \$5,000 a year—a figure that will be indexed to inflation in multiples of \$500. Unlike RRSPs, TFSA contributions are not tax deductible, and the investment earnings are not subject to income tax. Any unused TFSA contribution room can be carried forward, and amounts can be withdrawn at any time. So in many ways, TFSAs are RRSPs in reverse. Instead of giving tax deduction for contribution and making all withdrawals taxable, the TFSA offers no deduction for deposits, but no tax of any kind will be imposed on future investment returns.

Chart 1 Knowledge of TFSA



Source: Harris/Decima

http://research.cibcwm.com/res/Eco/EcoResearch.html

**TFSA vs. RRSP**

It is tempting to compare the new TFSA to the existing RRSP plan. More specifically, to what extent will the money going to TFSAs come at the expense of contributions to RRSPs?

The reality here is that the math behind the decision to choose a TFSA vs. an RRSP is simple. If retirement income is projected to be lower than current income, then RRSP is clearly the right choice. If retirement income is likely to be similar to current income, then the TFSA and the RRSP are equivalent. But, if one expects retirement income to surpass current income, then TFSA contributions should replace RRSP contributions. An additional reason to choose a TFSA over an RRSP is that the current system discourages low-income Canadians from contributing to RRSP since their withdrawals after retirement might reduce the eligible tax credit and supplementary pension payments. In contrast, the TFSA is truly tax exempt—free of any clawbacks from federal tax credit and benefit programs. So, the TFSA vs. RRSP analysis suggests that roughly 400,000 low-income Canadians who currently contribute to an RRSP will potentially switch to a TFSA. This would amount to roughly \$2.5 billion in cumulative TFSA contributions over the next five years coming from this segment of the population.

While the TFSA will clearly help those low-income individuals who already contribute to an RRSP, the unfortunate reality is that this group is relatively small. Only 5% of Canadians who earn less than \$20,000 a year contribute to an RRSP. And with average contributions

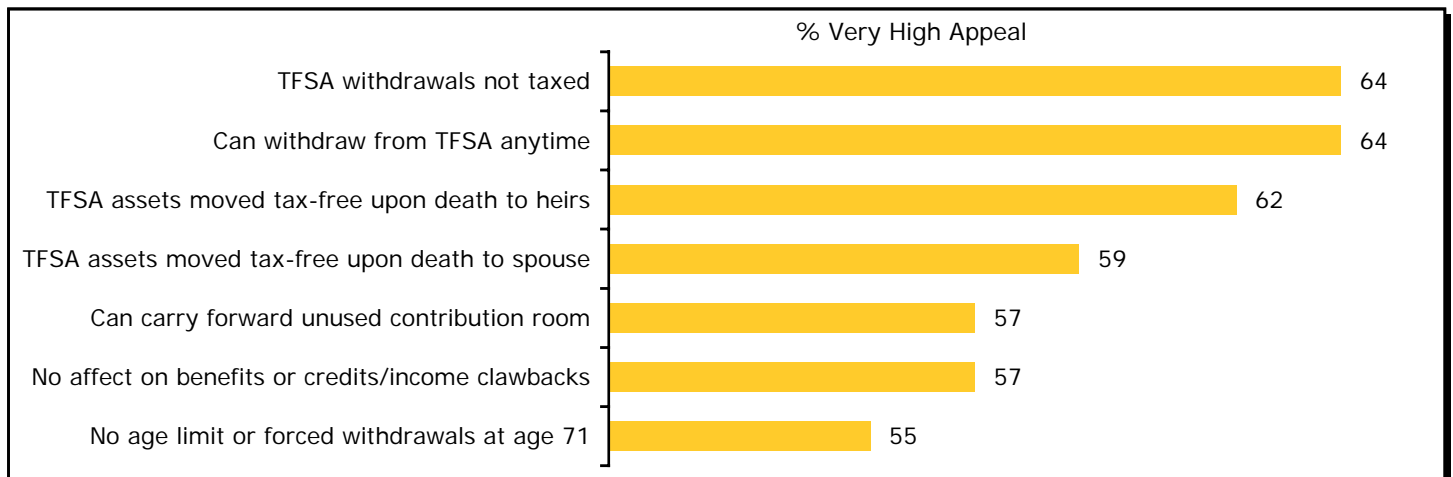
of just over \$1,000 a year, they account for less than 2% of total RRSP contributions in a given year. To the extent that the introduction of the TFSA is viewed as a vehicle to encourage savings among low-income Canadians—the success here would be limited at best.

But the magic behind the TFSA is in its versatility. It is not simply a tax measure designed to help low-income Canadians, but rather a vehicle that can fit almost every Canadian, regardless of income or stage in life.

For seniors, the plan provides an additional savings device free of tax. This will be an attractive channel to continue saving beyond the current cut-off age of 71 for making RRSP contributions. Moreover, upon the death of the TFSA account holder, assets can be transferred to a surviving spouse or child (or in fact anybody), tax-free without affecting the recipient’s contribution room. For high earners who find that their RRSP contributions are restricted by the current limit of \$20,000, this is a welcome addition to contribution room. For the nearly 40% of paid workers who are covered by a registered pension plan, TFSA provides a way to compensate for the pension adjustment that limits RRSP contributions. So in many ways the TFSA can be viewed not as a rival but rather a companion to the RRSP in Canada’s financial landscape.

Equally important is the fact that the TFSA’s flexibility makes it ideal for immediate needs such as emergency funds as well as a tax efficient way for Canadians to finance consumption. The account can be accessed multiple times during one’s lifetime to serve as emergency funds, and to

Chart 2  
**Appeal of TFSA**



Source: Harris/Decima

bridge periods of income volatility. This liquidity feature of the TFSA plan is of great importance as it will probably work to limit or even eliminate uneconomical behaviour such as RRSP withdrawal. In fact, the liquidity feature is viewed by Canadians to be as important as the tax-free feature in the decision to open a TFSA (Chart 2).

**Active Savings**

The TFSA will kick in exactly when many Canadians are making the transition from passive savers to active savers. It is well documented that the savings rate in Canada has fallen dramatically over the past two decades (Chart 3). Some of the factors that contributed to the dissaving by Canadians are: lower inflation expectations (that is, the inflation rate is expected to remain relatively low, and consequently savings does not need to compensate as heavily for inflation); an extended period of low interest rates (since there is less incentive to save when borrowing is less expensive and financial assets generate lower interest); a softening in the pace of growth in personal income; the cohort effect (for example, the changing financial attitude and behaviour of a 40-year-old person today compared to a 40-year-old person ten to twenty years ago); and innovation and deregulation in financial markets (which has increased access to credit through relaxed liquidity constraints).

Another factor that led to reduced active savings over the past decade was the booming housing market. After all, with the average house price in Canada doubling since 1997, many households have been saving passively

via the increase in their home equity, and thus feel less pressured to save from their current income. Therefore, this kind of passive savings has worked to compensate for the lack of active savings. But now, the levelling-off in house prices is stripping households of one of their most important means of savings. And just when Canadians are ready to go back to old-fashioned savings behaviour, the introduction of the TFSA will provide them with an additional tool to raise their active savings.

**Estimating the Size of the TFSA Market**

How popular will the new scheme be? And to what extent will Canadians utilize the \$120 billion annual TFSA contribution room that will be available to them starting next year? Where will the money come from? Will it be new money or will it be transferred from other accounts?

In this context, looking at the experience of similar plans in other countries might be a good starting point. In the US, "Roth IRA" is a similar tax-free scheme, but it is much more restrictive than the TFSA since contributions are limited only to employed individuals and are restricted to only low- and mid-income earners. It is also a pure retirement plan as individuals cannot withdraw the money before the age of 59. The British Individual Savings Account (ISA) is much closer to the TFSA—with the main difference being that the British plan imposes some restrictions on the cash/stock distribution held in ISA balances. In this sense, the Canadian TFSA is somewhat more flexible since it does not face such limitations.

Chart 3  
**Falling Savings Rate**

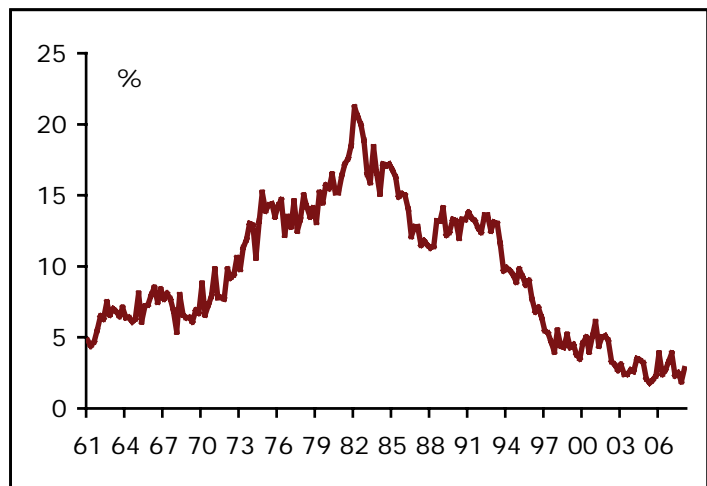
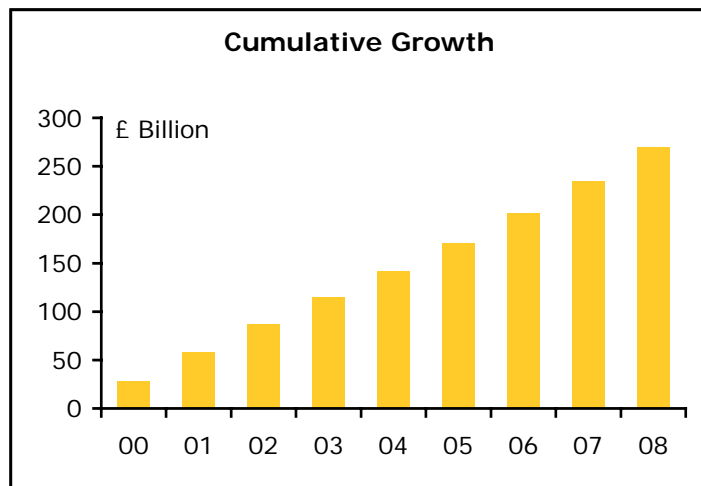
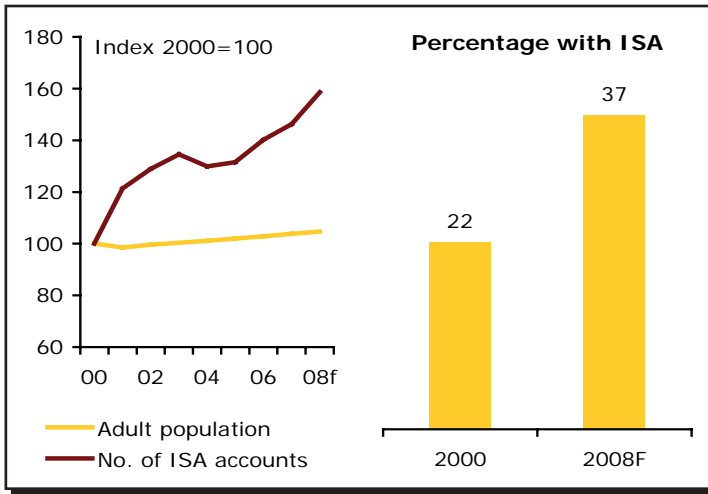


Chart 4  
**UK's Individual Savings Account (ISA)**



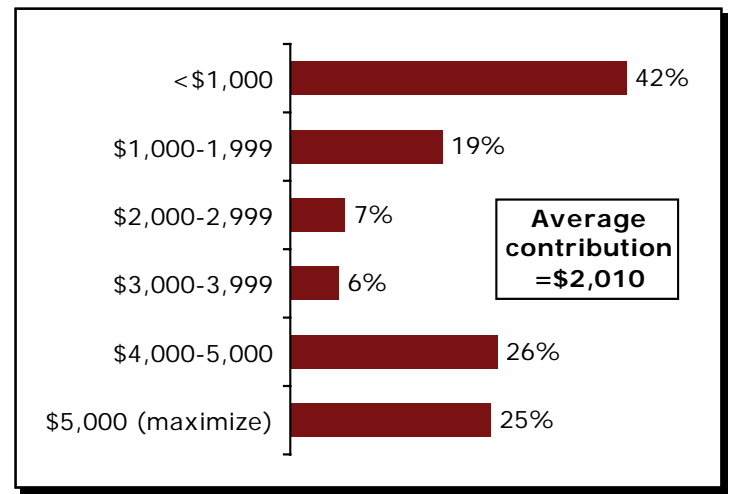
Source: HM Revenue & Customs

Chart 5  
UK's ISA Market—Rising Fast



Source: HM Revenue & Customs, UK National Statistics and CIBC World Markets

Chart 6  
Average Contribution to TFSA



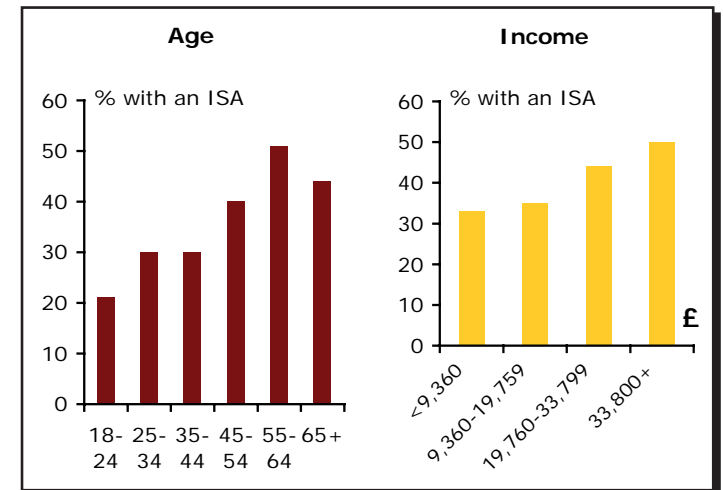
Source: Harris/Decima

But since the British version is so similar to the new Canadian one, it can provide us with some insight into the future trajectory of the TFSA. Note that the ISA was introduced in 1999 and it is now a £270 billion market (\$530 billion) (Chart 4). The number of accounts has been rising at a strong average rate of 6% a year. And with the British adult population hardly changed over the past decade, the share of UK citizens that use the ISA has risen to 37% in 2008 from 22% in 2000 (Chart 5). The average contribution is close to £2,500 (\$4,800) out of the £7,200 maximum contribution allowed.

The issue of who will contribute is of great importance. While the budget assumption is that two-thirds of the tax savings in the next few years would be enjoyed by low-income Canadians, the experience in the UK suggests otherwise. As illustrated in Chart 7, no less than 50% of high-income individuals contribute to the ISA—significantly above the 30% seen among lower income UK citizens. As well, note that individuals over the age of 55 have the higher tendency to contribute to the ISA. There is no reason to believe that the age and income distribution in the Canadian TFSA scene will be fundamentally different than what we see in the UK.

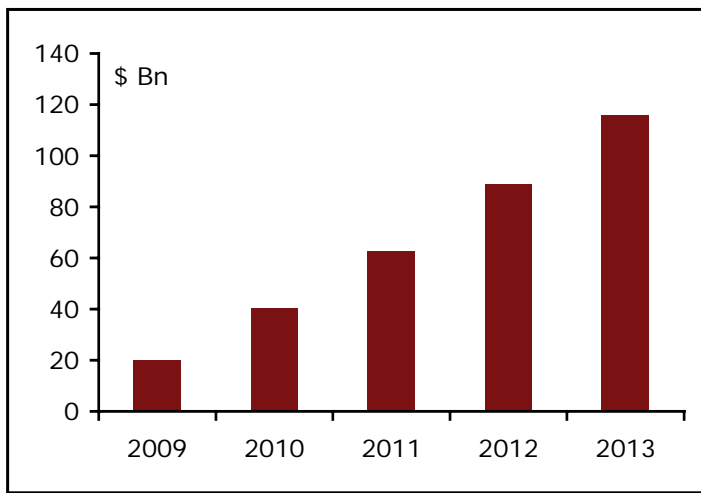
Another useful source of information is a recent Harris/Decima poll which examined Canadians' knowledge, perception and intentions with regard to the TFSA. The results suggest that no less than 52% of Canadians aged 18 and over are planning to open a TFSA. This is not surprising given that 58% of Canadian households hold an RRSP account. Interestingly, almost one-fifth of those planning to open an account will use borrowed money. Furthermore, as opposed to what is assumed by many, more than 40% of Canadians are likely to use new money in contributing to the TFSA. This is consistent with the situation in the UK where more than half of the money invested in an ISA is new money. While the average contribution to TFSAs is reported to be just over \$2,000 a year, 25% of contributors that maximize their RRSP or face a large pension adjustment will maximize their contributions. At the same time, 42% (most likely low-income and young Canadians) will contribute less than \$1,000 annually (Chart 6).

Chart 7  
UK's ISA Market—By Age and Income



Source: HM Revenue & Customs

Chart 8

**TFSA—A \$115 Billion Market By 2013**

Source: CIBC World Markets projection

Based on this information we estimate that Canadians will contribute roughly \$20 billion to the newly created TFSA in 2009, and will continue to utilize this vehicle at an impressive rate. Note that we assume a relatively modest 3-4% annual return on capital since the duality feature of the plan (investment for retirement as well as a vehicle to finance consumption) suggests that at least in the first few years, a significant portion of the money parked in TFSAs will be in cash and cash equivalent accounts. This assumption is supported by the Harris/Decima survey. Accordingly, we project that by 2013, the TFSA market will grow to a \$115 billion market<sup>2</sup>—with a cumulative tax savings for Canadians of roughly \$2 billion (Chart 8).

Note:

1. Source: Harris/Decima. The data gathered between April 30<sup>th</sup> and May 5<sup>th</sup>, 2008. Sample size: 2,613.
2. We assumed 2.5% inflation rate. We also allowed for a gradually rising withdrawal rate—reaching close to 10% by 2013.

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