

# **The Tax Free Savings Account: Introduction to the Policy Forum and Simulations of Potential Revenue Costs**

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The Tax Free Savings Account is now in its fourth year. The recent federal election campaign saw the Conservative Party of Canada offering a plan to extend the annual TFSA contribution limit from \$5,000 per person to \$10,000. This plan was predicated upon first returning to budget balance. Since a balanced federal budget is still some years off, this conditional promise conveniently affords us some time to analyze this proposed change in tax policy. The articles collected in this forum investigate the efficacy of the TFSA and discuss some ideas on where it should go in the future.

Before introducing the other articles comprising the forum, I will provide context on some of the long-run consequences of the TFSA for the revenue generated by the income tax system.<sup>2</sup> When first introduced, the new TFSA with an annual limit of only \$5,000 may have struck many Canadians as inconsequential. However, because the \$5,000 annual limits accumulate through time, the TFSA will have much larger consequences when it becomes a ‘mature’ system. For example, while today’s 40 year old will have only \$20,000 of available TFSA contribution room, a 40 year old twenty years from now will have \$110,000, having accumulated room since age 18.

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<sup>1</sup> I thank Rhys Kesselman for helpful comments on this draft.

<sup>2</sup> A preliminary analysis along the same lines as presented here appeared on the Globe and Mail’s Economy Lab blog during the election campaign. See “How TFSA expansion will hit future tax revenues,” Kevin Milligan, Globe and Mail, April 7<sup>th</sup>, 2011. <http://www.theglobeandmail.com/report-on-business/economy/economy-lab/the-economists/how-tfsa-expansion-will-hit-future-tax-revenues/article1975461/>

This means that the TFSA will affect coming generations much more than we have observed in its first few years.

To assess the long-run implications of the TFSA, I turn to the most recent microdata wealth survey available from Statistics Canada, the 2005 Survey of Financial Security.<sup>3</sup> Using this survey, I ask what implications a mature TFSA would have had for income taxation in 2005. That is, rather than projecting forward what a mature TFSA will look like a generation into the future, I instead examine data from 2005 under a counterfactual supposition that a mature TFSA was already in place in 2005.<sup>4</sup>

I implement this simulation by assigning an amount of TFSA contribution room to each family observed in the survey. For one-parent or single person families, I assume one TFSA account. For all other families, I assume two TFSA accounts. I repeat the analysis for four different levels of accumulated limit per account: \$50,000, \$100,000, \$200,000, and \$300,000. Depending on whether annual limits were \$5,000 per account (as is currently the case) or \$10,000 per account (as is proposed) these total accumulated account limits would take differing numbers of years to achieve, but can all be seen as varying degrees of a mature system.

For the simulations, I assume that existing assets producing taxable income (which I refer to as taxable assets) are placed in TFSAs whenever possible. Funds contributed to TFSAs may in fact

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<sup>3</sup> This analysis is based on Statistics Canada's Survey of Financial Security Public Use Microdata File, 2005, which contains anonymous data collected in the Survey of Financial Security. All computations on these Statistics Canada microdata were prepared by the author. The responsibility for the use and interpretation of these data is entirely that of the author.

<sup>4</sup> This analysis ignores the accumulation of investment returns within the TFSA, and the fact that income earned on these returns is also sheltered. In this way, I understate the impact of the TFSA on revenues.

come from several sources, such as money that would have gone into RRSPs, new savings generated by the extra savings incentives of the TFSA, or existing taxable assets that are switched into the TFSA. The assumption I use here is simply that households will first shelter their currently taxable assets.

In practice, families might not make full use of their TFSA room for many reasons. First, most households will keep a ‘float’ of money in a bank account to handle their monthly bills. Second, while the TFSA is quite flexible, it does restrict liquidity to some degree. Finally, the fixed cost (in hassles and time) of opening an account might exceed the tax benefits derived from the account.

While these practical concerns may lead to an overstatement of the use of TFSAs under my assumptions, they are quantitatively less important than might be thought. About 74 percent of total taxable assets are held by families with at least \$100,000 of taxable assets. This means that even when allowing for some ‘float’ of a few thousand dollars per family, the total amount contributed to TFSAs changes little, because the bulk of the total contributions come from high-wealth families who still make large TFSA contributions on top of any ‘float’ held outside the TFSA. Moreover, it is plausible to imagine that high-wealth families might not have bothered to open a TFSA in the first few years when the total available limit was small, since the tax savings were correspondingly small. However, when available room in the future is measured in the hundreds of thousands, it is harder to see why high-wealth individuals would continue to pay income tax on capital income with TFSA room available to them.

In addition to the Survey of Financial Security, I also make use of the Income Statistics available on the Canada Revenue Agency website.<sup>5</sup> In the categories of taxable capital gains, dividends, and interest income, the CRA reports a total of \$57.7 billion in taxable income for 2005. If assets producing this taxable income had been held inside a TFSA, then the taxable income would disappear from the tax base. Without detailed information on the precise holdings of taxable assets, it is not possible to know with certainty how much taxable income is avoided when assets are switched into a TFSA from being unsheltered. To make progress, I use the simple assumption that the proportion of taxable income that disappears is the same as the proportion of assets that are newly sheltered in TFSAs. That is, if twenty percent of taxable assets are sheltered in a TFSA, then I assume that twenty percent of taxable capital income disappears.

With the limitations of this methodology kept in mind, Table 1 presents the results of the simulation. Each row shows a different per account total accumulated contribution limit. Recall that for single people, I assume one account, while all other family types have two accounts each with the indicated limit. The first column indicates the proportion of families who have taxable assets exceeding their available contribution room. If I assume all possible taxable assets are contributed to TFSAs, then only 11 percent of families exhaust the available room under the \$50,000 per account scenario. This means that 89 percent of families would have their capital income taxation entirely wiped out under this scenario, and would face untaxed return to saving.

This \$50,000 scenario is reached under the current \$5,000 per year limit accumulation in only 10 years. The following three scenarios (\$100,000; \$200,000; \$300,000) present estimates for a

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<sup>5</sup> See Statistics Canada (2008), Income Statistics, Final Statistics-Sample Data, 2007 edition (2005 tax year). <http://www.cra-arc.gc.ca/gncy/stts/gb05/pst/fnl/menu-eng.html>

more mature system--or a system with a higher annual contribution limit accrual. With the \$300,000 per account scenario (which would be reached with 30 years of \$10,000 per year accumulation), only 1.8 percent of families would face any capital income taxation for savings.

The second column displays the proportion of all taxable assets located inside the TFSA, assuming that people switch all existing taxable assets they can into the TFSA account. The third and fourth columns translate this into the amount of capital income that is sheltered, and the percentage decline in the federal base of taxable income.

For the \$50,000 scenario, the TFSA shelters 42.4 percent of all taxable assets. Using the assumption of a proportional reduction in taxable capital income, this represents a drop of \$24.4 billion in taxable income, which is 3.2 percent of the total income tax base. For the \$200,000 scenario, 72.2 percent of taxable assets would be sheltered inside TFSAs, removing \$41.6 billion from taxation. This results in a 5.4 percent decline in the federal tax base.

Since capital income is received disproportionately among higher-bracket taxpayers, this 5.4 percent decline in the personal income tax base might be expected to have a more than proportionate impact on federal personal income tax revenues. For example, if we assume an average tax rate of 25 percent on the foregone taxable income, the newly sheltered \$41.6 billion under the \$200,000 scenario would lead to foregone revenue of \$10.4 billion or 10.6 percent of

federal personal income tax revenues in 2005.<sup>6</sup> For the \$100,000 scenario, the revenue cost would be \$8.2 billion using a 25 percent tax rate.

If any of these scenarios came to pass as simulated here, the impact on the taxation of capital income in Canada would be substantial--and one is tempted to say revolutionary. Only a very small share of Canadians would face taxation on their marginal savings decision. A large proportion of now-taxable assets would become sheltered, leading to a noticeable decline in the federal tax base and an even bigger impact on federal revenues. These simulations suggest a mature TFSA system results in an appreciably different income tax than exists today.

An important caveat here comes from looking at the most recent Tax Expenditure and Evaluation Guide.<sup>7</sup> For 2011, the estimated foregone revenue from TFSAs is only \$220 million. This is a small fraction of the billions of foregone revenue suggested by my simulations. One reason for this difference is that my simulations are based on a mature system in effect for decades, not the current TFSA that is only three years into its lifetime. The other reason for the difference between the experience so far and the simulations is my (perhaps strong) assumption that existing taxable assets will be shifted into TFSAs whenever room is available. It is not clear to what extent such asset shifts have happened up to now. With only a few thousand dollars of TFSA room available, many Canadians with existing taxable assets might not have wanted to interrupt their portfolio strategies by diverting funds into a relatively small account. However, as accumulated TFSA limits approach ever-higher amounts, it becomes increasingly likely that the

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<sup>6</sup> To note, the capital gains amount reported in the Income Statistics are the taxable amount after the 50 percent exclusion. Also, the majority of this income would be sheltered by high wealth individuals. This makes the 25 percent tax rate assumption reasonable. At 20 percent, the foregone revenue would be \$8.3B.

<sup>7</sup> Department of Finance (2012), "Tax Expenditures and Evaluations 2011". <http://www.fin.gc.ca/taxexp-depfisc/2011/taxexp11-eng.asp>

tax sheltering will outweigh the transaction costs for most Canadians. Moreover, given the concentration of taxable assets among wealthier Canadians, the simulation results here rely much more on asset shifting into TFSAs by higher wealth Canadians whom we might expect to have access to good financial and tax advice.

I conclude that a mature TFSA has the potential to transform the taxation of capital income in Canada. Left out of my analysis is any assessment of whether this substantial shift toward tax sheltering of capital income is good or bad for the Canadian economy. For that analysis, we now turn to the other articles in this Policy Forum. First up are Maureen Donnelly and Allister Young. Donnelly and Young provide some useful institutional background on the TFSA. They proceed to document the experience of the United Kingdom with the Individual Savings Account. Since the Individual Savings Account was introduced in 1997, we have the opportunity to learn from their much longer experience in the UK in order to develop some firmer expectations of what we will have in store in the coming years.

The second and third articles following this introduction examine the case for expanding the TFSA annual contribution room accumulation from \$5,000 a year to \$10,000 a year, as proposed by the Conservative Party of Canada in the 2011 election. These two articles are authored by the two ‘fathers’ of the TFSA, Jonathan Rhys Kesselman and Finn Poschmann.<sup>8</sup> Poschmann lays out the case in favour of TFSA limit expansion by arguing that if consumption is the preferred tax base, then a tool like the TFSA that moves us in that direction is good. Moreover, any

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<sup>8</sup> Kesselman and Poschmann proposed the “Tax Prepaid savings Plan” in the paper “A new option for retirement savings: Tax Prepaid Savings Plans,” C.D. Howe Institute Commentary 149. Toronto: C.D. Howe Institute. This was followed by a more detailed analysis in “Expanding the recognition of personal savings in the Canadian tax system,” *Canadian Tax Journal*, Vol. 49, No. 1, pp. 40-101. These articles are widely recognized as the precursors to the TFSA as introduced in 2009.

distributional arguments resulting from such a move should be measured against this preferred tax base. Kesselman, on the other hand, argues that the TFSA requires remedy of three important deficiencies before entertaining an expansion of contribution room. He also discusses three potential reforms to provide that remedy.

The articles in this forum together provide a solid base for informed discussion about the best future direction for the TFSA.

Table 1: Simulated impact of mature TFSA system in 2005

Accumulated Contribution Room per account		Proportion exhausting all available room		Proportion of total taxable assets in TFSA		Projected taxable income sheltered, \$Billions		Decline in federal tax base
\$50,000		11.0%		42.4%		24.4		3.2%
\$100,000		6.0%		56.8%		32.8		4.2%
\$200,000		3.3%		72.2%		41.6		5.4%
\$300,000		1.8%		80.8%		46.6		6.0%

Source: Author's calculation using the 2005 Survey of Financial Security