It IS broke... so fix it!

Why real pension reform is needed to address Alberta’s looming crisis in retirement income

November 2010
Retirement income reform in Canada – the Alberta perspective

Canada’s retirement income system

Retirement provisions in Canada and Alberta: what the data tells us

Retirement incomes and current retirees

The retirement income issue in Canada

Why has Canada’s private retirement income system failed to deliver?

The position of the government of Alberta

Key elements of a reformed system

Proposals for reform

Conclusion

By Hugh McKenzie of Hugh McKenzie & Associates
Data analysis for this project was conducted by Richard Shillington of Tristat Resources.
An analysis of Canada’s retirement income system tells two very different stories. The public component of the Canadian retirement income system that is directed towards the alleviation of poverty among retirees has been remarkably successful. The proportion of seniors living at or near the poverty line has dropped substantially as our public system has matured. The improvement in the living standards of low-income seniors is even stronger in Alberta, thanks to the effectiveness of the Alberta Seniors Benefit and other programs directed towards seniors.

The same cannot be said for the privately initiated component of the system – the part that is supposed to be providing for the retirement incomes of middle-income Canadians. While the Canada Pension Plan (CPP) has succeeded in delivering on its limited mandate, Canada’s private retirement income system has failed Canadians, and it has failed Albertans.

Coverage in the private pension system has deteriorated rapidly over the past 20 years, primarily among workers in the private sector. Coverage in the private sector under more desirable defined benefit pension plans has deteriorated even more rapidly. In Alberta, only 11% of employees are covered by a defined benefit pension plan. Worse still, many defined benefit pension plans provide less-than-adequate benefits and, because their benefits tend not to be indexed, shift substantial risks onto pensioners.

Private saving through the RRSP system cannot be the answer. That system has also failed, partly because it is inherently unable to deliver retirement income security at a reasonable cost; and partly because it has failed to deliver benefits that it should have been able to deliver and was expected to deliver.

Private savings leave retirees exposed to risks that they are unable to manage. They risk the consequences of fluctuations in investment markets. They risk outliving their retirement savings. They risk the loss of their purchasing power to inflation. The record shows that private retirement savings have not been adequate to meet the reasonable needs of Canadians and Albertans in retirement.

The RRSP system itself, with its reliance on the retail mutual fund industry, has proven to be a hopelessly inefficient and wasteful way for individuals to save for retirement. A comparison of investment returns alone – without making any allowance for the lack of risk sharing in the RRSP system – shows that the same amount of money invested in a pension plan rather than in individual RRSP savings would generate more than double the retirement income.
As it becomes clearer that the voluntary private retirement savings system is not working and threatens to produce a seniors income crisis in the near future, a remarkable consensus has emerged among provinces and the federal government in favour of an improvement of the public pension system through an expansion of the Canada Pension Plan. While there are differences among provinces as to the design and scale of an expanded system, Alberta stands virtually alone in denial and as an apologist for the status quo.

The arguments advanced by Alberta for its position simply do not stand up to scrutiny.

The Alberta government suggests that Albertans are better off in the current system than other Canadians. That is simply not true. Private pension coverage is weaker in Alberta than it is in the rest of the country, and is deteriorating more rapidly. Albertans are no more likely to contribute to RRSPs than other Canadians. They pay just as much in foregone benefits for the inefficiencies and high fees of the retail RRSP investment options available to them. Middle-income Albertans are just as likely as other Canadians to face inadequate income replacement rates in their retirement.

Alberta claims that an improvement in the CPP would reduce employment. There is no evidence to support that view. Canada’s own experience over a 15-year period in which CPP premiums were doubled fails to show any employment impact. Experience with policy measures that increase payroll costs, including both payroll taxes and minimum wages, shows that the effects, if any, are so small that they are swamped by the normal ebbs and flows of economic activity. An extensive academic literature finds no basis for claims for long-term negative employment effects from payroll taxes.

The government relies heavily on studies conducted for the federal government in 2009 to support a claim that there is no retirement income crisis in Canada and that the current system is serving Canadians well. Unfortunately for the government, the conclusions drawn from those findings have been discredited. Subsequent analysis and research has demonstrated that the results relied on by Alberta to support its complacency masked a sobering underlying reality: that a significant proportion of middle-income Canadians and Albertans face a substantial reduction in their standard of living in retirement.

More recently, a comprehensive study of retirement income reform options published by the School of Policy Studies of the University of Calgary concludes both that there is a significant retirement income adequacy issue facing Canada in the near future and that CPP expansion is the only viable option available to address the issue.

While the conclusions from this report might be ignored by a government which has been in “don’t confuse me with facts” mode ever since the issue of CPP expansion first surfaced at the federal-provincial level in June 2010 neither the source – the University of Calgary – nor the reaction to it can be ignored. Notably, University of Calgary economist Jack Mintz, whose 2009 report is claimed by the government of Alberta as the basis for its opposition to CPP expansion, has clearly indicated his public support for the proposal.

The government appeals to Albertans’ pride in their self-reliance, suggesting that the freedom to choose inherent in the current system alone justifies leaving it intact. Unfortunately for Albertans, the government’s freedom to choose amounts to the freedom to choose among equally expensive and inefficient retirement savings vehicles and, ultimately, the freedom to spend more and get less than they’d get in a publicly sponsored alternative.

So while the government of Alberta’s opposition to an expansion of the Canada Pension Plan may serve the interests of the Canadian retail mutual fund industry and support the living standards of its high-flying leaders, it does not serve the interests of Albertans.
The key to improving retirement income is to expand the public system. While Canada’s retirement income system is relatively effective in addressing poverty among seniors, it falls far short of the systems in other advanced countries in meeting the needs of Canadians with lower-middle incomes and above. Compared with other countries’ public systems, ours has a great deal of room to grow.

An expanded public system, with its guarantee of portability from job to job, is more consistent with the realities of the modern labour market than a system based on private pensions and private savings, where a move from one employer to another can destroy retirement savings value. An expanded public system, with its unparalleled capacity for risk pooling, is more consistent with Canadians’ needs for retirement income security than a privately-based system that shifts risk back to individual employees and retirees. But most important, an expanded public system better serves the interests of Canadians simply because it is a dramatically more efficient way to provide for retirement income.

Administration is more efficient. Investment management costs are lower. Professionally managed investments generate higher returns. And with a mandatory system, the benefits of broad risk pooling are maximized.
Retirement income reform in Canada – the Alberta perspective

Along with the province of British Columbia, Alberta played a leading role in setting the stage for pension reform in Canada with the November 2008 report of the Joint Expert Panel on Pension Standards. It did so, not only by being one of the first of several provincial pension policy reviews to report, but also by stepping outside the confines of its original pension standards review mandate to evaluate the adequacy and effectiveness of Canada’s retirement income system as a whole.

The Joint Panel reached the conclusion, since echoed by other reviews, that even with reformed standards, private pensions and RRSPs are not capable of meeting the objectives envisaged for private retirement income arrangements in the 1960s by the designers of Canada’s retirement income system. To fill this identified gap in the system, the Panel recommended that Alberta and B.C. take steps towards the creation of publicly initiated Alberta/B.C. pension plan.

As other provincial reviews arrived at similar conclusions, the debate broadened in scope from the original Alberta/B.C. focus to ideas for a national plan as either a supplement to or an enhancement of the Canada/Quebec Pension Plan (C/QPP). The debate also began to focus on a number of specific issues, including:

- The relationship of a new plan to the Canada/Quebec Pension Plan;
- The relationship of a new plan to already-existing private pension plans – replacement or wrap-around;
- Funding – pay-as-you-go vs. funding in advance;
- Participation – voluntary/opt in; opt-out; compulsory;
- Type of plan – defined benefit; defined contribution; hybrid; target;
- Governance.

In June 2010, the debate evolved further with a letter from the Federal Minister of Finance in advance of a federal-provincial finance ministers’ meeting, proposing “a modest, phased-in and fully funded enhancement to defined benefits under the Canada Pension Plan in order to increase savings adequacy in future”.

Remarkably, given the diversity of political leanings among provincial governments and the normal resistance of provincial governments to federal initiatives in areas of provincial jurisdiction, responses to the letter were indicative of broad support to take the issue to the next stage.

The only exception of note was the position of Alberta Finance and Enterprise Minister Ted Morton, who issued a terse news release in advance of the meeting rejecting the proposal out of hand, stating that “Alberta does not support an expansion of the Canada Pension Plan because it is not a targeted response to the issue at hand. Rather, it is an overreaction.”

With that simple statement, Alberta moved from a position of leadership in the effort to supplement the benefits provided under the CPP to that effort’s leading opponent.

The purposes of this paper are:

- To review the facts concerning Canada’s retirement income system that have given rise to the current move towards reform, from both a national and an Alberta perspective;
- To consider what differences, if any, between Alberta and the rest of Canada, might justify a different response to these issues in Alberta compared with the rest of the country;
- To examine the research and factual basis for Alberta’s contention that the state of Canada’s retirement income system does not support a broadly-based initiative like the expansion of the CPP;
- To identify the necessary elements for a retirement income reform package.
Canada’s retirement income system

Design – the so-called three-legged stool of retirement income

As it was envisaged by its original designers, Canada’s retirement income system was based on three key elements:

1. Basic benefits, indexed to the cost-of-living and partially income tested, payable essentially universally, regardless of labour force participation, specifically the Old Age Security benefit and the Guaranteed Income Supplement;

2. A universal, public, employment-related pension plan, the Canada/Quebec Pension Plan, supported by premiums divided equally between employers and employees; offering a maximum benefit of 25% of employment income up to the average industrial wage; entitlements based on career average earnings indexed to the rate of increase of the average industrial wage; and

3. Private employment-related provisions for retirement income, through registered pension plans and registered retirement savings plans (RPP/RRSP).

Neither the CPP nor the private retirement savings arrangements called for any direct contribution from general government revenues, although retirement savings through both the public C/QPP and the private RPP/RRSP systems are supported by a deferral of income tax – contributions are tax deductible; accruals are tax exempt; and benefits in pay are taxable.

In addition, various other forms of tax subsidy have been added over the years, including the non-refundable credit for pension income, various refundable credits applied through provincial income tax systems and, most notably, the option of pension income splitting offered to couples for the first time in the mid-2000s.

This original concept was a compromise between employment-related and non-employment-related benefits and between public and private provision. In particular, the C/QPP was constrained in two respects. Its benefits were limited, leaving a substantial role for private sector pension and/or retirement savings plans. In addition, to allay fears in the investment industry concerning the potential impact of a large public investment fund on securities markets, the C/QPP was designed to be a pay-as-you-go plan with contributions in excess of benefits paid invested in provincial government bonds in proportion to each province’s share of excess contributions.

The latter restriction was relaxed as a result of the CPP financial review in the late 1980s, as contributions were increased to provide a funding cushion sufficient to bridge the entry into retirement of the baby boom generation and the CPP Investment Board was established to invest the CPP’s growing asset base in financial markets.
Performance

After just over 40 years of experience, it is evident that the Canada’s system for retirement income has failed a significant proportion of the population.

While the publicly funded and publicly sponsored components of the system have performed as originally designed, the private components of the system have fallen far short of what was originally anticipated.

As we demonstrate in the next section highlighting the data describing Canada’s retirement income system, the proportion of the Canadian workforce that belongs to a workplace-based pension plan has been dropping steadily, in total and, most notably, among private sector employees. The form of private sector pension arrangements has also been changing, with a gradual shift towards defined contribution pension plans and away from defined benefit pension plans.

Registered Retirement Savings Plans (RRSPs) have also fallen far short of the goals originally set for them. RRSPs were intended to fill the gap between the amount of retirement savings generated through pension plan membership and the amount required to provide for an adequate level of income in retirement.1

Thanks to data that became available after the changes in income tax regulations that integrated pension benefit accrual and RRSP savings for tax purposes, we now know that the RRSP system has not adequately filled the gap. As critics of the system expected, participation in RRSPs, contributions to RRSPs and tax deferral benefits from RRSPs are all positively related to income. Unexpectedly, it is also evident that RRSP participation is positively related to membership in a registered pension plan, and that withdrawals from RRSPs prior to retirement are negatively related to income.2

In other words, RRSPs are not serving as a viable substitute for pension plan membership. Instead, they are serving largely as a supplement to retirement savings for employees who are pension plan members. More disturbingly, the pattern of early withdrawals suggests that RRSPs are being used in part as a supplement to employment insurance rather than as a vehicle for retirement saving.

The recent introduction of Tax Free Savings Accounts (TFSA) into the array of tax subsidized savings arrangements broadens tax support to include savings from sources other than employment and offers an alternative to RRSPs to low-income employees for whom RRSPs may not be financially attractive.3 While it is too early in the history of the TFSA system to draw any firm conclusions, the fact that benefits are driven by the availability of discretionary disposable income suggests that the system is unlikely to address the issue of low retirement incomes and that benefits from the system will be positively related to income as has been the case with RRSPs.

Because they do not generate an income subject to tax back in the Guaranteed Income Supplement system, TFSA theoretically offer an option for low-income Canadians as an alternative to RRSPs. For TFSA to assist low-income retirees, however, there would need to be advice available to direct these seniors away from RRSPs and to TFSA. So far in the relatively short life of the TFSA, there is no evidence of such advice in advertising, the media or in the material prepared by financial institutions such as banks.

At the same time, it must be stressed that the TFSA does not address the fundamental problem with the retail-based RRSP system: its high fees and low net returns. In that respect, the problems with TFSA will be identical to the problems with the RRSP system.

1 RRSPs were supported by income tax deferral benefits intended to be analogous to those provided under pension plans, with tax deductible contributions and taxable benefits. Until the early 1990s, the RRSP and pension systems were only crudely integrated through the establishment of a higher RRSP contribution limit for non-members of pension plans than for pension plan members.

In the early 1990s, new regulations were introduced to formalize the integration of pension plans with RRSPs, with RRSP “room” based on the difference between an overall limit on tax subsidized retirement saving and the estimated value of pension plan benefits accrued during the year.

2 Perspectives on Labour and Income

3 Subject to an accumulating annual limit that refreshes after withdrawals, contributions from after-tax income into TFSA accumulate investment income tax free and are tax free on withdrawal.
Retirement provisions in Canada and Alberta: what the data tells us.

Old Age Security, the Guaranteed Income Supplement and the CPP

The primary function of Old Age Security and the Guaranteed Income Supplement in Canada’s retirement income system is to guarantee a minimum standard of living in retirement for all Canadians, regardless of their employment history. In other words, the goal of these programs is to address poverty among seniors, regardless of its cause.

The Old Age Security (OAS) benefit is payable essentially universally to all Canadians after their 65th birthday. The Guaranteed Income Supplement (GIS) is an income-tested benefit, which is reduced by 50 cents for each dollar of earnings.

Old Age Security currently provides a benefit of $521.62 per month or $6,259 per year.

Guaranteed Income Supplement benefits depend on both income and family status. A single senior without non-OAS income receives a GIS benefit of $658.40 per month or $7,901 per year for a total of $14,160. A couple, both of whom are pensioners without incomes receives a total OAS/GIS income of $22,954.

Most provinces provide a top-up benefit to seniors’ OAS and GIS benefits. Alberta’s Seniors’ Benefit amount depends on family status and type of accommodation. The maximum benefit for homeowners and renters is $3,360 per year for a single senior and $5,040 for a senior couple.

In combination, these programs have increased the incomes of most seniors above official poverty lines and explain fully why Canada has been one of the most successful countries in the world in reducing poverty among the elderly. As we discuss in more detail below, however, because the maximum benefits payable under these programs tend to be quite close to official poverty lines, Canada’s success in reducing seniors’ poverty is highly dependent on the definition of poverty used and results in large numbers of ‘near-poor’ seniors with incomes very close to the poverty line.

The C/QPP benefits formula is designed to deliver a benefit of 25% of an employee’s average lifetime earnings up to a maximum earnings equal to the average industrial wage. The guarantee levels for OAS and GIS and the maximum and average CPP benefit are set out in Table 1, below.

Since the mid-1970s, median incomes of seniors have been increasing as a result of a combination of women’s increased participation rates in the workforce and the effects of the maturing of the post-war private retirement income system.

---

4 OAS benefits are taxed back through the income tax system. At present, the OAS benefit tax back begins at an individual net income of $66,733 and is taxed back at a rate of 15%, eliminating the OAS benefit for Canadians with individual net incomes above $108,214.

5 Source: Calculations using the SCF and SLID microdata files.
At the same time, over the last 25 years the purchasing power of OAS/GIS has remained reasonably constant. The ratio of these guarantee levels to median senior incomes has fallen from the range of 60-75% in 1985 (just after the last significant increase to GIS) to contemporary values of 40-65% as set out in Table 2, below.5

With respect to CPP benefits, two factors combined to reduce the average impact of CPP benefits on retirement incomes: the fact that earnings for CPP purposes are capped at the average industrial wage; and the fact that benefits are based on adjusted earnings over an entire career rather than on earnings immediately before retirement. This effect is evident from the following charts, which show for Alberta and for Canada the distribution of CPP retirement benefits, by amount of annual benefit. Given the fact that the maximum CPP benefit would be payable to anyone whose adjusted career earnings are above the Canadian average, one would expect to see a clustering of beneficiaries whose benefits are at the top of the range.

The fact that there is no such cluster reflects the fact that most people’s earnings experience is not consistent over a working lifetime. It also offers a cautionary note for policy analysts, who tend to assume that people with above-average earnings will receive the CPP maximum benefit when they retire.

The data also reveal a significant disparity between the CPP benefits of women and men.
Canada’s public pension system: how does it stack up internationally?

Data from the World Bank indicate that, on a number of different measures, Canada’s public sector retirement income system is among the least generous among those of high-income countries.6

As one might expect given the internal Canadian data, the Canadian system performs relatively better compared with peers for Canadians with incomes below the average income.

At an income level of half the average income in the country, the net replacement rate (the percentage of pre-retirement income provided by the public plans, after taxes and other transfer payments) is 89%, just above the average and ranked 10th among 24 high-income countries.

At an income of three-quarters of the average income, Canada’s net replacement rate is 68%, just below the average of 73% and ranked 15th among 24 countries.

At one times earnings, Canada’s ranking drops to 17th. The net replacement rate is 57%, well below the average of 68%.

At 1.5 times average earnings, Canada’s ranking slips further, to 20th with a replacement rate of 40%, compared with an average of 63%.

At 2 times average earnings, Canada ranks 21st with a replacement rate of 31% compared with an average of 58%.

And at 2.5 times average earnings, Canada also ranks 21st, with a replacement rate of 25% compared with an average of 53%.

The data clearly show that for middle-income earners and above, Canada is far more dependent on voluntary private retirement savings than other high-income nations. It also shows that Canada’s public retirement income system has substantial room to grow and still remain within the mainstream of pension systems in wealthy countries.

Private pensions

The data show clearly that Canada’s relatively greater reliance on private retirement savings is misplaced. Employment-based pension plans have fallen far short of the role expected of them.

In 1991, only 45% of Canadian employees participated in an employment-based pension plan. In Alberta, the figure was worse, at 40%. Since then, pension coverage has been dropping steadily, falling under 40% for Canada and under 35% in Alberta by 2008.

Chart 5 shows the percentage of the paid labour force covered by a private pension plan in Canada and in Alberta, from 1977 to 2008.

Coverage is lower in Alberta than in the rest of Canada, dropping much more rapidly than the Canadian average until the late 1990s, and then stabilizing at just under 35% in the past 15 years.
The coverage rate for private sector workers is much lower than for public sector employees. Private sector pension plan coverage is approximately 25% in Canada, slightly lower in Alberta. This contrasts with a coverage rate of 85% in the public sector across Canada, 80% in Alberta. It is noteworthy that the improvement in pension coverage in Alberta since the mid-1990s is entirely attributable to a recovery in pension coverage among public employees in Alberta in 2008 to the high in the early 1990s of 80%, as shown in chart 6.

Since 1991, private sector employees’ pension plan coverage in Canada has dropped from 31% to 25%. In Alberta, the decline has been slightly more modest, from 28% to 24%.

The form of pension coverage has also been changing. Pension plans in Canada fall into two broad categories: defined benefit (DB) plans, in which a specific benefit formula is set out in the plan and is either guaranteed by a sponsoring employer/employers or targeted by participants in the case of multi-employer plans; and defined contribution (DC) plans, in which only the employer’s contributions to the plan are guaranteed.

There is a substantial difference between the two types of plans, from the perspective of plan members. In a DB plan, the risks associated with providing a given level of benefit are borne by either the employer or the plan as a whole (in the case of multi-employer plans). In DC plans, all of those risks are borne by employees as individuals. From the perspective of an individual’s retirement income security, DB plans deliver a significantly more desirable benefit.

Unfortunately, when it comes to employment-based retirement income security, employers have been voting with their feet. At the same time as overall pension coverage has been declining, the balance between DB plans and DC plans has been shifting away towards DC plans as shown in chart 7. In the private sector, the DB coverage rate has dropped quite dramatically since the early 1990s, in Alberta and nationally. Nationally, coverage has dropped from 26% to 15%; in Alberta, DB coverage among private sector employees has dropped from 22% to just over 11%.
Pension coverage among women

Patterns of coverage differ somewhat between male employees and female employees, as chart 8 shows.

In Canada, between 1991 and 2008, pension coverage among women (public sector employees and private sector employees combined) has fluctuated around the 40% mark. Coverage among men has dropped from nearly 50% in 1991 to about 38% in 2008.

In Alberta, the coverage rate among women dropped from about 38% to about 35%, whereas the coverage rate among men dropped from 42% to 32%. Notably, in 2008 the coverage rate among female employees for the first time exceeded the coverage rate for male employees, in both Canada and Alberta.

It is important to stress that the difference in trends between women and men reflects structural differences in the private pension system, not any particular gain for women. Women make up a higher share of the workforce in the public sector than in the private sector. The decline in pension coverage in the private sector will tend to be concentrated among men. At the same time, women’s pension coverage will tend to hold up better because coverage in the public sector has actually been increasing.

Coverage data in perspective

These data on membership will tend to overstate the impact of private sector pensions on retirement income, for two important reasons. First, they make no distinction between pension plans that deliver benefits that are consistent with public policy objectives for income replacement rates and those that do not. As we will see in later sections of this paper, there are wide discrepancies in benefit levels in private pension plans, relative to pre-retirement earnings. Second, these data reflect an annual ‘snapshot’ of pension plan membership in Canada, and therefore cannot take into account the effect of employee turnover on pension adequacy.

Union membership and pension coverage

Pension plan coverage in the private sector is closely tied to union membership. According to data from Statistics Canada’s Survey of Labour Income Dynamics (SLID), a union member in the private sector is 2.5 times as likely to belong to a pension plan as a non-union member in the private sector.7

Table 3 summarizes the data for Alberta and for Canada linking union membership and pension coverage.

---

7 About 75% of Albertan survey respondents who are private sector union members report having pension coverage. The comparable figure for non-union private sector employees is 30%. In the public sector the comparable figures are 86% for union members and 61% for those not in a union. Some caution is warranted in interpreting these figures as research has indicated that some respondents may report pension coverage when it is not in fact in place. This suggests that the institutional data from pension plans themselves may be a more reliable indicator of overall coverage. (Morissette, René and Yuri Ostrovsky, 2006. Pension Coverage and Retirement Savings of Canadian Families, 1986 to 2003. Ottawa: Statistics Canada.)
On every measure, the private pension system is failing Canadians. Coverage – and especially DB pension coverage – is declining. The decline is most dramatic among private sector workers.

And on every measure, the performance of the private pension system is worse in Alberta than it is in the rest of Canada.
RRSP contributions and participation – Alberta and Canada

In any given year, roughly the same percentage of Albertans and Canadians with employment income contribute to an RRSP. In 2008, for example, approximately 38% of employed Canadians and Albertans contributed to an RRSP.

Contributors to RRSPs tend to have higher incomes than non-contributors. The median employment income in Alberta in 2008 was $36,570 (Canada: $29,500). The median employment income of those who contributed to RRSPs was $61,240 (Canada: $51,090).

The median RRSP contribution in Alberta in 2008 was $3,210 (Canada: $2,700), representing 5.2% (Canada: 5.3%) of the median employment income of RRSP contributors. This compares with the (now outdated, on the low side) standard established in the income tax system of 18%.

Another indicator of the weakness of the RRSP system as a substitute for pension coverage can be found in the data on accumulated RRSP contribution room. These data are of particular interest because RRSP contribution room takes into account both RRSP contributions and the value of pension benefit accrual. As the chart below shows, unused RRSP contribution room has been increasing rapidly in the 2000s, both in Canada and in Alberta.

Unused contribution room increased by 78% at the national level in Canada and by 89% in Alberta. These data reflect the growing gap between the estimate of necessary retirement savings implicit in the Income Tax Act’s deduction rules and the amount of saving that is actually taking place.

Both participation and contributions to RRSPs are closely related to income, with higher-income employees more likely to contribute contributing more, than lower-income employees.

As the chart below shows, RRSP contributors with incomes over $80,000 accounted for 17% of tax filers but 37% of RRSP contributors and over 60% of RRSP contributions.

Given that RRSP participation and contributions relative to income are similar in Alberta and Canada, and that pension plan coverage is much lower in Alberta than in Canada, on balance, the private retirement income system performs even more poorly in Alberta than in the rest of Canada.
So far, we have focused on the retirement income system in relation to Canadians and Albertans who are currently employed.

We now turn to an evaluation of the system in relation to Canadians who are already retired.

Retirement incomes and poverty

As we noted above, Canada’s most notable success in retirement income policy (and it might be argued, Canada’s only notable success in retirement income policy) is in the reduction in poverty rates among the elderly. As the OAS/GIS system has matured, and as most provincial governments have provided their own retirement income enhancements, poverty rates among seniors have dropped dramatically.

In this section, we look at seniors’ incomes in relation to several poverty measures:

- Statistics Canada’s Low Income Cut-off (the income level below which the share of families’ incomes spent on necessities – food, shelter and clothing) is 20% or more above the Canadian average share of income spent on those items) before tax;
- Statistics Canada’s Low Income Cut-off (LICO) after tax;
- The Low Income Measure (50% of the median income for the subgroup);
- A near-poor Low Income Measure (60% of the median income for the subgroup) – the European standard for low income.

Tables 4 and 5 present data on the percentage of seniors whose incomes fall below these various measures of poverty, for Alberta and for Canada.

Consistent with the results of other studies, the data show that poverty rates, by any measure, are substantially lower for families than for single individuals, and substantially lower for senior families than for senior individuals.

The data also demonstrate the significant impact of the tax / transfer system on poverty among seniors both in Alberta and in Canada, with a relatively greater impact in Alberta than in Canada. Poverty rates for senior families are comparable for Canada and Alberta, although the data show a lower proportion of Alberta senior families classified as near-poor (3%) than of senior families in Canada as a whole (8%).

The tax/transfer system makes a substantial difference in poverty measures, especially for single seniors. The impact is relatively greater in Alberta than in the rest of Canada. The poverty rate based on the before-tax LICO is similar between Canada and Alberta – Canada 34% female / 29% male; Alberta 33% female / 25% male. After tax and transfer, however, it is evident that the Alberta system has much more impact on poverty than the system in the rest of Canada. Whereas the poverty rate in Canada based on after tax LICOs drops to 14% for both women and men, in Alberta it drops to 6% for women and 4% for men.

In a similar vein, whereas in Canada, 21% of women and 17% of men would be classified as near-poor, in Alberta the percentages are 9% and 4%, respectively.

Poverty Rates by Family Type, for Alberta, 2007

<table>
<thead>
<tr>
<th>Poverty Measure</th>
<th>Non-Senior Family</th>
<th>Non-Senior Single</th>
<th>Senior Family</th>
<th>Senior Single Female</th>
<th>Senior Single Male</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>LICO (BT)</td>
<td>7%</td>
<td>24%</td>
<td>4%</td>
<td>33%</td>
<td>25%</td>
<td>13%</td>
</tr>
<tr>
<td>LICO (AT)</td>
<td>5%</td>
<td>21%</td>
<td>1%</td>
<td>6%</td>
<td>4%</td>
<td>9%</td>
</tr>
<tr>
<td>LIM</td>
<td>6%</td>
<td>20%</td>
<td>3%</td>
<td>0%</td>
<td>4%</td>
<td>9%</td>
</tr>
<tr>
<td>Near LIM (+20%)</td>
<td>9%</td>
<td>23%</td>
<td>6%</td>
<td>9%</td>
<td>8%</td>
<td>13%</td>
</tr>
<tr>
<td>MBM</td>
<td>6%</td>
<td>22%</td>
<td>2%</td>
<td>1%</td>
<td>4%</td>
<td>10%</td>
</tr>
</tbody>
</table>

Source: Tabulations using the Survey of Labour Income Dynamics
Retirement incomes of seniors generally

Individual Alberta seniors’ incomes are summarized in the following two tables. Looking first at average incomes, there are substantial differences in incomes among senior Albertans based on gender and whether or not they have income from a pension or annuity. Women, even those who have pension or annuity income, have lower average incomes than men. Women with pension or annuity income average $29,000. The corresponding figure for men is $40,000. For Albertans without pension income, the average for women is $20,000; the average for men is $26,000.

It is also noteworthy that Albertans over the age of 65 who do not have a pension income are much more heavily reliant on earnings from employment than those with a pension. This is particularly true for men, where average earnings for men without a pension income total $9,000 compared with only $3,000 for men with a pension income. It is also true for women, who earn $3,000 on average if they have no pension income; $2,000 on average if they have pension income.

For average Albertans over age 65, looking ahead to later years when employment earnings are less likely to be available, an average Albertan (both sexes) without a pension will see his or her income drop from $22,000 to $16,000; the average Albertan with a pension will see his or her income drop from $35,000 to $33,000.

The incomes of seniors – like the incomes of all other subgroups in our society – are skewed towards the high end, driving the average up relative to the median, which is a more reliable indicator of a “typical” income.

A comparison of the average and the median for the various subgroups of seniors analyzed here reveals a number of interesting tendencies in the data. First, it is clear that seniors who have employment earnings have total income that is skewed towards the top of the income scale. In all categories, the median senior – half have incomes higher; half have incomes lower – has no employment earnings at all.

Second, the data reveal the extent to which pension and annuity income in particular is skewed. Among Albertans with pension and annuity income, the average pension income is $14,000; the median is $8,000. Among women with pension income, the average is $10,000; the median is $6,000. Among men, the average is $18,000; the median is $12,000. These differences are a result of the fact that the averages are driven up by the data for a relatively small number of seniors with high incomes.

Third, the median Alberta senior is heavily dependent on the public part of the retirement income system – CPP, OAS and GIS – for their retirement income. The median male Alberta senior derives 60% of his income from these sources; the median female Alberta senior derives just over half of her income from these sources.

<table>
<thead>
<tr>
<th>Poverty Rates by Family Type, for Canada, 2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-Senior</td>
</tr>
<tr>
<td>Family</td>
</tr>
<tr>
<td>LICO (BT)</td>
</tr>
<tr>
<td>LICO (AT)</td>
</tr>
<tr>
<td>LIM</td>
</tr>
<tr>
<td>Near LIM (+20%)</td>
</tr>
<tr>
<td>MBM</td>
</tr>
</tbody>
</table>

Source: Tabulations using the Survey of Labour Income Dynamics
A similar picture emerges from an analysis of data on the incomes of Alberta seniors at the household level. Here, the data show an average income for senior households in Alberta of $57,000, of which $19,000 is accounted for by employment earnings. As is the case with individual incomes, senior households without pension or annuity income are much more likely to rely on earnings from employment than those with such income.

The impact of pension and annuity income is most evident looking at the median income data. The median household has no earnings from employment. The median income for senior households with pension or annuity income is $49,000; the median for senior households without pension or annuity income is $31,000. The median no-pension household derives half its income from OAS, GIS and CPP.

---

8 One note of caution in interpreting these data. Households are classified as senior households if there is one senior in the household. So, for example, a senior couple may include a man or woman who is under the age of 65 and still considered to be in the active workforce.
The conclusions that may be drawn from these data are not encouraging for defenders of the current retirement income system. Whether at the individual level or at the household level, representative (median-income) Alberta seniors rely very heavily on the public parts of our system for their incomes in retirement. Investment income makes up a trivial portion of the retirement income of the median senior individual or household.

At the same time, the data suggest strongly that a pension supplementary to the Canada Pension Plan, for the median senior household, is what separates that household from near-poverty. This observation might be encouraging, were it not for the fact that pension coverage generally and coverage in high-quality defined benefit pension plans, is dropping rapidly in Canada, and even more rapidly and to a lower level in Alberta.

### Assets of seniors and senior households

Another way to look at seniors’ retirement living standards is to look at their assets.

In what follows, we analyze in detail the results of special tabulations from the Survey of Consumer Finances, 1999.  

---

* We have chosen to use 1999 data rather than the more recent 2005 data principally because the 1999 data are based on a much larger sample than the 2005 data. As a result, some of the detailed analysis that can be performed based on the 1999 data is not possible to perform reliably with the 1999 data. A review of comparable data from the two surveys indicates that the conclusions that would be drawn from the 2005 data are not materially different from those drawn from the 1999 data presented here.  

---

* other sources of income include provincial and federal transfers and tax credits  
Source: Custom Tabulations using the Survey of Labour Income Dynamics, 2007  
Source: Special tabulations of the Survey of Consumer Finances 1999
The average Canadian senior household with a pension or annuity income has retirement assets valued at $210,000; the corresponding figure for Alberta is $180,000.

For senior households without pension or annuity income, the average of retirement assets is only $30,000 both in Canada and in Alberta.

Median values are particularly striking. Reflecting the skewed nature of pension / annuity entitlements, median retirement assets are valued at $140,000 for Canada; $120,000 for Alberta. The median household without pension or annuity income has no retirement assets at all, either nationally or in Alberta.

A Statistics Canada study released in 2001 based on the 1999 household asset survey found that, Canada-wide, the 25% of households with retirement assets of over $100,000 held 84% of all retirement assets. Half of these households had assets exceeding $200,000, accounting for fully 64% of household retirement assets. 29% of households had no retirement assets in 1999.10

Breaking the data down further, the pattern is similar for both single seniors and senior families.

---

A more detailed breakdown of the assets of Alberta senior families highlights the issue of saving for retirement.

### Values of Assets for Alberta Senior Families

<table>
<thead>
<tr>
<th></th>
<th>Average Values</th>
<th>Median</th>
</tr>
</thead>
<tbody>
<tr>
<td>Home Equity</td>
<td>100,000</td>
<td>95,000</td>
</tr>
<tr>
<td>Pension</td>
<td>60,000</td>
<td>-</td>
</tr>
<tr>
<td>RRSP</td>
<td>20,000</td>
<td>-</td>
</tr>
<tr>
<td>RRIF</td>
<td>10,000</td>
<td>-</td>
</tr>
<tr>
<td>Subtotal: Retirement</td>
<td>100,000</td>
<td>26,000</td>
</tr>
<tr>
<td>Investment</td>
<td>10,000</td>
<td>-</td>
</tr>
<tr>
<td>Other</td>
<td>10,000</td>
<td>-</td>
</tr>
<tr>
<td>Net Worth</td>
<td>300,000</td>
<td>198,950</td>
</tr>
</tbody>
</table>

This table presents the average and median values for each category of assets. That is, for all senior families in Alberta, the average of their home equity is $100,000; the median value of home equity among Alberta seniors is $95,000.

The average pension value is $60,000, but the median value is zero indicating that for more than half of Alberta, senior families no family member has a pension.

The average RRSP value is $20,000, but the median value is zero indicating that more than half of Alberta, senior families have no RRSP assets.

The average RRIF value is $10,000, but the median value is zero indicating that more than half of Alberta, senior families have no RRIF assets.

Looking at all assets related to the retirement income system combined (i.e., the total of pension, RRSP and RRIF assets), the average total value is $100,000 – roughly equivalent to the average asset value in home equity, whereas the median is $26,000. In other words, half of Alberta senior families have total retirement assets of less than $26,000.

Among Alberta senior couples without pension assets, only 38% have any RRSP or Registered Retirement Investment Funds (RRIFs).

For senior couples without a pension, but who have retirement funds, the median value is $31,000; the 75th percentile is $100,000.

To put these numbers into perspective, $31,000 would buy an annuity for a 65-year-old of approximately $2,000 in monthly payments of $170 at current rates; $100,000 would buy an annuity of approximately $6,600 in monthly payments of $550.

These studies have been prompted by a number of issues, including the data on coverage and retirement income adequacy presented above, as well as concerns raised by the private pension industry in Canada about the impact of regulation on employers’ willingness to offer pension plans as part of their compensation packages and about the impact of disputes over pension surplus ownership on funding adequacy.

While the detailed mandates of these reports were not the same, and while their detailed responses to controversial issues in pension regulation differed somewhat, the general tenor of the three reports was remarkably similar.11

Each of the reports addressed the need to achieve a balance between protecting the interests of pension plan members on one hand and addressing what are seen as disincentives facing employers considering establishing retirement income plans.

Each of the reports accepted to varying degrees the arguments advanced by employers and their agents that by getting that balance wrong, from their perspective, the pension regulatory system has contributed to the decline in pension coverage in Canada.

Each of the reports noted that a reasonable response to the impact of the 2008 financial crisis and the subsequent weakness in financial markets on the finances of pension plans would lead logically to a tightening of regulations regarding pension funding. Each recognized the tension between the pressure for tighter regulation motivated by financial market weakness and the pressure for more relaxed regulation motivated by concerns about coverage.

And while each of the reports highlighted declining pension coverage among employees in the private sector as a major public policy problem, each report, either directly or indirectly, accepted that it was extremely unlikely that regulatory changes would be successful in inducing employers to expand traditional single-employer sponsored pension coverage.

Thus, from their different perspectives and within differing mandates of varying scope, each of these reviews was driven towards the need for a new approach to employment-related pensions in Canada, one which, again in varying degrees, called for governments to play a prominent role as facilitators, catalysts or initiators of change.

In the debate that followed, the breadth and extent of agreement on broad directions for change was remarkable. While the specific vehicles proposed for change varied considerably with respect to the nature of the pension promise, plan design, the new system’s relationship to existing pension plans and the C/QPP and whether participation would be voluntary or mandatory, the debate reflected broad agreement that the current system was not delivering what Canadians need and that a large-scale, professionally managed vehicle for expanded retirement income coverage was needed.

That discussion was brought to a focal point by the release of a letter to provincial ministers of finance by Federal Finance Minister Jim Flaherty in June 2010 pointing towards an expansion of the Canada Pension Plan as a response to the pension coverage and pension adequacy issue.

11 For a comparison of the analysis and recommendations of these reports see two overview papers by pension policy expert Bob Baldwin (Baldwin, CD Howe, 2010; and Baldwin, IRPP, forthcoming).
Why has Canada’s private retirement income system failed to deliver?

The debate that followed the release of the Flaherty letter, and the role of the government of Alberta in that debate in particular, is critical to the future of employment-related retirement income in Canada. We will return to that debate in the next section.

It is important at this stage, however, to step back and go beyond the question of what has happened to an exploration of why.

In the public discourse about retirement security reform, various explanations have been offered for the weakness of Canada’s private retirement income system. The most prominent of these explanations attributes the blame, in part, to individual Canadians’ refusal to save enough to provide for an adequate standard of living in retirement and, in part, to the unintended consequence for plan sponsors of a well-motivated effort to protect the interests of pension plan members.

The fact that these explanations are brilliantly self-serving is only one of their weaknesses. Those articulating the inadequate saving explanation point towards more generous tax incentives as the solution and imply that because inadequate saving for retirement reflects individual decisions, the government’s role should be limited to offering better incentives for better decisions. Those focusing on the regulatory system ignore the fact that, at best, weaker regulation would trade greater retirement income insecurity for a slowing of the rate of decline of coverage in the private pension system.

More important is that these explanations ignore fundamental changes in the structure of our economy that challenged the assumptions on which the original policy model was based.

Can private the private pension system provide the answer?

Looking first at private pensions, the expectation underlying the design of the system is that an employee would remain for his or her entire career with a single employer and retire with a pension earned over that extended period of service. This perspective resonates through the provincial and federal regulatory systems that were established in the 1960s. Employee pension rights were vested only at age 45 with 10 years of service. Employees who left their place of employment prior to vesting were entitled only to receive a refund of their contributions, with interest. Employees who left their place of employment after vesting were entitled to the pension they had earned to date, deferred to age 65. There was no provision for pension portability.

The system was completely ill-suited for any employer-employee relationship that did not last for an entire career.

More fundamentally, the system’s reliance on employers for the provision of retirement income was based on a series of assumptions about our economy: that the economy would remain sufficiently stable to continue to support long-term employment relationships; that Canada’s economy would continue to be well-enough protected to support reliance on private employers for an important long-term entitlement; that in particular defined benefit pension plans would be established as the norm in Canada which employers would willingly follow; and the defined benefit pension model was a reasonable – both objectively and more particularly to employers themselves – reflection of the relative ability of employers and their employees to bear and manage risk.
None of these assumptions has turned out to be valid. The economy of 2010 is dramatically different from the economy of 1966. Rapid turnover of both employees and employers has meant that the career employee and retiree is a rare exception, rather than the rule. This affects the private pension system on both sides of the economic bargain. Employers have difficulty seeing the value of an investment in a career benefit for employees they do not see being their employees for a career. Employees are understandably reluctant to divert a significant portion of their compensation package towards a benefit that only makes sense in the context of a career that they do not expect to have.

The advent of trade and investment liberalization has placed Canadian employers who offer defined benefit pension plans and who have assumed the associated liabilities under enormous economic pressure. It is not an accident that pension plans have been at the centre of most of the major economic restructuring controversies in the past 15 years.

As far as the hope that private pension coverage would be the norm in Canada is concerned, the fact of the matter is that private pension coverage in Canada is closely related to union representation, either directly as a result of pensions being made an issue in collective bargaining or indirectly as the pay and working conditions of unionized employees became established as the standard for all employees in an industry or sector, whether members of a union or not.

The decline in pension coverage in the private sector in Canada mirrors the decline in union density among private sector employees in Canada.

Finally, a risk-sharing proposition that made broad economic sense in the 1960s is no longer viable. From a risk perspective, the proposition that lay behind the private defined benefit pension plan was that employers were in a categorically better position to bear and manage than employees. While nothing has happened in the intervening 40 to 50 years to improve the ability of employees to bear those risks, it is clear that the combined effect of a changing economic environment and changes in accounting rules has materially affected the capacity of employers to bear those risks.

That means that, increasingly, risks in retirement are being shifted to the participants in the system who are least able to bear them — individual Canadian employees and individual Canadian retirees.

Risk sharing is fundamental to the reform of the system. The three main risks faced by participants in the retirement income system are:

- Investment risk – the risk that savings set aside prior to retirement will not earn enough to provide adequately for income in retirement;
- Longevity risk – the risk that a retiree will outlive his or her savings; and
- Inflation risk – the risk that the value of a retiree's retirement income will erode to the point where his or her living standard in retirement is compromised.

In indexed defined benefit pension plans, investment risk, longevity risk and inflation risk are borne by the pension plan. The amount and duration of the retirement benefit provided for in the plan is established in the plan provisions. In the case of the CPP, those risks are shared proportionally by all contributors to the plan. In the case of employer-sponsored private defined benefit pension plans, investment and longevity risks are borne in the first instance by the plan sponsor. Except in indexed plans, inflation risk is borne by individual retirees. In the case of plans that are jointly sponsored by employers and employees, those risks are pooled among all participants and contributors. The Nortel example illustrates that even in defined benefit plans, the financial risk is ultimately borne by employees if the company fails.

In defined contribution pension plans and RRSPs, investment risk is borne by the individual plan member. The amount of his or her benefit is determined by contributions to the plan and the investment returns earned by the plan. While it is in principle possible to insure against longevity risk through the purchase of annuities on retirement, in practice the unfavourable economics of the Canadian annuity market lead most DC and RRSP retirees to bear post-retirement longevity and investment risk themselves by rolling their retirement savings into RRIFs.

As a result, the shift away from defined benefit pension plans towards defined contribution pension plans and private RRSPs carries with it a shift of retirement income risk away from employers to individual Canadians.

While the focus of the debate over the future of the retirement income system in Canada will naturally focus on the adequacy of saving for retirement and of the retirement incomes that can
be provided from that saving, the appropriate sharing of risk must be considered in the design of a renewed system.

It is clear that the answer to the risk management issue for Canadians is not to be found in the private pension system. Within the private sector, indexed pensions are extremely rare. More generally, employers have been responding to changes in our economic structure, where they can, by declining to bear those risks altogether or by off loading those risks to their employees, where they can.

While this shift in risk may make economic sense for individual employers, from a public policy perspective it makes no sense, because it shifts the risks associated with retirement income security onto those least able to bear or manage those risks.

The pension and associated regulatory system has responded to these pressures in a number of ways. Successive waves of pension regulatory reform have strengthened the entitlements of non-career employees and enhanced the rights of employees whose career retirement plans are interrupted by employer shutdowns and cutbacks, as well as providing for greater security for plans’ pension promises. On the industry side, multi-employer plans have been recognized beyond their origins in the construction industry as a viable way for risks to be pooled beyond individual workplaces and shared among employers, among larger numbers of employees and between employers and employees. Multi-employer plans also enable small workplaces to achieve a measure of economy of scale in providing pension benefits. Indeed, variants of multi-employer pension plans were identified in the Arthurs Report in Ontario as the most promising private sector vehicle for expanding pension coverage.

While expansion of the multi-employer pension system is the most promising of the options available for the current system, its role in the reform we need will inevitably be limited. Multi-employer pension plans exist almost exclusively in the unionized sector. There is no evidence that employers who do not currently offer pension plans or participate in multi-employer plans are lining up to expand their pension coverage.

In any case, the logic that leads to a recommendation for more multi-employer pension plans inevitably leads to the ultimate multi-employer pension plan – the CPP.

RRSPs and retirement income reform

The other part of the private retirement income system envisaged in the 1960s designed was private saving on a tax-deferred basis through Registered Retirement Savings Plans or RRSPs.

The theory was that Canadians who were not members of pension plans, or who were members of pension plans that did not provide enough income in retirement to meet their expected needs, would accumulate personal savings as a substitute. The tax treatment of RRSPs is roughly similar to that of pension plans. Contributions are tax deductible; withdrawals and payouts are taxable. The presumed substitutability between pensions and RRSPs was initially recognized on a rough justice basis through the establishment of lower contribution limits for members of pension plans than for non-members.

That substitutability was made more precise and formal with changes in regulations in the early 1990s that established a mathematical equivalency between a taxpayer’s accrual of pension benefits during a given year and the maximum amount by which the taxpayer’s RRSP contribution “room” could increase during that year.

The performance of the RRSP system falls far short of the expectations of the system’s designers.

• The system has not acted as a substitute for pension plan coverage.

Overall, the participation rate in RRSPs is higher for employees who are members of pension plans (58.2%) than for employees who were not members of a pension plan (33.1%). However, this is in part due to the fact that higher-income individuals are both more likely to belong to a pension plan and more likely to contribute to an RRSP than lower-income individuals.13

• While participation is greater among participants in pension plans, average contributions were lower among pension plan members than among non-members.

However, the difference, on average, was only about 20%. Members of contributory pension plans contributed an average of $3,168 to RRSPs in 1996; non-RPP members contributed $3,992.14


14 Earnest B. Akyeampong, “RRSPs in the 1990s”, Perspectives on Labour and Income, Statistics Canada, Spring 2000, p.8
• As critics of the system have argued, participation in RRSPs is positively related to income, both for employees with pension plan coverage and for employees without pension plan coverage.

For example, various Statistics Canada studies have found that RRSP participation was positively related to income, throughout the income range, for all employees, whether in a pension plan not.

• Average RRSP contributions were also strongly positively related to income.

• Because the tax preference for RRSPs is delivered in the form of a deduction from taxable income, the benefit from the preferential tax treatment of RRSP contributions is also strongly positively related to income.

• There is strong evidence that many Canadians find themselves forced to use their RRSPs to supplement their incomes before retirement.

For example, a 1996 Statistics Canada study found that by 1994, 700,000 Canadian tax filers withdrew a total of $3.9 billion from their RRSPs (an average of $5,550). To quote the study:

“Cashing in of RRSP savings grew dramatically in 1991. This situation was attributed largely to the recession and its accompanying job losses. Nearly 20% of those who made withdrawals had neither employment income nor unemployment insurance benefits that year; even those with employment income earned on average relatively little.” 15

Another Statistics Canada Study found that in the period 1993 to 1997, for people between the ages of 25 and 64, the rate of withdrawal from RRSPs was 20-25% of the rate of contributions. In other words, for every dollar contributed to an RRSP by people in this age group, 20-25 cents was withdrawn. 16

While it is tempting to jump to the conclusion that limited participation in RRSPs, even by Canadians without pension coverage, reflects inappropriately inadequate savings behaviour by Canadians, economic factors would appear to have a significant influence. Indeed, these factors suggest that low participation and contribution rates, rather than being irrational, may be a rational response to the economic environment generally and to the performance of RRSP investments specifically.

While there has been substantial growth in Canada’s GDP in total and on a per capita basis during the period since the mid 1970s, there has been very little growth in median individual or family incomes and there have been long periods of time in which there has been no growth in real incomes, either individual or family, for considerable periods of time, as illustrated in the following chart of real ($2008) median incomes of economic families in Alberta from 1976 to 2008.

It took until 2004 for incomes to reach their 1976 level, and until 2006 to reach the peak reached in 1981.

A combination of stagnant individual incomes during a period of real overall economic expansion is not conducive to saving, and the data on household assets and personal indebtedness confirm that observation. In addition to the fact that the past 35 to 40 years in Canada have not provided Canadians at median income levels with sustained increases in disposable income, the performance of retirement savings in RRSPs would be, to say the least, discouraging.

There are three reasons underlying the disappointing performance of RRSPs as vehicles for retirement savings: lower than expected investment returns; high retail investment management fees; and the prohibitively high cost of insuring against longevity risk through the purchase of annuities.

Studies of investment returns of retirement income funds in the United States have found consistently that returns earned by defined benefit plans exceed those earned by defined contribution plans; that returns earned by large DB and 401(k)

16 Akyeampong, Perspectives Spring 2000, p. 9
plans (the equivalent to DC plans in Canada) exceed those earned by smaller DB and 401(k) plans, respectively; and that returns on Individual Retirement Accounts (IRAs, the US equivalent to Canadian RRSPs) are the lowest of all.

For example, a study covering the period 1988 to 2004 by the Centre for Retirement Research at Boston College concluded as follows:

*The bottom line is that over the period 1988-2004 defined benefit plans outperformed 401(k) plans by one percentage point. This outcome occurred despite the fact that 401(k) plans held a higher portion of their assets in equities during the bull market of the 1990s. Part of the explanation may rest with higher fees, which are deducted before returns are reported to participants. But the one percentage point shortfall understates the investment problem in 401(k) plans, since an aggregate number does not reflect the fact that more than half of participants in 401(k) plans do not follow the prudent investment strategy of diversifying their holdings. Finally, the available data suggest that IRAs produce even lower returns than 401(k) plans, which, if true, implies trouble ahead given the massive amount of money that is being rolled over into these accounts.17*

The results of this study for the period 1988 to 2003 are summarized in the following chart taken from study data.

Similarly, a presentation by the giant investment management firm BlackRock at a fall 2010 investment conference in Toronto included the data on average returns in the 20-year period since 1990 earned by various classes of investments and types of investors.18

It showed returns on the S&P 500 at 8.2%; bonds at 7.0%; inflation (US) at 2.8%, and the average retail investor at 2.3%.

These differences are not trivial. As a rough rule of thumb, a difference of 1% in annual return over a retirement saving cycle translates to a 20% difference in the amount of money available to provide income in retirement.

There are several reasons why the returns earned by individual investors are below those earned by larger institutional investors. First, size matters in investment administrative costs. In a larger entity, administrative, trading and custodial costs can be spread over a large asset base and shared indirectly by many participants, resulting in much lower per-unit costs. Second, larger institutional investors are able to access a much broader investment opportunity set than small or individual investors. Individual investors are largely limited to securities purchased on public markets; large investors are able to increase returns through alternative types of investments that do not trade publicly. Even where funds rely on third party managers, large institutional investors have access to a much broader universe of managers than do individual RRSP investors.

The most important reason for the difference, however, lies in the extraordinary difference in the investment management fees paid by larger institutional investors and those paid by individual RRSP and non-RRSP investors. Canadian retail investment management fees – expressed in the Management Expense Ratios of mutual funds – are among the highest in the

---

17 Alicia H. Munnell, Mauricio Soto, Jerilyn Libby, and John Prinzivalli, “Investment Returns, Defined Benefit vs. 401(k) Plans”, Issue in Brief, Centre for Retirement Research, Boston College, September 2006, Number 52, p.1

18 BlackRock, Toronto CFA Society Forecast Dinner Presentation, September 2010
Management fees for equity funds typically run in the 2.5% to 3.5% range, or higher. Fees for fixed income (bond) funds typically run in the 1.5% to 2% range. This compares with average fees paid by institutional investors in the 0.3% range, and with fees for typical retail exchange traded index funds in the 0.5% range.

At a conservative estimate, the premium paid for investing through mutual funds compared with institutional or exchange traded index funding is at least 2%. For an average retail investor saving for retirement over a working lifetime, with a balanced 60% equity 40% fixed income asset mix, investing through mutual funds, and earning the expected returns before fees on his or her investments, between 45% and 60% of the proceeds of his or her savings (contributions plus accumulated investment returns) will end up in the hands of mutual fund managers. Canadian RRSP investors pay a huge penalty for the privilege of being able to pick and choose among an array of high-cost retail investment options.

The second most important difference between providing for retirement income through a large institutional plan has to do with the cost of converting retirement savings into a retirement income.

A large institutional savings plan is in a position to pool post-retirement longevity risk and investment risk among a large number of participants. All defined benefit plans, by definition, convert a plan member’s accumulated retirement savings into a monthly benefit on retirement. Even some large defined contribution plans offer their participants the opportunity to pool post-retirement longevity and investment risk by offering the option of converting savings accumulated to retirement into annuities.

For the individual RRSP investor, the post-retirement world is very different. Based on an analysis using typical actuarial assumptions and life tables, the current typical retirement annuity price for a male annuitant age 65 of $100,000 for a $550-per-month payment implies an embedded rate of return of less than 2.25%. Using the return assumption more typical of large pension plans of 6.5%, that $100,000 would pay for a monthly benefit of more than $800 per month – nearly 50% more. Even using the much more conservative liability matching return on long term bonds, an investment of $100,000 would support a monthly benefit of $650 – nearly 20% more.

The prohibitive expense of the current annuity market leads most Canadian RRSP holders to convert their RRSP funds into Registered Retirement Investment Funds. This is clearly more cost effective on average than the annuity purchase option. However it exposes retirees dependent on RRSP savings to two significant risks: the same investment performance and fee issues as they were exposed to pre-retirement; and an additional risk related to longevity – the risk that they will outlive their RRIF.

The retail markets to which individual RRSP savers are tied are so costly, so inefficient and so burdened with overhead that it is hardly surprising that individual Canadians have been reluctant to participate in those markets.

The common denominator among all of the proposals for change in the Canadian retirement income system is a desire to give Canadians access to a more cost-effective method of saving for retirement and to give Canadians access to a more efficient and affordable mechanism for converting their pre-retirement savings into retirement incomes.
After having taken the lead – along with the province of British Columbia – in recognizing the gaps in Canada’s retirement income system by proposing an Alberta/BC pension plan, Alberta Minister of Finance and Enterprise Ted Morton was quick to reject the proposal for discussions on the expansion of the CPP advanced by the Federal Minister of Finance in June 2010.

Since then, Alberta’s objections have been made more explicit.

“Expanding the CPP would provide additional and unnecessary benefits to those Canadians – a majority – who already planned for adequate retirement income provisions.

“It would also hurt low-income workers who would be required to make higher contributions while working but whose higher CPP benefits in retirement would likely result in a reduction in their Guaranteed Income Supplement (GIS).

“Further, increasing CPP premiums for employers could cost jobs, at a time when our economy is recovering from the recession, as businesses would have to reduce their costs to pay higher premiums.

“My government believes strongly that individual Canadians should be given the freedom and responsibility of choosing how best to plan their retirement savings strategy.”

Are improved benefits necessary?

While overtly political considerations likely played a role in Alberta’s change in position, the rationale advanced for the position based on controversial and largely discredited economic analyses of Canada’s retirement income replacement rate – the relationship between pre-retirement and post-retirement incomes.

Specifically, Alberta’s position draws on a passage in a report prepared by University of Calgary professor of public policy and tax expert Jack Mintz for the federal government. In that report, Mintz summarizes the conclusions of a paper by consultant Keith Horner prepared for the Federal-Provincial-Territorial Working Group follows:

The estimates suggest 70 percent of households achieve 100 percent and 78 percent achieve 90 percent of replacement consumption. Those with low incomes generally have sufficient retirement income to achieve desired consumption levels after retirement due to government transfers and CPP/QPP benefits. High income households are less able to achieve their targeted consumption levels with RPPs and RRSPs since limits are imposed on contributions made to these plans (other financial assets would then be needed to fund higher levels of consumption if desired). A greater degree of inadequate savings is estimated for modest and middle income Canadians, with two earner couples and singles less likely to be able to achieve consumption replacement at retirement.

Before getting to the issues concerning the findings, it is clear that taken at face value they do not support the degree of complacency about the current system reflected in Alberta’s changed position. A conclusion that 22% of households are not saving enough to maintain 90% of their consumption points to a significant problem.

Moreover, the further conclusion that modest and middle-income singles and two-earner couples are less likely to be able to achieve consumption replacement at retirement, passed over with little comment in Mintz’ report, actually highlights a significant problem. In fact, the affected households make up 31% of the households in the analysis. The very paper cited by Alberta as the basis for its dismissal of the need for fundamental reform actually finds that the system is failing nearly 1/3 of all Canadian households.

A closer look at the details reveals that the study is not actually based on a measure of the impact of savings on the relationship between pre-retirement and post-retirement consumption. Rather, it is the output of a modeling exercise based on a single year of data on incomes, taxes and contributions to registered pension plans and RRSPs linked to pre-retirement savings and consumption on one hand and post-retirement consumption on the other through a series of assumptions. The key assumptions are described as follows:

19 Footnote to come from Andrew Jackson.
• The build-up and exhaustion of home equity plays a key role in the model. The model assumes that a household buys a home equal in value to three times earnings during working years and then liquidates the accumulated equity over the period of retirement.

• The model assumes that households save at their rate in 2006 for exactly 35 years of work between age 30 and 65 and are retired for exactly 20 years.

• The model assumes that retirement savings will earn a real rate of return of 3.5%.

Missing from these assumptions is any acknowledgement of the role of risk in determining how much should be saved for retirement. There is no acknowledgement of risk of reduced earnings or unemployment pre-retirement. Reflecting those risks in the analysis would result in lower estimated consumption replacement rates.

The analysis makes the implicit assumption that all saving is directed towards retirement. Yet we know that significant amounts of RRSP savings are withdrawn prior to retirement every year, to be used for current pre-retirement consumption, to bridge income losses and/or to pay for their children’s education, for example.

There is no acknowledgement of longevity risk. By assuming that everyone remains retired for exactly 20 years, no account is taken of the ‘risk’ (from a strictly financial perspective) that an individual might live longer than 20 years after retirement. To plan for that possibility, pre-retirement savers must either plan to save more as a hedge against outliving their retirement savings or insure against that risk by converting their savings to retirement annuities. The former strategy implies a need for greater savings at retirement than assumed in the model to generate a savings cushion; the latter requires greater savings at retirement to cover the substantial premium charged for life annuities above the assumed market rates of return.

The assumed investment return on savings is also highly questionable. Given data showing that retail investors earned only an average 2.5% real return during a period in which equity markets were generating the highest returns in history suggests that an assumption of a 3.5% return in the future is wildly optimistic. The Mintz report acknowledges this problem in part, indicating that reducing the estimated return to 2.5% would raise the insufficient savings rates by 4% for the 100% replacement target and 3% for the 90% of consumption replacement target.

The conclusions drawn from the Horner study were buttressed in Mintz’ report by data from another study conducted for the Working Group by Yuri Ostrovsky and Grant Schellenberg of Statistics Canada.

As Mintz reports, Ostrovsky and Schellenberg used long-term data on individuals to measure retirement income as a percentage of earnings in the period 1989 to 1991. It found retirement income replacement rates above 65% for all categories of men and women. Notably, it also found that replacement rates were higher, for almost all groups, for individuals without a registered pension plan than for individuals with a pension plan, largely because individuals without pension plans had much greater average earnings from employment than individuals with pension plans – i.e., individuals without a pension plan were working more after retirement.

The Mintz report noted but did not address two major shortcomings with this analysis: the use of averages, which had the effect of obscuring variations within the income groups and pension coverage categories; and the focus on individual incomes, whether the individuals were single or in couples.

Two subsequent papers by Ostrovsky and Schellenberg addressed these issues.

In general, these analyses concluded for both men and couples:

• Distributions of replacement rates were skewed towards the top end for all income groups, with the most skewed distributions in the lowest income groups;

• Distributions were more skewed and more dispersed for groups without a pension plan than for those with a pension plan;

• In all income groups and all pension coverage categories, significant portions of couples / men had income replacement rates below thresholds of 50% or 60%.

References:

22 Yuri Ostrovsky and Grant Schellenberg “Pension Coverage, Retirement Status, and Earnings Replacement Rates Among a Cohort of Canadian Seniors” Analytical Studies Branch Research Paper Series, December 2009

23 Mintz, p.15

24 Yuri Ostrovsky and Grant Schellenberg, “Pension Coverage and Earnings Replacement Rates Among Canadian Couples”, Analytical Studies Branch Research Paper Series, Statistics Canada, July 2010 (Ostrovsky / Schellenberg July 2010-I)

Furthermore, the results also reveal that the anomalous finding in the earlier study cited by Mintz in his report that replacement rates were lower for individuals in pension plans than for individuals not in pension plans is entirely attributable to the impact of a highly-skewed distribution on the average.

This subsequent finding is bad news for Alberta Finance Minister Morton, who had been using the earlier misleading finding in his arguments against the federal government’s CPP initiative. Contrary to the Minister’s claim, a comparison of the actual distributions highlights the positive role that pension plan membership plays in retirement incomes, and underlines clearly the potential problems flowing from declining pension coverage.

One of the weaknesses of the studies relied on by Mintz is that, generally speaking, they are backward looking. As such, they reflect the experience of a cohort of retired Canadians whose retirement income experience is not likely to be repeated if the current system remains unchanged. Future retirees are unlikely to benefit from a repeat of the investment returns enjoyed by current retirees. The period 1980 to 2000 exhibited the longest sustained period of high real investment returns in Canadian history. Compared with long-term average real returns of 3%, returns during that period averaged close to 5%. Future retirees’ incomes will also be affected by the decline in pension coverage in the private sector discussed earlier in this paper. In addition, with the growth in the life expectancies of 65 year olds, future retirement saving needs will be greater.

A preliminary report from a more recent study by former Statcan statistician and current University of Ottawa professor Michael Wolfson takes a different approach. 27 Using Statistics Canada’s leading edge LifePath’s simulation model, Wolfson analyzed income replacement rates for subgroups consisting of renters / owners and women / men. The focus of the study was on the baby boom generation born between 1945 and 1970. The study concludes that about half of middle-income individuals in the cohort expected to retire in the next 25 years will experience a decline in consumption after retirement of more than 25%.

---

25 Ostrovsky / Schellenberg July 2010-I, p. 14
26 Ostrovsky / Schellenberg July 2010-II, p. 20
Although the debate among the experts continues, it is already clear that the analytical foundation for Alberta’s position is not sustainable. It is already clear that Alberta’s claim that most Canadians have already provided adequately for their retirement is not true.

It is now clear from the data that significant numbers of Canadians in upcoming cohorts of retirees will experience significant declines in living standards after retirement.

The bad news for the position of the government of Alberta does not end there, however.

A recently published study by Simon Fraser University economist Jonathan Kesselman considers the need, analyzes the options, and concludes that improvements in retirement income security in Canada are needed, and that CPP expansion must be central to our public policy response, summarized in the paper as follows:

“In summary, diverse empirical and analytical considerations support the expansion of CPP retirement benefits as the centrepiece of pension reform to achieve benefit adequacy for all retirees.”

The conclusion could not be stated more clearly:

The CPP was established in 1966 with a deliberate low replacement rate based on the expectation that workplace pensions and personal savings would grow to supplement the OAS/GIS to provide an adequate overall replacement rate for all Canadians. That outcome has not occurred, and trends in workplace pensions as well as individual savings do not bode well for many future retirees. Moreover, even workers who save adequately and invest well bear costs and risks that are significantly higher than those a Big CPP could offer. Many of the original CPP’s deficiencies were recognized as early as 1979, when the Task Force on Retirement Income Policy examined a Big CPP proposal and concluded that “a powerful case can be made for expanding the C/QPP.” More than 30 years later, public officials are finally acknowledging the case for expansion. In June 2010, the federal and provincial finance ministers agreed to work toward expanding CPP benefits along with requisite premium increases. Federal finance minister Jim Flaherty stated, “We agreed to consider a modest, phased-in, and fully funded enhancement to defined benefits under the Canada Pension Plan.” While essential details and final agreement have not yet been reached, further deliberations should focus on the proper scale for benefit expansion. This kind of reform opportunity arises at best once in a generation, and full maturation of expanded CPP benefits would take two generations. Accordingly, the greatest policy risk is that the promised “modest enhancement” will be overly cautious and constrained. Will the forthcoming CPP reforms be sufficiently “big” to meet the needs of Canada’s growing senior population?

The bad news for Alberta’s position does not end there. Kesselman’s paper was published in the government’s own backyard, by the School of Public Policy of the University of Calgary. And prominent among those quoted in support of its conclusion in favour of CPP expansion was Professor Jack Mintz, the very economists whose earlier work had been used as the justification for its position of denial and refusal. As the Canadian Press story on the release of the Kesselman paper reports:

Prof. Mintz is known for his skepticism about government meddling in retirement planning. He has championed more flexibility for private-sector solutions. And he wrote a pivotal paper for the federal and provincial governments a year ago concluding that Canada’s system was working well and not in need of major reform.

But Prof. Mintz now says he recognizes that many Canadians, especially those with low or medium incomes, don’t want to take risks with their money and invest hard-to-find savings in market instruments. He also sees company after company abandoning defined-benefit pension plans for their employees, leaving them vulnerable in their retirement.

“I’m very concerned about this movement away from defined-benefit plans. It’s really important to have that as an option for people,” he said.

29 Kesselman, p.30
The current pension system and low-income Canadians

For many low-income Canadians, the part of the Canadian retirement income system that is not tied to employment – OAS and GIS – by itself replaces a substantial share of their pre-retirement earnings. The fact that this is the case is not a consequence of the generosity of Canada’s retirement income system (the numerator in the replacement fraction) but rather a consequence of their low earnings prior to retirement (the denominator in the replacement fraction).

It is the interaction between extraordinarily low working earnings prior to retirement and the universally provided benefits under OAS/GIS that gives rise to the more-than-100% replacement rates that the studies above commonly find for the lowest-income fifth of the groups studied.

That taken as a given, the fact that low-income seniors derive most of their retirement income from OAS and income-tested GIS and provincial supplementary benefits creates an issue for the design of the system in general and for the design of improvements to that system in particular. The blunt truth is that low-income retirees derive little or no benefit from their retirement savings. The claw-back of GIS benefits as incomes rise means that for every dollar of income generated by an Albertan from C/QPP benefits, RRSP proceeds or registered pension plan benefits roughly 68 cents will be clawed back before any other taxes are applied. When combined with Alberta’s 10%-flat-income-tax rate and the bottom rate of 15% for federal income taxes, this means that the effective tax rate on income from a pension plan, RRSP or CPP benefits is approximately 93%. And when other benefits for which Alberta seniors are qualified based on their incomes are taken into account, the effective rate of tax can exceed 100%.

On this issue, the Alberta Minister has a point. Introducing measures to require or even to encourage low-income Albertans to increase their savings for retirement will do those individuals a disservice, and must be taken into account in designing a new and/or improved retirement income system.

The impact on employment

The argument advanced by the Minister concerning employment impacts is a red herring, for several reasons.

First, none of the proposals for reform is suggesting that the increased contributions that would accompany an expansion of the Canadian retirement income system would be implemented overnight. As many provinces have done with their change in minimum wages in recent years, increases in retirement income contributions would inevitably be phased in over several years.

Second, just as was the case with the introduction of the Canada Pension Plan in the 1960s, an expanded public system will result in changes to currently existing retirement savings provisions, with enhanced public benefits substituting in whole or in part for pre-existing privately provided benefits.

Third, there is no support in economic analysis for a contention that increases in payroll-related costs will have a negative effect on employment in the longer term. This analysis generally shows that, in the longer term, increases in taxes and premiums related to payroll are shifted economically back onto workers, whatever their original incidence.

Finally, when it comes to shorter-term effects, there is considerable debate in the economic literature. While it is generally agreed that these effects are quite small, recent studies suggest that even the small effects predicted by traditional studies cannot be distinguished from the impact of other economic factors.

The short-term impact of payroll levies and other government measures that increase labour costs on employment has been the subject of vigorous debate in the academic literature for decades, largely in debates over the impact of increases in minimum wages.

This literature is based on the basic principle in economics that if you increase the price of something, other things equal and under competitive market conditions, demand for that thing will go down. Translating that proposition to the labour market, these studies postulate that if the price of labour goes up because of increased social insurance premiums, less of that labour will be demanded.

---


These types of studies look at employment patterns over time to develop estimates of the labour demand response to increases in minimum wages. These studies typically find a small negative employment effect of approximately 1/5 of the percentage change in the minimum wage for teenage minimum wage workers, a reduced impact for workers in their early 20s, and little or no impact of statistical significance on the employment of workers over age 25.

What this means is that, for example, for a 10% increase in the minimum wage, these studies would predict a 2% reduction in employment among young workers.

Not all of these studies arrive at the same conclusions. In general, the results vary in the 1% to 3% range with a 10% increase in minimum wage. The most detailed models found the lowest disemployment effects\(^2\), predicting disemployment effects in the neighborhood of 1%.

The principal difficulty with these studies is that, while they confidently predict fairly substantial employment impacts for young workers resulting from increases in minimum wages, actual employment data fail to show any observable negative impacts resulting from actual increases in minimum wages.

The reality in economics is that there is a wide variety of causes and effects, such that the isolated impact of any one phenomenon can easily be swamped by other, more important, policy variables. While these academic studies predict employment effects, “all other things being equal,” in reality payroll levies exist in a context that is constantly changing.

As it has become more obvious that other factors dominate the employment effects of modest changes in payroll costs, even economists who have in the past adhered to the employment impact view have begun to change. Economic Policy Institute economist Liana Fox notes in her November 2006 review of the literature on employment impacts:

“Some distinguished economists have acknowledged their change of opinion on the issue. Former Federal Reserve Vice Chairman and current Princeton economist Alan Blinder commented, “My thinking on this has changed dramatically. The evidence appears to be against the simple-minded theory that a modest increase in the minimum wage causes substantial job loss” (Chipman 2006).\(^3\)


The controversy in the economics literature referred to above is related strictly to estimates of short-term impacts.

With respect to the longer term impacts of changes in payroll taxes and levies, there is a consensus among economists that, through the operation of the labour market, such changes – positive or negative – are largely shifted backwards onto employees through changes in wages and salaries, and that employment impacts are limited.

While the economics literature on this issue is of long standing – the key references are from the 1970s – recent articles focusing on the obverse issue of the impact of payroll tax cuts reach similar conclusions. For example, a recent article in the journal International Tax and Public Finance concluded as follows from an analysis of the impact of a payroll tax cut confined to a specific region in northern Finland.

According to our results, the reduction in the payroll taxes led to an increase in wages in the target region. The point estimates indicate that the increase in wages offset roughly half of the impact of the payroll tax cut on the labor costs. The remaining labor cost reduction had no significant effects on employment.

The freedom to choose

While it has an intuitive appeal, particularly to conservatives, the idea that individuals will be better off in retirement making their own individual pre-retirement savings and investment decisions flies in the face of the facts. Individual retirement savings plans suffer from four substantial disadvantages.

First, the evidence shows clearly that the people who most need to save carefully for retirement don’t save nearly enough. People with low pre-retirement incomes don’t need to save to maintain their pre-retirement living standards. Thanks to the fact that the low-income elderly are defined as “deserving poor”, most Canadians who depend on social assistance – welfare or disability benefits – and those who fall into the category of the “working poor” see their living standards actually increase once they cross the magic threshold of age 65. People with very high pre-retirement incomes and high disposable incomes don’t need to expend much effort in pre-retirement saving to maintain their level of consumption in retirement. However, the data show that significant numbers of middle-income households are not saving nearly enough to maintain their standard of living.

Second, the retail retirement saving and investment system is hopelessly inefficient. Exorbitant retail investment management fees extract such a high price for participation in investment markets that a significant proportion of retail retirement savings actually leaks out of the system into the balance sheets of the money managers who run the system. Substitute institutional investment management fees for the fees paid by retail investors and the savings effort required to achieve any given retirement income goal can be cut virtually in half.

Third, because the investment risk in an individual savings plan cannot be shared, prudent individual savers tend to adopt more conservative strategies (with lower returns) as they get closer to retirement. In a larger fund investment risk can be pooled, increasing returns for all participants.

Finally, when it comes time to convert pre-retirement savings into post-retirement income, individual savers find themselves without a financially viable way to insure against the risk that they will outlive their savings. As part of a large pool, in which every participant converts his or her savings into a regular income at retirement, annuitizing pre-retirement savings becomes cost-effective. And the larger the group in the pool, the more cost effective it will be.

As a variant of the freedom to choose argument, it has been suggested that a mandatory expansion of the Canada Pension Plan would penalize those who have already provided adequately for their retirement, either through membership in a pension plan or through personal retirement savings. Similar arguments could have been made when the Canada Pension Plan was created in the first place. What actually happened, however, was that existing pension plans were amended to take into account benefits provided under the CPP as well as the premiums required to pay for those new benefits. And those Canadians who feel they have saved enough from personal resources to fund their retirement, an expansion of the CPP will be in a position to divert some of those savings to other purposes while getting the full benefit of enhanced CPP benefits.

In summary, with individually focused retirement savings, the freedom to choose is purchased at great expense in reduced returns and higher risk, largely for the benefit of the fee takers in the retail investment management industry.
Key elements of a reformed system

Issues with the public system

Although the issues with respect to the publicly funded and publicly sponsored components of the retirement income system are of a second order compared with the evident failure of the privately funded and sponsored components, there are indeed issues with that system that are of particular relevance to subgroups of the population.

First, OAS and GIS benefits are not indexed to a measure of the general standard of living in Canada; they are indexed to changes in the Consumer Price Index for Canada. This means that, to the extent that real wages increase in the economy, these benefits will tend to shrink in relative terms. It also means that for residents of parts of Canada, like Alberta, in which living costs are increasing faster than the national average, these benefits do not keep up. This is a particularly important problem both for non-participants in the labour force, for whom these programs are the only publicly-subsidized sources of retirement income and for low-income employees for whom these benefits make up a substantial share of their retirement income.

Second, OAS and GIS benefits are not well integrated into the overall retirement income system. In particular, low-income employees whose CPP benefits and private retirement benefits may put their total incomes within the range in which GIS benefits are taxed back will find themselves, after the fact, gaining little or no benefit from their employment related retirement savings.

Third, because C/QPP benefits are based on adjusted career earnings, the actual benefits Canadians receive are highly dependent on patterns of earnings over a working lifetime. While the C/QPP system makes special provision for a limited number of low-income years (15% of years of eligibility may be dropped out of the benefit calculation), years spent raising children under the age of six and years of disability eligible for CPP disability benefits, many Canadians are disadvantaged by the inclusion of low- or no-income years in the determination of their C/QPP benefits.

The key issue, however, is that the public system as a whole is too small. It replaces too low a percentage of pre-retirement income in the middle-income range, partly because the replacement rate is limited to 25% of adjusted lifetime average earnings, and partly because the maximum income for CPP purposes is set at the average wage. Particularly at income levels in the lower-middle income range and above, Canada’s public system is significantly less generous than that of other high-income countries.

In and of itself, that would not be a problem if the private retirement income system were able to fill the gap. It is not.

Filling the gap left by the private retirement income system

An analysis of the data suggests that no single or simple change will address all of the retirement income needs of Canadians.

The data tell us that the employment-related retirement savings system does not serve lower-income Canadians well. They also tell us that, while Old Age Security, the Guaranteed Income Supplement and various provincial add-on plans do a good job of lifting seniors above the official poverty line, they leave large numbers of seniors categorized as “near poor”, with incomes within just a few thousand dollars above the poverty line. Taken together, these two sets of data suggest that the best way to address the issues faced by the lowest-income Canadians is to increase the benefits paid under our universal benefit plans.

With respect to the employment-related retirement income system, it is clear from the data on coverage and savings adequacy that the current system is not working and that, left in place, its performance is likely to deteriorate further. For the reasons cited above, the only reasonable approach is to expand or add onto the Canada Pension Plan.
To ensure that the benefits of large scale, risk pooling and universal national portability are maximized, participation must be mandatory. A voluntary system may address the issues of efficiency and investment returns, but offers no answer either to savings inadequacy or to the lack of a viable mechanism for converting pre-retirement savings into post-retirement incomes.

Mandatory participation would also generate substantial administrative cost savings, making it relatively straightforward to deliver the system through the existing Canada Pension Plan infrastructure.

The expanded system must be designed to deliver a formula-based defined benefit. That way, system improvements can be appropriately integrated with those current retirement income plans that already deliver adequate benefits, just as private pension plans were modified to accommodate the introduction of the Canada Pension Plan in 1966.

The data also suggest that any improvement in the employment-related retirement income system should be designed so as to avoid forcing low-income Canadians into retirement savings that will ultimately have no impact on their post-retirement living standards.

The question of whether an enhancement to the current system should be delivered through an expanded CPP, or through a separate but integrated add-on to the CPP depends largely on decisions about how the benefit should be phased in and funded. Canada’s experience suggests that there is no compelling reason why enhanced benefits could not be funded on the same modified pay-as-you-go basis as the current CPP. Our system has performed well in the face of very difficult economic and demographic circumstances.

The expanded or add-on plan should be open to additional voluntary contributions, so that Canadians who wish to can convert their RRSP savings.

Investments should be centrally managed in a large scale fund, either by the Canada Pension Plan Investment Board, by a companion national fund, or by pooling the investment results from additional investments by provincial-level public sector pension funds.
Proposals for reform

Remarkably, there is a widespread consensus on the need for major changes to strengthen our retirement income system and on the critical role to be played by an expanded Canada Pension Plan in that strengthened system. As Jonathan Kesselman stresses in his recent study, we have a once-in-a-generation opportunity to achieve gains in retirement income security for all Canadians at a time of critical need. We cannot afford to lose the momentum for change. It is essential that the debate continue to move towards a consideration of concrete proposals.

The Canadian Labour Congress (CLC) has proposed to phase in a doubling of Canada Pension Plan benefits from 25% to 50% of insured earnings (i.e., earnings between the Yearly Basic Exemption and the Yearly Maximum Pensionable Earnings). The increase in benefits would be fully pre-funded as additional premium revenues are invested to pay for higher pensions in the future. Pre-funding of increased benefits is required by current legislation.

A 100% increase in future CPP benefits can, according to calculations undertaken for the CLC by the former Chief Actuary, be financed by raising CPP premiums by a total of just under 6% of pensionable earnings, divided equally between workers and employers. (The current premium rate of almost 10% is significantly higher than the “go forward” rate as calculated in the most recent CPP Actuarial Report.) The CLC has proposed that the required premium increase be gradually phased in over seven years to ensure that there would be no significant impacts upon employment. This was the same rate of increase employed in the 1990s when the CPP was placed on a more sustainable financial basis.

It would take approximately 40 years for the expanded CPP to be fully mature such that pensioners would collect a doubled maximum and average benefit. However, a doubled pension credit would be earned in every year following a decision to expand the CPP. Partial benefits would be earned while the premium increase is being phased-in over seven years. Even after a few years, there would be a significant increase in the CPP pensions of new retirees. 37

Since the great majority of employer pension plans are integrated with the CPP, the CLC notes that there would be some reduction of required employer and employee contributions as an expanded CPP matured. There would likely also be reduced contributions to RRSPs (which have much higher costs and lower returns than the CPP Investment Fund.) The CLC has also called for a 15% increase to the maximum Guaranteed Income Supplement to raise the incomes of seniors in need today and as expanded CPP benefits are gradually phased-in.

The CLC has been at the leading edge of the debate over retirement income security in Canada in general and over CPP expansion in particular. The strength of the building consensus suggests that this opportunity for a generation might engender support for an even more ambitious program.

An enhanced universal benefit

Alberta, with its relatively more generous provincial supplementary plan to OAS/GIS, is well positioned to address the issues faced by the lowest income seniors. A reasonable target would be to guarantee a retirement income equal to 60% of the median income of retired Albertans. This would ensure that no retired Albertan would have an income low enough to qualify as “near poor.”

Enhancing universal benefits is the only way to improve the situation of individuals who, for whatever reason, have not been lifelong participants in the labour force. It is also the only practical way to improve the living standards of those who are already retired or who are currently close to retirement.

An enhanced CPP

Compared with the universal public plans in other countries, the Canada Pension Plan offers more limited coverage to Canadians in a more tightly-constrained income range.

The obvious vehicle for improvement in the public system is the universal Canada Pension Plan. The core of the reform should be a doubling of coverage to 50% of adjusted lifetime average earnings. To extend the benefits of the universal public system well into the middle income range, and to address the needs of employees whose incomes change substantially over their working lifetimes, it would be appropriate to double the income covered by the CPP as well, to two times the average industrial wage. These two moves would bring Canada’s universal employment-related pension system into line with the best-in-class of the plans offered by OECD countries.

The particular issues faced by lower income workers could be addressed in a number of ways in the design of the plan. The overall CPP exemption could be increased – perhaps to the OAS/GIS guarantee income level. CPP contribution requirements could be adjusted through the tax system to exempt employee contributions on incomes below a certain threshold. This would address the issues faced by low-income workers without providing a benefit in the form of lower premiums to their employers. Another approach, which could be used in combination with one of the suggestions above, would be to increase increasing coverage from 25% of income to 50% of income on a sliding scale based on income, with no increase in coverage at income levels for which CPP delivers little or no net benefit.

It has been suggested that an expansion of the CPP should be either strictly a defined contribution plan or a target benefit plan – one that establishes a benefit level as a target that can be changed as circumstances change. For practical purposes, however, with the broad scope of risk pooling in a national compulsory plan, there is no practical difference in the likely outcome among the three options. Given that fact, there would appear to be no legitimate reason not to design the plan to provide real retirement security through a defined benefit design.

It has also been suggested that an expanded CPP could be offered on either an opt-in or an opt-out basis. Expanding CPP on an opt-in basis would defeat the one of the key purposes of an expansion. While it would address the issues of high administrative costs, high fees and low returns in the existing system, it would not address the problems of chronic undersaving leading to inadequate retirement incomes. It would also sacrifice much of the benefit from the pooling of longevity risk, since only a universal system can ensure that these risks are shared by all Canadians. Allowing for an opt-out would undermine risk pooling as well, and would be unnecessary. Rather than allow for an opt-out of the expanded CPP, we should take the same approach to CPP expansion as was taken when the CPP was originally introduced – rely on private pension plans and private retirement savers to adjust their plans to reflect the introduction of this new, superior, benefit.
Conclusion

The evidence is overwhelming that there is a dangerous gap in Canada’s retirement income security system that can only be filled through an expansion of the Canada Pension Plan.

Too many Canadians lack the protection of a good defined benefit pension plan to supplement the current CPP. Too many Canadians have been unable to fill the retirement income gap left by absence of private pensions for workers in the private sector. Too many Canadian seniors live at or near the poverty line.

The options offered by critics of CPP expansion are simply not credible.

No matter how much Canada’s pension regulatory system is relaxed, employers are not suddenly going to start offering defined benefit pension plans to their employees.

No single-employer option can realistically respond to the realities of today’s rapidly evolving economy and labour market.

The RRSP system cannot be part of the solution; it is a major part of the problem. The system is hopelessly inefficient, ridiculously costly and notably underperforming. A system that generates as much for its managers as it does for its investors is serving itself, not the Canadian public interest.

The ideal pension plan to supplement the Canada Pension Plan, from the perspective of a young worker today, is a multi-employer pension plan in which all of his or her future employers are participants. There is only one such pension plan: an expanded Canada Pension Plan.

Alberta’s support for CPP reform may not be required – change could, in principle, proceed without the support of the government of Alberta – but it is needed. Support from Alberta would help to maintain the momentum needed to deliver on this once-in-a-generation opportunity for change. It would make for a better substantive outcome. And it would address the clear needs of the people of Alberta.