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Do Public Pension Plans Need to Be Expanded?

by **Youri Chassin**

Do Canadians save enough for retirement? What is the government's responsibility in the matter? All across Canada, these questions have taken centre stage over the past year. Several major public plan reform proposals are being discussed. They all begin with the same observation, that people are not saving enough for retirement, and they all propose similar solutions based on mandatory saving. This *Economic Note* asks if the diagnosis is correct, and if the proposed solutions are adequate.

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The different components of pension plans

The Canada Pension Plan (CPP) is funded by deducting contributions representing 9.9% of pensionable earnings (currently between $3,500 and $52,500 in annual income) over the course of one's working life.[1] Benefits corresponding to nearly 25% of pensionable earnings are then paid out to retirees 65 years and older, up to $1,038.33 a month.[2] The Quebec Pension Plan (QPP) is similar in many regards.[3]

All retired Canadians also receive Old Age Security benefits from the federal government, and those with low incomes can also receive the Guaranteed Income Supplement. Some also benefit from private pension plans connected to their work. Finally, anyone can build up tax-sheltered personal savings with the help of financial instruments like RRSPs and TFSAs.

All of these components give Canada an elderly poverty rate that is lower than the average among industrialized countries and lower than the poverty rate for the Canadian population as a whole.[4] Despite this, many voices are calling for the expansion of our public plans (CPP and QPP).

Unions have been fighting for many years for the public plans to guarantee a retirement income equal to 50% of pensionable earnings, rather than 25%, by raising contributions.[5] The Finance Minister of Prince Edward Island, Wes Sheridan, recently proposed that the pensionable earnings maximum be doubled. Retirement benefits for higher income earners would therefore increase.[6] The Ontario government for its part is getting ready to launch its own plan, more generous than the CPP,[7] while the Quebec government is studying the creation of an additional public pension for those aged 75 and over.[8]

These proposals would increase everyone's contributions and benefits, in the manner of universal plans, instead of making changes targeted to help those who really need it. They therefore represent economic costs that are larger than they need to be. This is often ignored in public debates. Even the Sheridan proposal, which is the most modest one, would impose additional payroll taxes of between $9.8 and $12.3 billion a year.[9]

Insufficient savings: myth or reality?

Proposals to expand public pension plans are based on the notion that households are not saving enough to maintain their living standards in retirement. In other words, their projected

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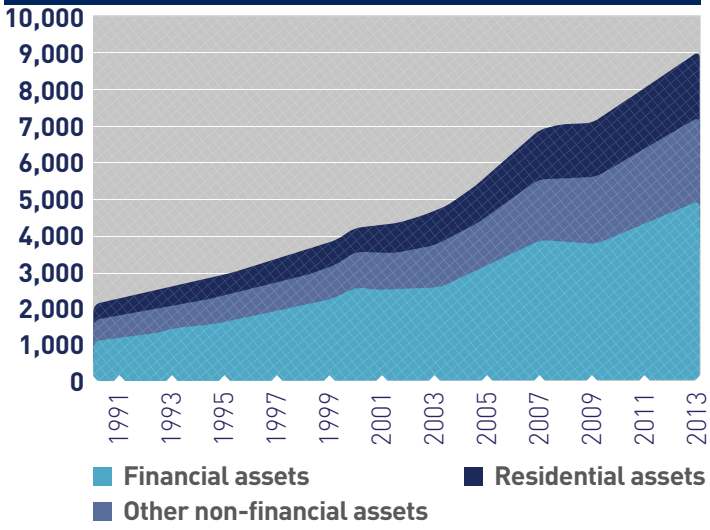
retirement incomes are less than 60% of the incomes they were earning before retiring.

The concept of sufficient savings, however, is ambiguous in a number of ways. The 60% threshold is an average and is not equally relevant for everyone. Families with low employment incomes generally need retirement incomes up to 80% or even 100% of their employment incomes, while those with high employment incomes can maintain their standards of living with just 50%. This concept is also based on the hypothesis of full retirement at age 65.

Despite the imperfect criteria used to define sufficient savings, studies on this question generally conclude that the living standards of the poorest households are well protected in retirement. Canadians who are less likely to maintain their standards of living after they turn 65 are mostly found among the middle class and the more affluent.[10] But two significant methodological weaknesses call into question the widespread diagnosis of insufficient preparation for retirement.

Figure 1 — Value of Canadian households' different assets (in billions of current dollars)



Source: Statistics Canada, Table 378-0121, National Balance Sheet Accounts.

1. The value of real estate investments

The main weakness of the studies carried out to date is that they do not take into account non-financial assets like houses and family businesses, yet these are popular investment vehicles for middle class and well-to-do households. Total non-financial assets represent around 40% of what households own,[11] including over $1.8 trillion just in terms of the estimated value of houses (see Figure 1). This amount is much greater than the financial assets invested in RRSPs and TSFAs.[12]

These proposals would increase everyone's contributions and benefits instead of making changes targeted to help those who really need it.

The fact of not including Canadians' real estate investments considerably underestimates their total savings and therefore their standards of living in retirement. Although a house is not the equivalent of an RRSP from which one can withdraw a certain amount each month, financial tools like reverse mortgages allow a portion of its value to be liberated. A household can choose to sell its home and buy a smaller one or decide to rent instead of owning. Furthermore, by continuing to live in a house that is completely paid for, a retired household enjoys the equivalent of a housing service whose value increases its disposable income by 10% or 15% on average. Such a contribution is liable to profoundly alter the picture of Canadians' preparedness for retirement.[13]

2. The retirement age

The second methodological weakness of the insufficient savings diagnosis is considering the age of retirement as fixed at 65 years. On the contrary, households decide when to retire based on their particular financial situations.

A person's financial situation depends partly on life circumstances and individual preferences, which can vary enormously. For example, some people choose to travel when they're younger, while others save such projects for retirement. Some save to shelter themselves from financial reversals that, if they do not happen, leave savings available for retirement. The choice to save can also reflect a desire by some to leave an inheritance to their descendants, while others will on the contrary count on their children to look after them.

On average, people in Canada retire earlier than in many other industrialized countries.[14] Since this choice is voluntary, we can conclude that most Canadians think that they have saved enough when they enter retirement. If they do not, they can in fact continue to work a few more years to make up the difference. Actually, 12% of Canadians 65 and older continue to work, which is a much higher percentage than ten years ago.[15]

In other words, not only is the diagnosis of insufficient savings not well-founded, its consequence is neither indigence nor a draconian reduction in living standards at retirement, but rather a delay of a few years before retiring.

Are mandatory savings and public plans the solution?

Proposals to expand the public plans all depend on the government imposition of mandatory savings programs. However, it is very likely that additional savings invested in a public plan will crowd out private savings.[16] Between 1993 and 2003, while the contribution rates for the CPP practically doubled, savings invested in RRSPs fell. As a result, total savings remained relatively stable as a proportion of income during this period.[17]

Despite these transfers, the two categories of savings do not offer the same services. The advantages of public plans are too often overvalued, whereas private savings have advantages of their own that are too often ignored or undervalued.

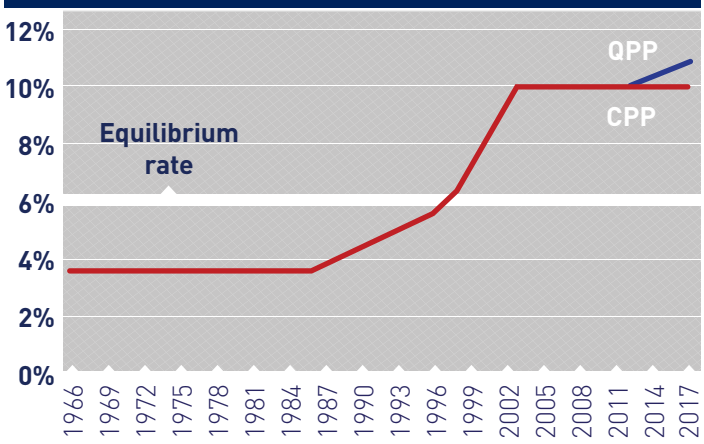
Temporal myopia and intergenerational equity: Many people underestimate the savings required to obtain a given amount in the distant future, which we can call temporal myopia. A public plan should be able to set contribution rates on the basis of actuarial goals so as to correspond exactly to the benefits promised. However, the contribution rates were not set at a high enough level by governments when the CPP and the QPP were launched. This deficit for prior generations had to be made up later with higher contribution rates. Specifically, instead of contributing 9.9% to the CPP, Canadian workers today should only have to contribute 6%[18] (see Figure 2).

The main weakness of the studies carried out to date is that they do not take into account non-financial assets like houses and family businesses.

Pooling of risk and intra-generational equity: Without a doubt, the pooling of risk constitutes the main advantage of mandatory public plans. Since no one knows what his or her future holds, it is possible not to have saved enough if one lives to an advanced age. With the pooling of savings in a public plan, forecasting average longevity becomes possible thanks to the law of large numbers. This therefore reduces a significant risk. However, the different groups that make up society do not all have the same life expectancy. Those with lower incomes are also those whose life expectancies are lower. The pooling of risk can therefore entail *intra*-generational inequities that work against the less well-off, who are required to pay more than they need to for services they will enjoy for a shorter time on average.

Administrative fees and returns: The size of public fund managers leads one to believe that their administrative fees will be low, since the management of a fund that is twice as big does not automatically cost twice as much, and they therefore should earn better net returns. This explanation is not confirmed empirically, however.[19] It should also be noted that in the case of the public plans, the administrative burden of deducting contributions is taken on by employers and the self-employed, for whom it is a major irritant.[20]

Figure 2 — Evolution of contribution rates to the CPP and the QPP (1966-2017)



Note: The equilibrium rate is the rate Canadian workers should have paid since 1966 to correspond exactly to the benefits promised. Before 1997, the contribution rate was too low to attain equilibrium, whereas it has been set above the equilibrium rate since 1997 in order to make up for the accumulated shortfall.

Sources: Canada Revenue Agency, CPP contribution rates, maximum and exemptions; Régie des rentes du Québec, Qu'est-ce que le Régime de rentes du Québec?; Fred Vettese, "Five reasons Canada should go slow on CPP expansion," *Financial Post*, January 26, 2013.

Solvency and performance: The solvency of public fund managers is more or less guaranteed by governments, which is reassuring for contributors. There is a risk, however, that governments will make investment decisions based on political objectives rather than on the maximization of returns, causing investors to lose significant sums of money.

Advantages of private savings: Private savings belong to the saver by rights, which gives him or her more flexibility in their use. He or she can therefore use those savings as a financial cushion to weather unforeseen circumstances and not exclusively for retirement. If they are not used for these purposes, they can also be passed on in the form of an inheritance.

Because private savings are theirs by rights, individuals feel responsible for the returns they earn. They stay more informed about how their assets are doing than they do about the returns to public funds that do not affect them directly.

Finally, private savings are invested according to personalized risk and return preferences. Moreover, investment choices can reflect the values of each individual by favouring certain industries or companies.

The advantages of public plans are too often overvalued, whereas private savings have advantages of their own that are too often ignored or undervalued.

Conclusion

The current balance between mandatory savings and private savings allows us to efficiently reach a clear political objective, namely the reduction of poverty among retirees. All of the reforms being discussed propose a paradigm shift. The goal of the public pension plans would no longer be to ensure a minimum for everyone, but rather to guarantee to all an income sufficient to maintain their living standards, including middle and upper class Canadian households.[21] These proposals all have significant costs since they would lead to a reduction in the disposable incomes of Canadian families during their working lives.

References

1. The 9.9% contribution is divided equally between employer and employee. However, the economic impact of payroll taxes essentially falls on employees, regardless of the formal breakdown prescribed by law.
2. This is the maximum for the year 2014 for retirement at age 65. One can choose to start receiving benefits at age 60 with a penalty of around 30% or to wait till age 70 and enjoy a 42% bonus.
3. QPP contributions are 10.35% for 2014, however, as opposed to 9.9% for the CPP. Higher contributions in Quebec are primarily due to demographic differences.
4. Organisation for Economic Co-operation and Development, *Pensions at a Glance 2013: OECD and G20 Indicators*, 2013, p. 165.
5. Canadian Labour Congress, Retirement Security for Everyone: Get the Job Done; FTQ, Campagne pour sécuriser et augmenter les revenus de retraite de tout le monde : Une retraite à l'abri des soucis.
6. Bill Curry, "Proposed changes to CPP spur momentum for pension reform," *The Globe and Mail*, October 3, 2013.
7. Robert Benzie, "Wynne says new Ontario pension plan 'not a tax'," *The Toronto Star*, January 28, 2014.
8. Alban D'Amours *et al.*, *Innovating for a Sustainable Retirement System — a Social Contract to Strengthen the Financial Security of all Québec Workers* (French only), April 2013.
9. See the Technical Annex on the website of the Montreal Economic Institute. Estimates of the amount that would be deducted under the Sheridan proposal vary between $9.8 and $12.3 billion depending on whether data from the Canada Revenue Agency or from Statistics Canada are used. Even without increasing payroll taxes in order to expand the public plans, total benefits would increase due to demographics. In Quebec, QPP and Old Age Security total benefits will double in the next 20 years. Jean-Yves Duclos, "Les revenus de retraite des Québécois évolueront considérablement d'ici 2030," *Huffington Post Québec*, September 26, 2013.
10. Using a 2011 poll of over 10,000 Canadian households detailing their assets and incomes, the consulting firm of McKinsey & Company produced the most exhaustive data available to date. McKinsey & Company, *Are Canadians Ready For Retirement? Current Situation and Guiding Principles for Improvement*, April 2012.
11. The McKinsey study estimates that "other assets" accounted for 38% of total savings in 2012, while the National Balance Sheet Accounts compiled by Statistics Canada evaluates them at 42% in 2012.
12. Statistics Canada, Table 378-0121, National Balance Sheet Accounts. The data for the amounts invested in RRSPs and TFSAs, which amounted to $825 billion in 2010, are taken from McKinsey, *op. cit.*, note 10, p. 6.
13. W. Mark Brown, Feng Hou, Amélie Lafrance, *Incomes of Retirement-age and Working-age Canadians: Accounting for Home Ownership*, Statistics Canada, July 2010, p. 39.
14. Canadian Institute of Actuaries, *Issues Related to Increasing the Retirement Age*, May 2013, p. 31. Nine of the 16 industrialized countries retained for purposes of comparison have higher average effective retirement ages than Canada, both for men and for women. The average effective retirement age is even lower in certain provinces like Quebec.
15. The employment rate of those aged 65 or over went from 6.5% in 2002 to 12.0% in 2012. Statistics Canada, Table 282-0002, Labour force survey estimates (LFS), by sex and detailed age group (employment rate, both sexes, Canada, 65 years and over).
16. See for example Jack Mintz, *Summary Report on Retirement Income Adequacy Research*, December 18, 2009, p. 23.
17. Charles Lammam, Milagros Palacios and Jason Clemens, *RRSPs and an expanded Canada Pension Plan: A preliminary analysis*, Fraser Institute, June 2013.
18. Fred Vettese, "Five reasons Canada should go slow on CPP expansion," *Financial Post*, January 26, 2013.
19. Vijay Jog, "Investment Performance and Costs of Pension and other Retirement Savings Funds in Canada: Implications on Wealth Accumulation and Retirement," Finance Department of Canada, 2009.
20. Laura Jones, Nina Gormanns and Queenie Wong, *Canada's Red Tape Report with US Comparisons*, Canadian Federation of Independent Business and KPMG, 2013, pp. 4 and 13.
21. See for example Jack Mintz, "Affluent Canadians don't need more government help in providing security for their old age," *Financial Post*, November 26, 2013.

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