Montreal Economic Institute
Ideas for a More Prosperous Nation

ECONOMIC NOTE

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Reforming the Quebec Pension Plan to Give Control Back to Workers

The pension plan crisis caused by the aging of the population is affecting all western countries, with Quebec especially hard hit by this phenomenon. The long-term financing of the Quebec Pension Plan (QPP) is a cause of concern, and experts say changes are needed to ensure its viability. As in the past, a new rise in contributions is being suggested to balance the program's reserve. Other countries have had to reform their public pension systems in recent decades. One of them – Chile – has stood out because of its success and has inspired about 30 other governments. Can Quebec also learn something from their experience?

The situation of the Quebec Pension Plan

The creation of the Quebec Pension Plan (*Régime de rentes du Québec*) goes back to the mid-1960s. The program came into effect on January 1, 1966, and began issuing cheques to retirees in 1967. It is a universal government-run pension plan to which all workers from ages 18 to 70 are required to contribute.

Over the years, the plan's financial position has become increasingly precarious. This added pressure can be explained in particular by longer life expectancy, a low birth rate and lower-than-expected wage growth.

Some of these factors have been used to justify a substantial rise in contribution rates over the years, pushing them up from 3.6% of pensionable earnings between 1966 and 1986 to 9.9% since 2003.[1] These increases have led to growing inequity between workers who contributed from the start and those contributing now at triple the rate. Merely raising this rate from 3.6% to 9.9% represents an increase of more than $2,300 in annual QPP contributions for a worker earning $40,000.[2]

Despite these major increases in contributions, we are still below the break-even rate, in other words, the rate that would enable a stable reserve to be maintained. This rate now stands at 10.95% according to the latest actuarial estimates.[3] These estimates even suggest that the contribution rate will have to reach 12.5% if nothing changes soon.[4] These data are based on the reserve obtaining average annual returns above 7%.[5] If the realities of returns, demographics and the labour market end up being less favourable than is hypothesized, contributions will have to be raised even more.

At the current rate, the QPP reserve will start falling in 2023 and will be completely empty in 2037. The heavy losses registered by the Caisse de dépôt et placement du Québec in 2008, in particular, have brought this crucial date forward to 2037, whereas it had been thought previously that the reserve would run out in 2051.[6]

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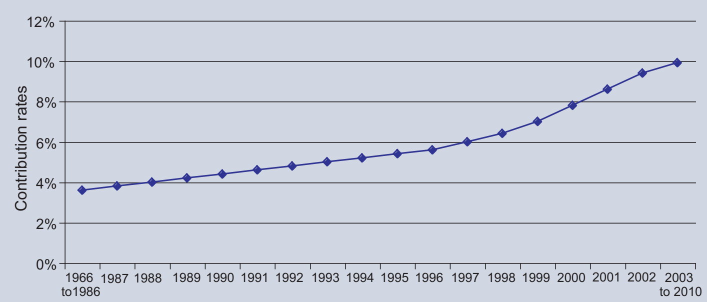
1. Quebec Pension Plan, *Our story in numbers*, http://www.rrq.gouv.qc.ca/en/regie/historique/Pages/histoire_chiffres.aspx.
2. Technically, half the contribution is paid by employers, but in fact companies put this burden on workers by paying them lower wages.
3. Quebec Pension Plan, *Actuarial Report of the Québec Pension Plan as at 31 December 2006 updated to 31 December 2008*, 2009, p. 21.
4. Quebec Pension Plan, *Toward a stronger and fairer Québec Pension Plan*, Working paper, 2008, p. 23.
5. Quebec Pension Plan, *op. cit.*, footnote 3, p. 24.
6. *Id.*, p. 19.

FIGURE 1

Changes in contribution rates from 1966 to 2010



Source: Quebec Pension Plan.

Intergenerational unfairness

Current retirees enjoy substantial advantages in relation to the contributions they have paid. The same is true of baby boomers who are preparing to retire. Younger Quebecers will end up having to fill the gap between the amount paid by current retirees during their working lives and what they are receiving today.

A Quebec worker who was born in 1930 and who retired at age 60 has enjoyed an average return of 14.5% on the money he paid into the plan, largely because he did not start paying when he arrived on the job market. The comparable return is 8.4% for a person born in 1950 and will be just 5.5% or 5.1% for someone born in 1970 or 1990 respectively.[7]

To illustrate the impact of these very different rates of return, we can take the case of a young worker currently earning $47,200 (the maximum amount on which contributions can be paid in 2010) and who would be putting 9.9% of his income aside for his old age. Depending on whether the rate of return is 14.5%, 8.4%, 5.5% or 5.1% (the same rates as those estimated by the QPP for each generation paying into the plan), when he retires 35 years from now, he would be able to count on a pension worth $3,888,080, $1,002,337, $557,961 or $516,784. This fictitious example merely serves to show that, for each dollar invested, some grandparents obtain the equivalent of seven times what their grandchildren will be entitled to. In other words, future generations will be obliged to contribute much more than their elders to enjoy comparable or even lesser benefits.

Whereas in 1986 there were seven workers for each retiree, today there are only three, and the ratio will be just two workers per retiree in 2020.[8] A system like the QPP – under which workers' current contributions are placed in a fund used to pay current benefits to retirees – implies that the number of workers is substantially higher than the number of retirees. Otherwise, workers would have to carry far too heavy a burden to keep the plan afloat. Accordingly, the viability of traditional public pension plans must be re-evaluated in light of demographic change in the developed countries.

Unless major changes are made, intergenerational conflicts could break out between young people opposed to having too great a share of their wages confiscated and retirees who are living in fear of seeing their benefits reduced.

Making things worse, we should point out that Quebecers retire at an earlier age than people in other western countries. In 2006, the average retirement age among the male workforce was 62, compared to 64 in Canada as a whole, 65 in the United States and 64.1 for the G7 countries.[9] Quebecers thus pay in for two years less than the average.

To get around this flaw in the system, the Quebec government is currently studying various scenarios that aim, in one way or another, to raise contributions by current and, especially, future workers, to raise the retirement age, and/or to reduce some benefits.[10] These proposed actions would merely accentuate intergenerational inequity without necessarily ensuring the plan's long-term viability.

Contribution rate increases have led to growing inequity between workers who contributed from the start and those contributing now at triple the rate.

7. Quebec Pension Plan, *op. cit.*, footnote 4, p. 23.
8. *Id.*
9. *Id.*, p. 26. More recent data for both sexes are available for Quebec: the average retirement age was 60.2 in 2008. See: Institut de la statistique du Québec, *Annuaire québécois des statistiques du travail*, Vol. 5, No. 2 (December 2009), p. 210.
10. *Id.*, pp. 53-54.

Table 1
QPP rates of return based on year of birth

Year of birth	Rate of return	Pension value at retirement *
1930	14.5%	$3,888,080
1950	8.4%	$1,002,337
1970	5.5%	$557,961
1990	5.1%	$516,784

* Assuming that the maximum contribution in 2010 is invested each year during 35 years at the rate indicated. This amount is used only to illustrate the impact of different rates of return on each dollar invested. See the appendix on the MEI's website for more details on these hypotheses.

Ideas on reform to give control back to workers

The shortcomings in the Quebec public pension plan model result first of all from a separation in the relationship between effort and reward. Quebec workers do not see the link between contributions and benefits. In a certain respect, citizens are passive beneficiaries of a public system rather than players who are responsible for their own future. Political reality results in governments of whatever party tending to favour short-term benefits as a way of winning support from current voters without showing much concern over future indebtedness.

Chile faced similar problems three decades ago. The country undertook a major shift, reforming its public pension system from top to bottom. The Chilean reform relies on the virtues of individual responsibility.

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On May 1, 1981, José Piñera,[11] the minister of labour at the time, replaced the public pension plan with a system of individual capitalization and retirement savings accounts, with each worker having an account managed by the private sector.[12]

This is how the new system worked: the employer pays 10% of the employee's wages each month into the employee's retirement savings account. The worker may also choose to pay an additional amount of up to 10% of his wages (deductible from income tax) into his account. These savings enable workers who so desire to retire earlier or to benefit from a higher pension. Returns on retirement saving accounts are not taxable, but withdrawals are taxed based on the tax rate applicable to a person's annual income (as with an RRSP). A typical Chilean worker can obtain a pension equal to 70% of wages at the time of retirement thanks to his retirement savings account.[13]

When this new plan came into effect, Chileans could be in one of the three following situations:

1) All Chileans who are already retired maintained their vested rights, and the government guaranteed their benefits under the public plan.

2) Workers still in the labour force had the choice of whether or not to join the new system. Those who opted for the new system got a "recognition voucher" representing the value of their past contributions (indexed at a rate of 4%[14]) deposited into their retirement savings account.

3) Finally, those newly arrived on the job market had to contributed directly and solely to their retirement savings account.

This amounted, in effect, to a gradual transition toward a system of retirement pensions that transferred power from the government to the worker, moving from a public monopoly to individual private accounts.

Private pension fund administration firms (*Administradoras de Fondos de Pensiones* or AFPs) are authorized to manage these retirement savings accounts within the framework of strict rules set by the government. Workers select their funds and administrators freely among those that have been approved, based on their risk tolerance, age, financial security, family, etc. Each person can express his preferences and provide himself with a plan made to measure for his personal situation.

11. José Piñera has a Ph.D. in economics from Harvard University and is the architect of pension reform in Chile. He was a candidate in the 1993 presidential election and is president and founder of the International Center for Pension Reform. His brother Sebastián was recently elected president of Chile.
12. See: José Piñera, *Prendre le taureau par les cornes : comment résoudre la crise des retraites*, Institut Charles Coquelin, 2008.
13. It should be noted that the Chilean plan aims to replace a much larger portion of income than the QPP; the contribution rates thus cannot be compared directly.
14. José Piñera, *op. cit.*, footnote 12, p. 83. This indexing rate is lower than the public plan's actual returns. The government was thus able to finance a portion of the transition by pocketing the difference. This did not prevent workers from opting in massive numbers for the new plan, showing their willingness to take control of their retirement savings.

In the very first month that the new plan came into effect, 25% of eligible workers decided to join. After a year, more than 80% of workers who had the choice opted for a retirement savings account. Today, 95% of workers are covered by the new system. In the first 26 years after it came into effect, the average annual return for savers, with inflation taken into account, reached 10.3%.

One of the greatest benefits of the Chilean reform was to give workers true and tangible ownership of their retirement savings.

Following this success, the Chilean model was later imitated by about 30 countries al over the world. Most of these are in Latin America or Eastern Europe, but a number of western countries are also starting to show interest in these pension plan reforms and are introducing some elements of the Chilean model – the United Kingdom, Australia and Sweden, in particular.

The example of Sweden is drawing attention since it was the first country in the world to institute a universal public pension plan. With the system headed for a financial abyss, a major reform was undertaken in the 1990s, partially privatizing the plan. Since January 1, 2001, all Swedish employees may invest 2.5% of their wages (out of a total compulsory contribution of 18.5%) in personal accounts.[15]

This system provides for greater labour mobility, not only by making workers independent of company pension plans but also by giving them the chance to work anywhere in the world while maintaining their retirement savings accounts. Workers can also choose their retirement age and take early retirement if they have accumulated sufficient savings.

It is important to note that the available savings supplement has contributed substantially to Chile's economic activity and has largely offset the transition costs.[16]

Finally, one of the greatest benefits of the Chilean reform was to give workers true and tangible ownership of their retirement savings, enabling them to play a direct role in their country's economic life and instilling an interest in stock markets and interest rates – in short, becoming more attached to economic growth and to a free society.

Conclusion

By trying to plug the holes in the QPP, the government is merely postponing the inevitable and accentuating the unfairness toward young workers. Worse yet, there is even talk of creating a new centrally managed retirement savings program.[17]

The best way to guarantee the future retirement savings of young Quebecers today, while guaranteeing benefits for current retirees[18] as Chile has done – would be to give workers who are still in the labour force the freedom to choose to invest for their old age in their own retirement savings account rather than to make it an obligation for them to rely on the Caisse de dépôt et placement du Québec.

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15. Goran Normann and Daniel Mitchell, *Pension Reform in Sweden: Lessons for American Policymakers*, Heritage Foundation, 2000. The contribution rate of 18.5% may appear high, but it should be remembered that, in Canada, the federal government also provides funds to retirees (Old Age Security and Guaranteed Income Supplement). These programs are financed by taxation.
16. José Piñera, *op. cit.*, footnote 12, p. 85.
17. Michel Hébert, "Québec prépare un REER public," *Le Journal de Québec*, November 5, 2009, http://lejournaldequebec.canoe.ca/journaldequebec/politique/provinciale/archives/2009/11/20091104-200639.html.
18. Political choices will have to be made to finance these pledges, but these commitments already exist and do not depend on the suggested reform.