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SUBMISSION
to the Federal-Provincial Relations and Social Policy Branch, (Federal) Department of Finance on the following subject:

ENSURING THE ONGOING STRENGTH OF CANADA'S RETIREMENT INCOME SYSTEM

This brief from the Pension Committee of CURAC/ARUCC is directed to the Consultation on the above subject. As the only national federation of post-secondary retiree organizations, CURAC/ARUCC speaks for the interests of some twenty thousand retired faculty and staff in associations from fifty campuses of our major academic institutions in every Canadian province.

The **CURAC Pension Committee** is comprised of retired Professors Paul Huber, Chair, (Dalhousie) and Howard Fink (Concordia).

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May 14, 2010

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1. Prefatory Comments

Fifteen years ago, the World Bank [James *et al*. 1994] started its report on *Averting the Old Age Crisis* with the observations that

> "As we grow old we work, produce and earn less, and therefore need a secure source of income to see us through life." . . .
>
> "As the world's population ages, old age security systems are in trouble worldwide. Informal community- and family-based arrangements are weakening. And formal programs are beset with escalating costs that require high tax rates . . . while failing to protect the old." [James *et al*., p. 1]

Statements echoing these sentiments over the last decade in Canada abound. It is true, of course, that governments in Canada [as noted in Department of Finance, "Ensuring the Ongoing Strength . . .," 2010, pp.1-2] have recently introduced some desirable changes regarding the regulation of private pension plans and created a new, voluntary savings vehicle – the TFSA. But these changes affect only the "third pillar" of the retirement income system. It also is true that the number of seniors in Canada that live below Statistics Canada's "low-income cut-offs" is modest. But income replacement levels among those with middle incomes appear to be quite low, as both registered and unregistered savings are concentrated toward the upper end of the income spectrum. See CARP [2009, p. 2] for details.

Inadequate pension coverage is the overriding issue in Canada, in our view. Large numbers of seniors enjoy little pension income except via OAS/GIS and CPP/QPP. Not only is a decreasing minority of employees enrolled in an RPP of any type, but the amounts set aside in RRSPs and similar registered savings vehicles is far less than what will be needed to provide adequate income replacement as people live longer after age sixty-five. To fill the coverage gap, what is needed is modernization and improvement of the CPP in conjunction with similar changes in the QPP.

In addition [as shown in Huber, 2009], extraordinarily high marginal tax rates afflict low-income Canadian seniors as a result of lack of proper integration of provisions of the Income Tax Act with OAS/GIS/SA. Indeed marginal tax rates for those at or just below the "poverty line" (i.e., the low-income cut-offs) are well in excess of 70%. At the highest income levels, on the other hand, the highest marginal tax rate – including provincial surtaxes – that applies to seniors and non-seniors alike is only about 48%. This major disincentive to saving for retirement by those with modest incomes needs also to be addressed, as do discriminatory features of this first "Pillar" of Canada's retirement income system [See Townson, 2009 and Huber, 2009.] Given four very recent governmental reviews of pension regulations and the substantial ferment that currently prevails regarding pension issues, this is a uniquely favourable time to introduce improvements and alter dysfunctional arrangements.

We are fully aware that pension funding takes place in a political, social and economic environment. It depends crucially on the following factors:

* the magnitude of pension promises that have already been earned and which may be in the process of payment,
* the on-going success in investing accumulated past pension contributions,
* the levels of contributions of current employees, employers and governments (i.e., taxpayers),
* the extent of new, and as yet unearned, promises.

In our view, a reasonably fair distribution of pension burdens between generations is important to avoid weakening inter-generational solidarity. We do not claim to know what the optimal trade-off is between inter-generational solidarity and burdening the current generation to pay current pensions that are underfunded. But clearly there is a trade-off, just as there would be if current pensions were squeezed in order to provide much superior retirement benefits to the following generations.

The changes we propose should be funded fully by employees and employers jointly. No employer will be put at a competitive disadvantage, since all will pay equally in proportion to their payrolls. Should unexpected contingencies subsequently arise that result in relatively minor funding shortfalls, these shortfalls would be met by relatively minor reductions in new promises being earned and relatively minor contribution increases, i.e., modification of the last two elements listed in the paragraph above, only. When shortfalls were replaced by surpluses, these changes could be reversed.

Most members of CURAC will not benefit from any changes to the existing retirement income system; we are too old. Moreover, most of us enjoy decent pensions from our respective colleges and universities. But younger Canadians (including former colleagues) will be less fortunate. First, hybrid and defined-benefit pensions are gradually being replaced by defined-contribution arrangements, which inevitably will transfer investment and longevity risk from employer to employee; second, employment is increasingly on a free-lance 'contract' basis which denies access to institutional pension plan membership; and third, younger Canadians will likely survive longer than us, and hence face an increased risk of outliving their DC pensions. **It is on behalf of all younger Canadians that we make this submission.**

This brief is organized as follows.

- Section § 2 discusses the principles that should govern efforts to reform our retirement income system and takes issue with some "considerations" presented in section IV of "Ensuring the Ongoing Strength . . ." [2010];
- Section § 3 takes up in sequence the questions for consultations set forth in section VI of "Ensuring the Ongoing Strength . . ." [2010];
- Section § 4 presents our detailed proposals for changes to the CPP;
- Section § 5 discusses problems with the OAS/GIS/SA arrangements; and
- The final section is a list of references.

2. Principles for Evaluating Retirement Income System Issues

We agree that retirement income issues are long-term in nature. But we have difficulties with the rest of section IV of the Department of Finance's paper. The rather vague "principles" set forth there have not governed OAS/GIS/SA and CPP/QPP in the past and prevail only partially at the present time. Both these public pension "pillars" continue to involve inter-generational transfers, both (inevitably) create disincentives to private savings. In our view, genuine principles are needed, not rhetoric that justifies every new CFO in business and every new Minister of Finance introducing changes because existing arrangements purportedly are "unaffordable," "inappropriate," "unbalanced" or "unsustainable."

The following ideas outline a genuinely principled approach to structuring the retirement income system.

2.1 Retirement income arrangements should primarily be structured to serve the interests of future and current Canadian retirees.

2.2 Retirement income arrangements should aim at permitting each retiree to enjoy sufficient income to approximate his or her previous standard of living.

2.3 Ideally, retirement income arrangements should be distributionally neutral in terms of lifetime incomes. Note that James, *et al*. [1994] argue that pay-as-you-go [PAYG] pension arrangements systematically transfer dollars away from the lifetime poor to the lifetime affluent, whose life-expectancy at retirement age is clearly longer. Similar effects occur in some defined benefit [DB] pension plans.

2.4 Promises made to seniors should be kept, recognizing that other priorities (e.g., war, economic Armageddon) may temporarily make this very difficult, and accepting that long-term demographic change may gradually alter the economic environment negatively. The Nova Scotia Pension Review Panel got this point right [Black *et al*., 2009].

2.5 Retirement income arrangements should be stable and substantially adjusted for inflation, so that individuals and families can plan their futures.

2.6 Public arrangements, including income tax provisions, should be structured to minimize disincentives to saving privately, particularly by low-income earners.

2.7 Retirement income arrangements should not unnecessarily expose Canadians to longevity and investment risks that they are ill-prepared to address.

2.8 Finally, the system should treat Canadians even-handedly. Persons in similar circumstances should receive similar treatment.

3. Questions for Consultations

3.1. *What are the main issues/challenges that Canadians face in saving for retirement?*

3.1.1 Three-quarters of Canadian workers in the private sector have no pension plan, so pension coverage is an extremely serious issue. This relative absence of RPP membership is exacerbated by the general lack of portability of DB pension entitlements among pension plans, which results in large reductions of entitlements for those who switch employers.

3.1.2 Many Canadians live from payday to payday, often purchasing products and services on credit. Two-thirds or more run unpaid balances from month to month. They have little discretionary income to set aside for retirement.

3.1.3 Many Canadians are unsophisticated financially and lack skill and experience with investments. Where medium-sized DB pension plans can project returns of 6.25% annualized after fees (of about 0.5% per year), individual investors buying mutual funds pay 2.5% annually or more in fees on average, lowering net returns to 4.0% annualized before inflation for those whose investment behaviour is consistently focused on the long-term. Low returns and common investment errors make saving for retirement unattractive.

3.1.4 As noted above, the extraordinarily high effective marginal tax rates in the net income range between $15,000 and $30,000 which result from the claw-back of GIS/SA are a major disincentive to saving. Why should someone at modest income levels make a determined effort to save, if most of the resultant RRIF or annuity income will be taxed away?

3.2. *What is the appropriate role of governments in supporting Canadians to achieve adequate retirement income?*

Social solidarity is an important value that Canadians believe in. Governments are not agents independent of the desires and values of citizens; we Canadians elect them and expect them to act for our general benefit. "Tax expenditures" related to registered retirement income arrangements, on OAS/GIS/SA, and in support of potential shortfalls in CPP/QPP funding must be viewed in the context of government spending on a wide variety of programmes that benefit Canadians. In a strictly fiscal sense, governments currently may be playing an appropriate role in relation to pension issues. However, taxation and regulatory policies appear dysfunctional in some respects.

3.3 *Does the retirement income system currently have the appropriate mix of public and private support?*

No. The CPP component (pillar #2) is too limited; income tax interactions with some aspects of the OAS component create strong disincentives to saving for retirement; and it is not clear that the current level of tax expenditures in relation to advantaged private savings by the affluent is justified.

3.4. *Are changes needed to further strengthen Canada's retirement income system?*

Yes. We outline our proposals below.

3.5. *Should there be more mandatory retirement savings.*
Yes. Our proposals below outline an expansion of CPP/QPP in two dimensions, and a modification in two other respects. We recognize that an increase in mandatory public savings in Canada through these changes may somewhat reduce voluntary private savings, yet by a somewhat smaller amount. However, capital markets need fear no shortage of savings for commercial ventures. Today, both the CPPIB and the Québec Caisse invest a substantial portion of their assets in the private sector. Thus the investment deployment of these public pension assets has dramatically changed over the past forty years.

3.6. *Should individuals be auto-enrolled in any new voluntary savings program?*
A new voluntary savings program cannot possibly provide a just and effective solution to strengthen Canada's retirement income system. Not only would it unnecessarily expose Canadians to investment and longevity risks, but it would fail to provide pension coverage to those who need it most. Instead, such a program would primarily benefit those who are already enrolled in defined-contribution RPPs, while inducing some private-sector pension sponsors to eliminate defined-benefit RPPs B to the detriment of their employees. The establishment of such programs should be approached with the greatest caution.

3.7. *Should increased savings, whether mandatory or voluntary, be locked-in for retirement purposes only?*
The purpose of retirement savings is to protect society generally (i.e., taxpayers) from being forced to support the indigent elderly through welfare arrangements. Hence, mandatory retirement savings should in principle be locked in, but existing regulations to permit some unlocking strike a reasonable balance in providing flexibility for unusual situations. Canadians may voluntarily save for a wide variety of reasons, including retirement; hence no case for locking-in voluntary savings is apparent.

3.8. *Should there be more flexibility and choice with respect to private savings options.*
The new, as yet underdeveloped TFSA is extraordinarily flexible. We know of no argument that the existing, relatively minor, constraints on investments for RPPs, RRSPs or TFSAs unduly limit flexibility or choice.

3.9. *How would the approaches described in this paper impact you personally and/or your business?*
CURAC is neither an individual nor a business; it is a national federation of retiree groups, whose members would be largely unaffected by most of the approaches. However, mooted attempts to reduce vested benefits of retirees frighten us gravely.

3.10. *How should any changes to the retirement income system be financed?*
If new entitlements are introduced for individuals, they should be funded (in actuarial terms) in advance by those Canadians (and their employers) who will benefit.

4. Avenues to Explore to Modernize and Improve the CPP

4.1. Several desirable modifications to the CPP should be given serious consideration. We consider some detailed but relatively modest changes first:

4.1.1 Both CPP and QPP propose to remove the "Work Cessation Test," which under the CPP prevented an early retirement pension unless work ceased, and under the QPP restricted early payments somewhat less. The proposal would be implemented in 2011 in Québec and a year later in the rest of Canada (ROC). This was one way that phased retirement was hindered up to now, to the detriment of society, employers and employees. This is good change.

4.1.2. Both CPP and QPP currently "drop out" 15% of the lowest-earning years from the "contributory period" (which starts at age 18 and ends at retirement). In 2011, Québec proposes to start phasing in a fixed contributory period of 40 years for this calculation, which would reduce early retirement pensions by about five percent. The ROC proposes in contrast "to increase the general drop-out to 16 percent in 2012. . . . [and] to 17 percent in 2014" [Finance, 2009, p. 3]. This change would generally improve most CPP pensions, but favour most those whose labour force participation is shorter or more variable. No argument supports this proposal, except that money is available. As a thought experiment: suppose the general drop-out were increased to all but one year of service; would that make sense? Some CPP contributors would really have earned their pensions, others would have been lucky in a single year and contributed little or nothing for most of their careers. Moral hazard might become significant.

4.1.3. Change the adjustment factors for early and late retirement to reflect actuarial fairness better. In both the CPP and QPP, the proposal is to increase the penalty factor for early retirement and raise the reward for late retirement from 0.6% per month to 0.7% per month. Both changes would be phased in over several years for the CPP and possibly differently for the QPP. These changes are appropriate in the current low-interest rate environment, but may need to be reversed when interest rates return to more normal levels.

4.2 Major changes have also been proposed for the CPP/QPP, not just tinkering. Many have urged both a rise in YMPE to a multiple of the Canadian Average Industrial Wage and an increase in the maximum 25% replacement ratio. In addition, Huber and Fink [2009] proposed that the normal retirement age be increased in small increments to age 67 from age 65 and that consideration be given to making indexation of benefits partly contingent on investment returns. Each of these proposals involves a different rationale and a different scheme of implementation. We discuss these next:

* increase the CPP insured level of earnings and the corresponding contributions and benefits above the average industrial wage in Canada;
* raise the extent of income replacement in increments from 25% to perhaps twice that level. This obviously would also necessitate higher contribution levels for current employees to pay for the increased future benefit;
* increase the normal retirement age gradually from age 65; and
* consider making indexation of existing and future pensions partially contingent on investment returns of the CPP fund.

4.3 The first three of these changes should obviously be coordinated with changes in the QPP, just as changes in that Plan should be coordinated with Canada. Probably the fourth change should be coordinated as well.

4.4 Except as modified by the fourth change, the benefit formulae of both plans would remain unchanged. As a consequence, calculated contributions and benefits would rise immediately, but fully phase in over a period of about 35 to 40 years as the additional contributions altered the inputs to the benefit formulae.

4.5 To consider the logic underlying each of these four modifications to the CPP, one must understand that inadequate pension coverage is the overriding issue. Setting a new maximum pensionable earnings level at, say, 1.5 times the Canadian average industrial wage would help reduce the coverage gap for those with slightly greater than average employment incomes. But even more coverage would follow from increasing the CPP replacement rate above 25%; this would ultimately increase CPP benefits for all formerly employed retirees, and thus improve the income replacement in retirement.

Since the vast majority of defined benefit plans across the country are integrated with CPP or with QPP, sponsors of these plans would experience no cost increase from these extensions of CPP. Instead, a welcome reduction of investment and longevity risk would be experienced by most DB plan sponsors.

4.6 Increases in the normal CPP retirement age by – say – one month a year starting 2012 would lead to a gradual increase in actuarial reduction factors for retirements at ages below 65 and a phased drop in actuarial augmentation factors for retirements at older ages. This would gradually improve the funding situation of the CPP by reducing the benefits flowing to those retiring at each age slightly and encouraging continued attachment to the labour force. A number of countries have already started this process and are gradually raising the normal retirement age toward age 67 (or more) because public pensions have to deal with the demographic pressure arising from reduced mortality. Life expectancy at age 65 increased by about 1.2 months per year over the past forty years in Canada and is projected by the Chief Actuary to rise by only 1.0 month a year up to 2025 and 0.5 months per year thereafter [Menard I, 2007, p. 62]. Given the likely error in any long-term demographic projection, Canada needs to be prepared for a larger than projected rise in the share of seniors in the population.

4.7 A scheme of pension indexation that is partially contingent on investment returns of the pension reserve fund exists in some private-sector pension arrangements. Properly structured, it can permit partial or total catch-up of "missing" CPI indexation when investment returns recover. A major advantage of this sort of arrangement is that it helps maintain intergenerational solidarity. We suggest that the government give consideration to this option for the CPP.

5. Eliminating Dysfunctions with Old Age Security, the Guaranteed Income Supplement and the Spouse's Allowance

5.1 Changes to income tax legislation are needed to integrate its provisions better with the OAS/GIS/SA arrangements and reduce excessive implicit and explicit marginal tax rates. For example (using 2009 tax rates), the clawback of the GIS benefit for an individual could end at $32,300, just where the Federal implicit age tax begins, rather than at the much lower level of $21,860; this would reduce the implicit marginal tax rate of the GIS to about 30% from 50%. As another example, the clawback of OAS could start at a much lower income level – say, at the same level as the implicit taxation of the age deduction = $32,300 – and extend over twice the net income range as at present, thus lowering the marginal rate of OAS taxation by half. At the same time, the implicit marginal tax rate on age could be reduced by one percent, by extending upwards its phase-out level. Such measures would not eliminate the variations and regressive features of the existing system of marginal tax rates, but they would substantially meliorate them.

5.2 The Spouse's Allowance is restricted to married spouses of GIS recipients between the ages of 60 and 65; it is unavailable to a spouse who is married to someone who is the exact same age, and it is unavailable to former spouses who reach age 60 without their once older partner as a result of divorce (say, at age 59). And, obviously, single individuals who reach age 60 are ineligible. If one thinks of lifetime SA eligibility, a couple with an age difference of five years or more may get the maximum amount, but, should the age difference be less, eligibility drops in proportion. Some Canadians benefit, while others with the identical incomes and ages do not. Extreme implicit marginal tax rates suggest that the SA program may induce younger spouses to leave the labour force at age 60 and stay out for several years – until their job skills have atrophied. When a labour shortage in Canada is gradually developing, even a non-discriminatory program with these features should be re-examined. Is it not possible to create a fairer SA, and one with less disincentive effects?

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