FAIR PENSIONS FOR FUTURE GENERATIONS

Tripled Tax Rates & Prospects for Reform
A Taxpayer's Guide to the Canada Pension Plan

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Executive Summary – Findings

One: Canadian Pension Plan (CPP) taxes are higher than ever before. The 1997-2003 CPP tax increases cost taxpayers an extra $41.2-billion.

At the start of the Canada Pension Plan in 1966, tax rates were set at 3.6 per cent of contributory earnings, split between employee and employer (1.8 per cent each). CPP taxes first began to rise from that rate in 1986. In the case of the 1997-2003 reforms alone, CPP taxes have almost doubled. The cumulative tax increase over that period (compared to a 1996 CPP tax rate) amounted to a $41.2 billion tax increase between 1997 and 2003.

Two: Despite reductions in Employment Insurance (EI) taxes, overall payroll taxes are up significantly.

While CPP taxes increased and EI taxes were reduced over the past decade, CPP rates rose much faster. The result is that employees earning $41,000 paid $817 more in payroll taxes in 2003 than they did in 1992, while their employers paid an extra $701. In total, annual payroll taxes have increased by $1,518.

Three: Overall taxes are also up significantly since the introduction of the CPP in 1966.

In 1966, total government revenues (taxes, premiums, user fees, and revenues to Crown Corporations to all governments) constituted 31.7 per cent of the economy compared to 41.9 per cent in 2002[a]. Canadians face a much higher overall tax burden today than they did in the mid-1960s when the CPP was created.

Four: The federal government has concentrated little on expenditure reforms within the CPP but has instead consistently raised taxes since the plan's inception. CPP taxes have almost tripled since 1966 but the official retirement age has remained the same despite extended life spans.

The post-1997 reforms mostly ignored the expenditure side of the CPP and instead concentrated on ever-higher CPP taxes. While the definition of disability claims was narrowed back (excluding socio-economic reasons as a basis for a claim, for example) little else was done to control costs.

Life expectancy has now advanced by about four years since the CPP was introduced in the 1960s. However, there has been no increase in the age at which full CPP benefits may be collected. Canada's official retirement age – 65 years – is the same as it was almost four decades ago at the plan's inception. As Prime Minister Paul Martin has noted, mandatory retirement at age 65 makes little sense at a time when people are living much longer than ever before.[1]

[a] The latest year for which this comprehensive statistic is available.

Five: The rate of return in market investments is historically higher compared to the CPP's loans to the provinces.

Between 1911 and 1999, the mean annual rate of real return on stocks in the United States was 6.9 per cent.[2] In Canada, the Canadian Institute of Actuaries noted the average annual real yield in private pension funds over a recent 25-year period was 5 per cent.[3]

In comparison, the CPP Investment Board currently forecasts an annual real return on new investments of between 4.25 per cent and 4.59 per cent over the next 75 years. However, that forecast rate of return for the CPP Investment Board is based on investments in both equities and bonds and is a more balanced risk than investing solely in stocks. Importantly, the forecast rate of return for the CPP Investment Board is higher than the real rate of investment earnings on money primarily lent to the provinces, assumed at a return of 2.5 per cent per year.[4]

The superior performance of market returns in the past and forecast returns for the future (based on conservative assumptions) is a significant reason why the CPP should not return to a CPP investment policy of lending money mostly to the provinces.

Six: Public pension payments in OECD countries will increasingly take up a larger share of tax revenues and the economy, and Canada is no exception. This is occurring as the ratio of working taxpayers to non-working pensioners will fall in half from four-to-one today to two-to-one by 2030.

While non-working pensioners still pay some taxes – income, property, some capital gains and sales – payroll taxes are not paid in large numbers given the relatively few post-65 workers. The consequence is that the tax burden will increasingly fall on a smaller ratio of workers in the future unless changes occur both to the incidence rate of earlier retirement and also the expenditure side of some public programmes.

Seven: The current structure of the CPP is unfair to younger contributors. The more mature the CPP recipient, the less likely they are to have paid into the CPP at a rate necessary to fund their own pension. The CPP pensions of the very first retirees cost them relatively little relative to their contributions.

For those born in 1930, the real rate of return on CPP contributions is almost five times that which will accrue to those born in 1990 or 2000. Canadians born in 1950 garner real rates of return double that of later generations.

Eight: Retirement income of $24,000 equals $63,400 in working income. In addition, Canadians face a higher tax and debt burden than they did in 1966 when the CPP was created.

There are particular costs of living associated with each stage of life and they are not equal. For example, someone in their early twenties is faced with the cost of higher education; a couple in their mid-forties may have financial demands such as mortgage payments and raising children. Meanwhile, seniors have passed through such stages and are more likely to possess a mortgage-free home and have no children residing with them. Their main costs are therefore retirement needs and retirement desires.

Statistics Canada makes this observation: According to some actuaries, a mortgage-free retired couple living solely on CPP, OAS, GIS, and tax credits would have a 'consumable income' of $24,000 – the equivalent of a middle-income family earning $63,400 after factoring in tax, retirement savings, and mortgage payments.

In addition, in 1966, the year the CPP began, total debt as a percentage of the economy amounted to 19.4 per cent while in 2002 total net government debt amounted to 40.4 per cent of the economy. Health care expenditures are forecast to rise given an ageing population. Meanwhile, the financial status of seniors has improved significantly in comparison to other age cohorts.

Nine: Other countries are raising or plan to raise their official retirement age.

Countries that are moving to Canada's official retirement age of 65 years include Japan, Italy, Britain, and New Zealand. Countries that are moving to a retirement age *beyond* 65 years are Norway, Iceland, Germany, and the United States. Countries where the average effective retirement age is above the official retirement age are Japan and South Korea.

Ten: Other countries have made private retirement savings plans accounts mandatory as part of their retirement security programs. They use innovative combinations of government and private pensions to hep citizens provide for retirement and to avoid demographic shifts that can place an undue burden on a future generation.

Twenty countries have made private retirement savings plans accounts mandatory as part of their retirement security programs. All of them have a variety of approaches in their mandatory retirement pensions but in essence, they constitute a public-private partnership approach to retirement income, not "privatization" as is sometimes erroneously assumed. They include Argentina, Australia, Bolivia, Chile, Colombia, Denmark, El Salvador, Hong Kong, Peru, Hungary, Kazakhstan, Mexico, Poland, Sweden, Switzerland, Netherlands, United Kingdom, and Uruguay.[5]

Executive Summary – Eight Proposals

Proposal # 1: ***There should be no change to CPP benefits or in the retirement age for those already in retirement.***

The reforms of the CPP proposed in this paper do not affect those already in retirement, including veterans. Instead, this paper focuses on reforms that would affect post-World War Two baby-boom pensioners and future "Generation X" pensioners, and how to ensure more equitable fairness and sustainability for their contributions.

Proposal # 2: ***Cost saving measures enacted in the CPP should be re-directed to current contributors in the plan. That money – and any investment returns in the CPP Investment Board fund higher than forecast – should be transferred to individual CPP accounts in the form of guaranteed portions of the assets of the CPP Investment Board***.

This will help younger Canadians and offset part of the actuarial unfairness built up in the CPP over the decades.

Proposal # 3: ***In time, allow the individual CPP portions to be transferred to private sector RRSP-style accounts that cannot be withdrawn until retirement.***

Mandate that unlike RRSPs, such amounts could not be withdrawn until the official retirement age. In essence, such accounts would be Mandatory Retirement Savings Plans (MRSPs).

Proposal # 4: ***The retirement age should be raised from 65 to 69 over a period of 16 years in three-month increments annually beginning in 2005 and finishing in 2020***.

Proposal #5: ***The early retirement age should be raised to age 64 but done in tandem with the gradual rise in the main retirement age, i.e., over 16 years. The CPP should be made actuarially neutral at the age of retirement, as per recommendations from the Office of the Chief Actuary.***

Proposal #6: ***In the case of CPP funds transferred to mandatory individual accounts, a balance should be struck between risk-taking and prudence, in favour of the latter***.

Proposal #7: ***The federal government should significantly lower Employment Insurance (EI) taxes to offset the steep rise in CPP premiums over the past sixteen years.***

Proposal #8: ***Taxpayer-financed benefits should be targeted to those in need regardless of age.***

Introduction to the CPP

Unless both the benefit and the contribution structure become more targeted, as in the recommended design of the public pillar, old age systems will contribute to the growing polarization of income among workers and will fail to avoid poverty among the old.
- James Estelle, Canada's Old Age Crisis in International Perspective

The Canada Pension Plan

The Canada Pension Plan began in 1966 following negotiations between the federal government and the provinces. The program is managed by Ottawa and operates in all provinces, except for Quebec where a separate, but similar, plan is in place with respect to both rates and benefits.

The CPP is a "contributory, earnings related social insurance program" according to the Department of Finance. This is a different, and a more accurate, description of the CPP than how it is often, and mistakenly, referred to as a pension plan. *Indeed, it is important to understand that the CPP is less a pension plan and more a social welfare program*. While earnings affect CPP pension payments, the financial return on one's contributions is still determined more by one's birth year and in a manner unlike contributions to a Registered Retirement Savings Plan (RRSP) or company pension plans (at least those with defined benefits).

Rising CPP taxes: An extra $41-billion since 1997

The Canada Pension Plan is a government program of retirement income support, created when the demographic make-up of the country allowed for low rates and high benefits (relative to contributions). At the beginning of the Canada Pension Plan, tax rates were set at 3.6 per cent of contributory earnings, split between employee and employer (1.8 per cent each). Over the past sixteen years rates have almost tripled, to 9.9 per cent, with employees paying 4.95 per cent and employers paying the other 4.95 per cent.

In the last eight years, CPP taxes have doubled with a tax increase that, cumulatively, amounted to $41.2-billion between 1997 and 2003 when compared with pre-reform rates that existed in 1996. Corresponding reductions in Employment Insurance (EI) have not cancelled out the effect of the CPP increase and the result is overall payroll taxes (CPP and EI together) rose dramatically over the past decade – often on the people who least can afford to pay the increased burden: lower- and middle-income earners.

1997 changes: Higher taxes, but little in the way of cost-saving reforms

The 1997 round of reforms moved the Canada Pension Plan from a pay-as-you-go (PAYG) system to a partially advance-funded system with an increasing reliance on investment portfolio returns to fund future pensions.

In essence, the 1997-2003 increase in contribution rates meant that those approaching retirement have, since 1997, paid more into the CPP than otherwise would be the case under a strict pay-as-you-go (PAYG) scenario. For example, under a PAYG system, combined employer/employee rates in 2003 would have been 8.36 per cent as opposed to

the legislated and partially funded and existing rate of 9.9 per cent.[b] However, under a PAYG system, rates would have risen to 14.2 per cent by 2030,[6] whereas under current forecasts, rates are to be maintained at 9.9 per cent.

The rationale of the rate increase was simple. Those approaching retirement should pay more into the plan. This made sense from a demographic perspective; after all, under the pre-1997 scenario, young Canadians would have continued to pay an ever-increasing share of the pensions of those in retirement and those soon to retire.

However, the almost doubling of CPP premiums between 1997 and 2003 is a tax that every worker and employer pays equally. There is no special levy on those closest to retirement in proportion to the amount *not* paid by that age cohort or other age cohorts in the past. It remains the case that the younger one is, the more one will pay into the CPP and the less that contributor will receive back relative to older cohorts. Thus, while the 1997-2003 rate increase (and previous increases) decreased part of the imbalance between generations, *it did not fully compensate for the earlier too-low tax rates paid by the first contributors to the CPP*, contributors who then became the plan's earliest recipients.

In the case of pre-1997 plan, the youngest taxpayers would in fact have received less back from the CPP than they contributed – a negative return.[7] However, even after the 1997 reforms, the older one is, the better one will do in terms of a rate of return. For example, those born in 1930 will (for their contributions to the CPP) receive a real rate of return of 9.4 per cent. Those born in 1940 will receive a real rate of return of 6.1 per cent. However, those born in 1970 will see only a 2.3 per cent return on their CPP contributions. Those born in 1990 or 2000 will see even less, a paltry return of 2.0 per cent on contributions.

Defenders of the CPP's current arrangements have argued that at the very least all age cohorts will now receive a net benefit for their contributions compared to pre-1997 projections. However, the CPP still functions as the proverbial "Ponzi" scheme in that it is the first contributors who receive a much larger share of the benefits while those who follow receive a smaller share.[c]

Thus, those born in 1930 currently receive CPP benefits at *almost five times the real rate of return that will be paid out to their grandchildren and great-grandchildren*.

This is an intergenerational transfer of wealth, and occurs as current taxpayers must also repay other government liabilities – such as the federal debt – that are significantly larger than they were in 1966. In addition, there are looming liabilities of the now retiring

[b] Note that the steady state rate is 9.8 %. In other words, the amount needed to make the CPP actuarially sound according to current estimates is 9.8 %. The legislated rate is just above that necessary rate, at 9.9 %, presumably to leave some room for adjustments on the assumption side.

[c] A "Ponzi" scheme refers to the activities of Italian-American Robert Ponzi in 1920. Ponzi, then living in Boston, claimed that he could make money by speculating in international postal reply coupons, coupons that were prepaid and allowed mail to be sent from international locations. Ponzi promised to return the principal plus 50% interest after 90 days to those who lent him money. Early contributors did receive such returns, but only because they were paid with money borrowed from later contributors. To continue to pay out such returns to an ever-larger number of people meant even more people had to "invest" money just to cover those already in the scheme who wanted their principal plus 50%. Eventually, when not enough new people could be found to pay new money into the scheme, the plan collapsed under its own unsustainable fiscal imbalance, but not before making Charles Ponzi U.S. $15-million richer and causing the collapse of several banks.

generation, including increased healthcare costs that will continue to swallow ever-larger portions of federal and provincial budgets.

Similar to the debate over deficits in the 1990s – where Canadians recognized the impropriety of handing current spending "bills" to later generations through higher debt – it should not be assumed that baby boomers and older generations are willing and desire to see such a pension imbalance perpetuated against younger generations. In fact, given the response of many Canadians to the deficit problems in the 1990s, politicians should assume that a reasoned reform of the CPP that benefits all generations would be seen as fair by most Canadians, precisely because such reforms would indeed be more equitable than the current arrangement.

We live four years longer now than when the CPP was introduced in 1966

In contrast to the hike in CPP taxes, the last round of reforms to the Canada Pension Plan did little to address the expenditure side of the plan. For example, at the plan's inception in 1966, the average lifespan was 78.5 years for males and 81.1 years for women. Almost four decades later, the average lifespan has lengthened by about four years for each gender.[d]

The increased lifespan is a welcome development but in terms of a taxpayer-funded program, it means the plan will continue to pay out benefits long past an age for which it was originally designed. There has been no increase in the age at which CPP benefits may be collected; Canada's official retirement age – 65 years – is still the same as it was almost four decades ago at the plan's inception. In fact, Canadians can collect early benefits (though reduced) beginning at age 60.

The CPP is actuarially sound…for now

The CPP's unfunded liability is, as of the latest actuarial report, $443-billion. That amount represents what will be needed to pay future CPP benefits. Since the 1997 reforms, which raised CPP taxes, the Office of the Superintendent of Financial Institutions projects that the combination of higher CPP tax rates, program adjustments, changed assumptions, and long-term investment returns from the CPP Investment Board will be sufficient to pay for the liability.

In short, for now, the Canada Pension Plan is actuarially sound. However*, the question this study poses is whether the CPP rate hikes since 1987 and the post-1997 reforms were fair to taxpayers in general and younger contributors in specific, and if not, what reforms can be made to the CPP to make the plan more equitable for all contributors*?

This study answers the first query in the negative and then offers proposals that would make the CPP fairer, including a long-term proposal to move some CPP contributions into first, individual CPP accounts, and then private accounts over time.

[d] These figures are drawn from lifespan expectations calculated from age 65; life expectancy from birth has advanced even more dramatically. For example, male life expectancy from birth has increased to 76.2 years in 2000 from 68.8 years in 1966. Female life expectancy has increased from 75.2 years in 1966 to 82.2 years in 2000. Sources: Office of the Superintendent of Financial Institutions, Canada Pension Plan: Seventeenth Actuarial Report, December 1998, Available on the Internet at www.osfi-bsif.gc.ca and Statistics Canada, Canadian Life Tables, Series: 1965-67 and 1975-77.

Top Ten Reasons to Reform the CPP

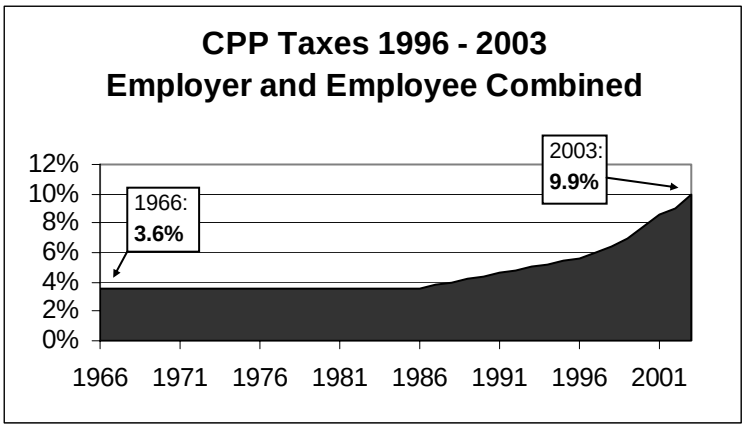
One: CPP taxes are higher than ever before

At the start of the Canada Pension Plan in 1966, tax rates were set at 3.6 per cent of contributory earnings, split between employee and employer (1.8 per cent each).

According to a 1992 information circular from the Department of Finance, it was assumed from the start of the plan (in 1966) that "contribution rates would have to be reassessed in the mid-1980s as the plan matured. Some time later, it was also recognized that the plan's financing requirements would have to change to reflect changing demographic conditions in Canada, including fertility and mortality rates."[8]

In other words, the CPP was designed to redistribute money across generations. By the federal government's own admission, the CPP was not a pension plan based on actuarially sound principles for each age cohort and where each generation paid into the plan at a rate that would roughly parallel eventual benefits. Instead, the plan was designed and assumed to be inexpensive for early contributors and generous to the same individuals in terms of returns on the earliest CPP taxes.

History of CPP taxes 1966-2003



Graph 1: Source 18th Actuarial Report on the Canada Pension Plan.

From the beginning of the Canada Pension Plan in 1966, the structure and early rates meant that those who contributed decades later would pay not only for their own pensions but those that preceded them. It is this purposeful design that has led to the accurate description of the CPP as a partial "ponzi" scheme, where those first in reaped the most benefits, while those last in see much less of a return in comparison.

CPP taxes: An extra $41-billion since 1997

Thus, as designed, by the mid-1980s it was inevitable that CPP taxes would rise to correct the earlier deficiencies. In 1987, rates began to climb for the first time since the plan's inception, first to 3.8 per cent (from 3.6 per cent) and then steadily higher. The last round of rate hikes (as result of 1997 reforms to the plan) finished in 2003, with joint

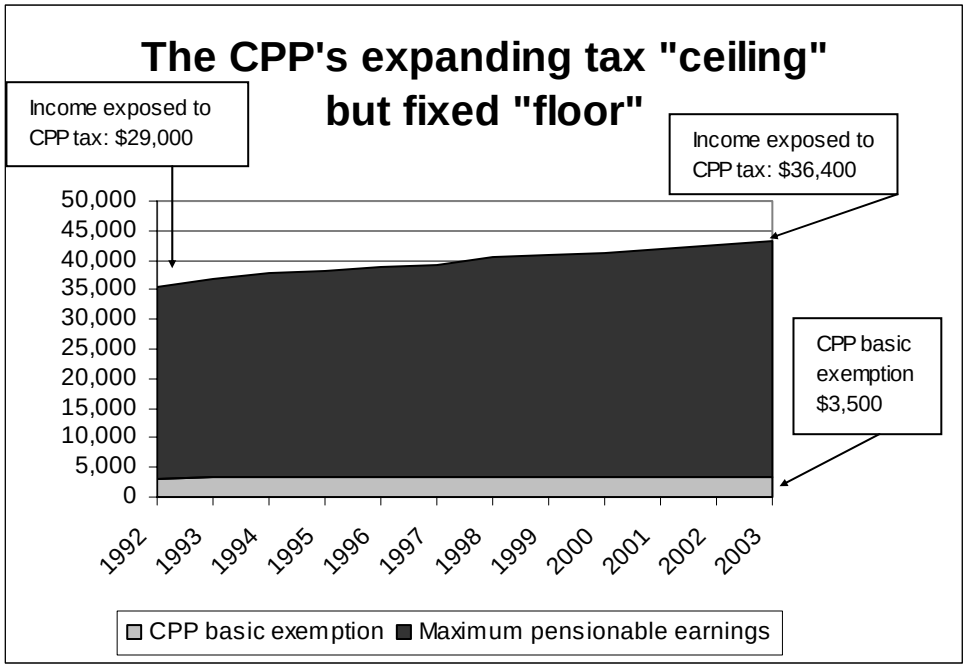
employee/employer contribution rates set at 9.9 per cent for the foreseeable future, almost triple the rates set at the plan's inception in 1966.

In the last eight years alone, CPP taxes have doubled with a tax increase that (cumulatively) amounted to over $41.2-billion between 1997 and 2003 when compared with pre-reform rates that existed in 1996.[e]

The hidden tax increase: the nailed-down "floor" but an ever-higher "ceiling"

In addition to the CPP rate increase, another reason that tax has increased is due to what might be described as the ever-expanding CPP tax "ceiling" but with a nailed-down tax "floor."

More income subject to CPP taxes than ever before



Graph 2. Sources: HRDC and CCRA information circulars.

In 1992, the CPP tax was applied to income between $3,200 and $32,100. In other words, the CPP tax was applied to $29,000 worth of income in that year. By 1996, the "floor" – the income where CPP taxes begin to be paid – was raised to $3,500. However, the "ceiling" had expanded to $35,400. Thus, in 1996, $31,900 was now subject to CPP taxes.

After 1996, the joint provincial-federal agreement on CPP tax increases in effect "nailed" the CPP floor at $3,500 but expanded the ceiling. So CPP taxes applied on all income between $3,500 and $39,900. That meant by 2003, CPP taxes applied to $36,400 worth of income.

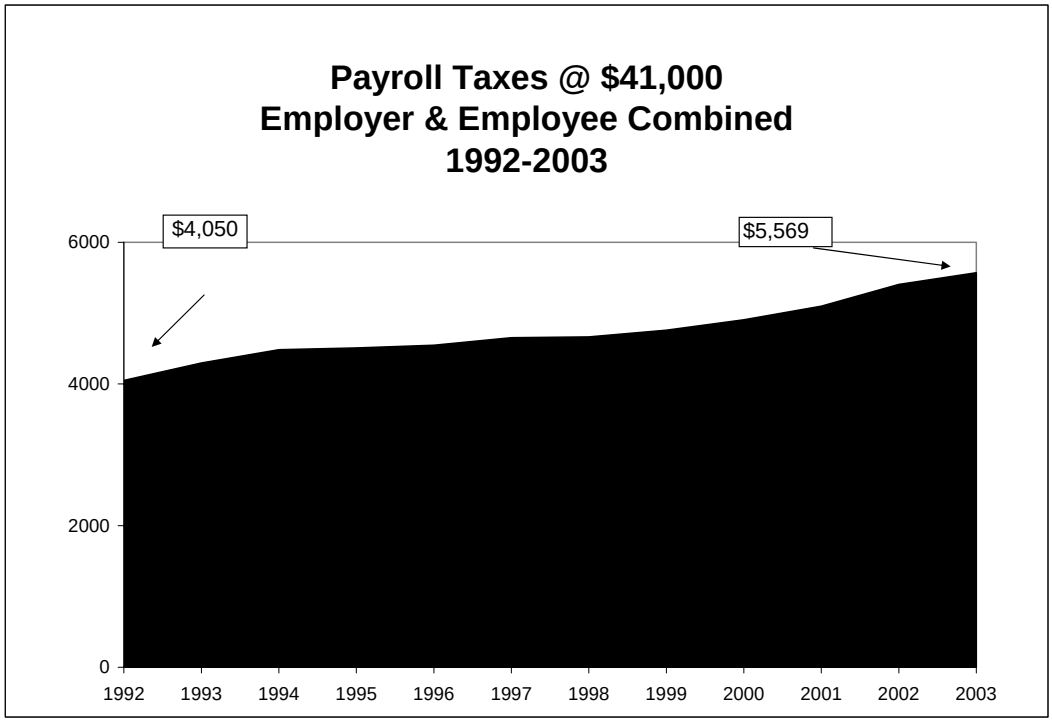
[e] This calculation accounts for income growth and inflation; contributory earnings over the period were compared to 1996 rates throughout the 1997-2003 period and also actual rates throughout the 1997-2003 period to arrive at the difference had rates been frozen at the 1996 levels.

Since 1996, the reach of CPP taxes has steadily expanded which compounds the effect of the rate increases. Ever-increasing numbers of people are subject to the full measure of CPP taxes now applied on more income and with higher rates.

Two: Despite reductions in EI taxes, overall payroll taxes are up significantly

While CPP taxes have risen and EI taxes have been lowered over the past decade, CPP rates have risen at a faster rate than EI taxes have dropped. The result is that *employees earning $41,000 paid $817 more in payroll taxes in 2003 than they did in 1992, while their employers paid an extra $701.* That is $1,518 more once employer and employee contributions are both accounted for.[9] Total payroll taxes for a $41,000 salary amounted to $5,569, up from $4,050 in 1992.

Total payroll taxes paid on $41,000



Graph 3. Source: HRDC/CCRA information circulars.

It is important to note the effect that such increases have on wage growth and job creation. In the case of an employee, the $817 they paid in 2003 compared to 1992 was a straight loss of income that could not be used for debt repayment, an extra mortgage payment, consumer purchases or savings. The $701 extra that the employer paid compared to 1992 was money unavailable for higher salaries for existing employees, or for hiring new ones, or investment in equipment (itself key to productivity improvements and general wealth and employment creation).

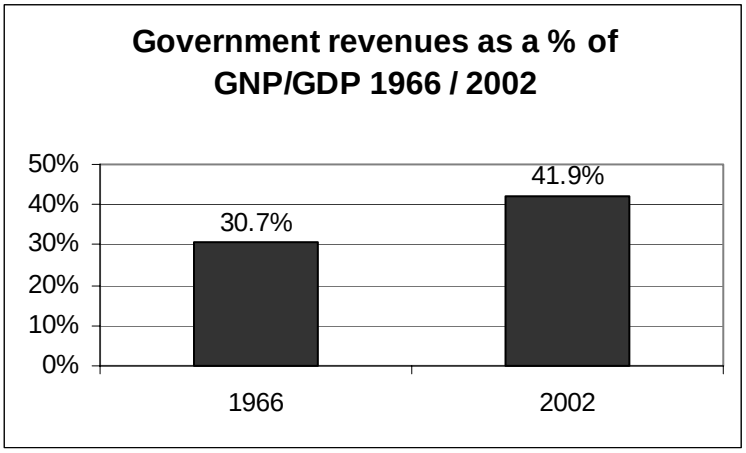
In the case of job creation, consider that an employer with 40 employees (where the employer pays the maximum payroll taxes for those employees) pays over $28,000 more in payroll taxes now compared to one decade ago. That is equal to a middle-income salary – a full-time job that cannot be created and is due solely to higher payroll taxes.

In addition, higher taxes, especially higher payroll taxes, encourage growth in the underground, non-taxable economy. Those who do not now earn enough income to be subject to maximum payroll taxes will be tempted to under-report real earnings to avoid paying maximum payroll taxes in the future. Those who do pay the full burden will likewise be tempted to minimize recorded earnings in the future so as to avoid continuing high payroll taxes.[10] James Estelle notes this effect:

> High payroll tax rates that are not linked to benefits lead to evasion and labour market distortions… The underground economy and underreporting of income, particularly among the self-employed, is also common in OECD countries. Evasion undermines the system's ability to pay pensions, makes it necessary to raise payroll taxes still further, and hurts the economy, since people who work in the informal sector are less productive.[11]

Three: *Overall* taxes are up significantly since the introduction of the CPP in 1966.

A comparison of total government revenues



Graph 4. Sources: Department of Finance Fiscal Reference Tables[12]

In 1966, total government revenues (taxes, premiums, user fees, and revenues to Crown Corporations to all levels) constituted 31.7 per cent of the economy compared to 41.9 per cent in 2002, the latest year for which this comprehensive measurement is available. Thus, Canadians faced a much smaller tax burden in the mid-1960s than presently.

Four: The federal government has concentrated more on raising CPP taxes, and little on expenditure reform within the CPP. CPP taxes have almost tripled since 1966 but the official retirement age has remained exactly where it was in that year.

The 1997 approach mostly ignored the expenditure side of the CPP and instead concentrated on ever-higher CPP taxes with one significant exception. The most recent actuarial report on the CPP notes that the 1997 reforms did scale back disability claims to medically verifiable cases, and de-emphasized socio-economic factors as a basis for a disability claim.

However, that reform was the only one that examined the cost side of the CPP. No other attempt was made to lessen the cost of the plan to contributors. Yet Canadians are living

longer than ever before. In 1921, those who lived until age 65 could expect to live on average until age 78 (for males) or age 78.6 (for females). In 1961, a few years before the CPP was introduced, life expectancy was 78.5 for males and 81.1 years for females. By 2001, that life expectancy had advanced to 82.3 year for males and 85.7 years for females.

Total life expectancy (assuming age 65 is reached)

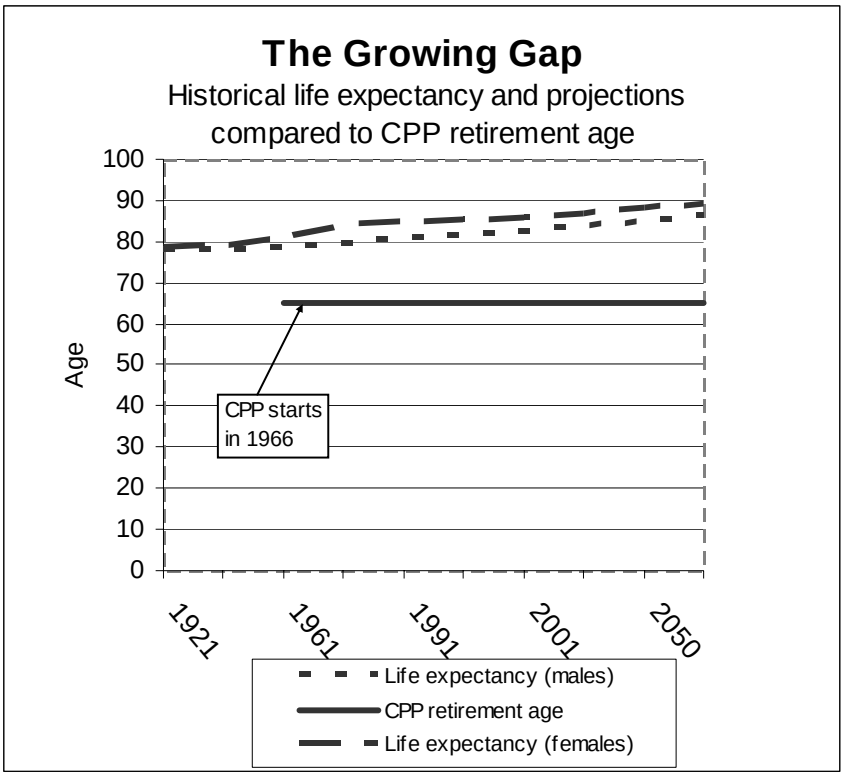
Year	Male	Female
1921	78.0	78.6
1941	77.8	79.1
1961	**78.5**	**81.1**
1981	79.6	83.9
1991	80.7	84.9
1999	81.5	85.3
2001*	**82.3**	**85.7**
2025*	83.6	86.8
2050*	84.8	87.8
2075*	86.0	88.9

Table A. Source: Historical results from Statistics Canada. Life expectancy estimates from the 18th Actuarial Report on the Canada Pension Plan. All figures assume lifespan estimates based on reaching age 65. Projections based on estimates from birth are *higher*. *Estimated.

An increased lifespan is a welcome development. Yet it raises an important public policy question: How do we pay for pension benefits give the reality of extended life spans? The CPP, never a pension plan in any actuarial sense, continues to pay out benefits long past an age for which it was originally designed. As economist Bev Dahlby has noted, 30 per cent of the increase in CPP taxes is due to increased life expectancies,[13] a positive development but one that should bring with it a re-examination of Canada's retirement age.

Until now, there has been no increase in the age at which full CPP benefits may be collected. The CPP retirement age – 65 years – is still the same as it was almost four decades ago at the plan's inception when Canadians who reached age 65 had subsequent life expectancies about four years less on average than currently. As Prime Minister Paul Martin has noted, mandatory retirement at age 65 makes little sense at a time when people are living much longer than ever before.[14]

The Growing Gap:
Historical life expectancy *v.* CPP retirement age



Graph 5: Sources: Statistics Canada / 18th Actuarial Report on the Canada Pension Plan.

Five: The rate of return in market investments is historically higher compared to the CPP's loans to the provinces.

Between 1911 and 1999, the mean annual rate of real return on stocks in the United States was 6.9 per cent.[15] In Canada, the Canadian Institute of Actuaries noted the average annual real yield in private pension funds over a recent 25-year period was 5 per cent.[16]

In comparison, the CPP Investment Board currently forecasts an annual real return on new investments of between 4.25 per cent and 4.59 per cent over the next 75 years. However, that forecast rate of return for the CPP Investment Board is based on investments in both equities and bonds and is a more balanced risk than investing solely in stocks. Importantly, the forecast rate of return for the CPP Investment Board is higher than the real rate of investment earnings on money primarily lent to the provinces, assumed at a return of 2.5 per cent per year.[17]

The superior performance of market returns in the past and forecast returns for the future (based on cautious assumptions) is a significant reason why the CPP should not return to a CPP investment policy of lending money mostly to the provinces.

It is critical to note that the very existence of the CPP Investment Fund is a reflection of a policy change. The federal government decided to improve returns and invest more of Canadian's pension money in the private sector – equities and bonds – and not primarily in government bonds as was the case before the 1997 reforms. In that sense, the case that the pension money of Canadians should be invested in the private sector has already been acknowledged by the federal and provincial governments via their 1997 decision.

Thus, the federal government's 1997 CPP reforms recognized what 71 per cent of families – who already have private pension savings in RRSPs, RRIFs, or employer or union pension plans – already knew: investment diversity and returns are enhanced by placing retirement money in a variety of private instruments.[18]

On a related note, the OECD notes why private pensions increasingly compliment taxpayer-funded pensions:

> Notwithstanding the difficulties, there are many reasons why the development of complementary schemes may be seen as desirable. They help to spread the risks across a wider range of pension provision. They can play a role in helping the development of more stable and liquid capital markets. They may help individuals to identify more clearly with their accumulating pension "wealth" and to feel a sense of ownership of the underlying assets. Complimentary pension schemes may also offer a greater degree of flexibility to employers and employees to manage the total remuneration package, as well as providing governments with more room for manoeuvre on making changes to public social security schemes.[19]

The OECD reference is to private pension plans in countries where, traditionally, as with Canada, there has been a greater reliance on taxpayer-funded, pay-as-you-go pensions. However, the explanation of why such complimentary schemes are useful equally applies to why investing in private markets makes sense for CPP funds: risk diversification, and the development of stable and liquid capital markets. In addition, such investing also leaves room for individual CPP accounts and later, transfers from such accounts into individual pensions plans.

One caveat should be noted about the OECD comment on private pensions and how it relates to the CPP Investment Fund. The comparison is valid insofar as such investments are free from political interference, or even indirect political direction of the sort that would harm either prudent investment strategies and/or returns. However, one example of latent political interference is the artificial injunction to invest 70 per cent of the CPP's investment fund portfolio funds in Canadian assets. Canada's stock market capitalization represents less than three percent of the world's stock market wealth; thus, such limits prevent a more diversified portfolio and also the possibility of greater returns. Given the high exposure to Canadian stocks, this is a cause for concern. The restriction should be ended.

Six: Public pension payments in OECD countries will increasingly take up a larger share of tax revenues and the economy and Canada is no exception. This is occurring as the ratio of working taxpayers to non-working pensioners will fall in half from four-to-one today to two-to-one by 2030.

The Organization for Economic Cooperation and Development (OECD) has warned that countries face "potentially enormous fiscal liabilities if they fail to reform their public

pension programmes."[20] For an understanding of why, consider the chart on the following page:

Public pensions: A growing share of the economy

Country	Public pension payments as a % of GDP	
	1995	2030 estimate
United States	4.1	6.6
Japan	6.6	13.4
Germany	11.1	16.5
France	10.6	13.5
Italy	13.3	20.3
United Kingdom	4.5	5.5
Canada	5.2	9.0

Table B. Source: OECD/ Centre for Economic Policy Research.[21]

As the percentage of the economy devoted to public pensions grows, citizens face a dilemma: higher taxes to support such expenditures, reductions elsewhere in government spending to shift money to public pension programs, reductions in the scope of public pension provision, or some combination of all three strategies.

While CPP taxes have reached the planned maximum for now, and on current actuarial assumptions the CPP is actuarially sound, there is no guarantee they might not be raised again if current assumptions are in need of revision in the future.

The CPP is actuarially sound and becoming pre-funded; OAS and GIS are not

Moreover, *with the near tripling of CPP tax rates over the past four decades, the CPP is now considered to be actuarially sound*. But the Canadian government also administers the Old Age Security (OAS) and Guaranteed Income Supplement (GIS) programmes, which are not pre-funded at all but are administered on a pay-as-you-go basis. Given the demographic shifts forecast, it is entirely possible that governments may attempt to raise taxes at some point to fund those programmes. Given that possibility, it is thus even more imperative that the CPP be re-balanced in favour of the generation that may be paying higher taxes in coming decades to support those programs.

Given the already large size of government revenues-to-GDP that exists, and the other burdens that Canada's citizens will face, such as increasing health expenditures, some restructuring of public pension benefits is desirable. Moreover, it is prudent policy to restructure and reform income support programs to combat poverty at all ages.

Thus, targeted income support should be the goal of the federal and provincial governments and part of any reforms. It is a superior use of resources and preferable to divert tax dollars to increased benefits for low-income seniors such as single seniors on fixed incomes and elsewhere where such increases are necessary, than to provide benefits for high-income seniors who are not in need of such support.

Working taxpayers and non-working pensioners: the dramatic shift

The OECD has noted that over the past two-and-a-half decades, pensioners in OECD countries increased by 45 million but the number of workers increased by 120 million. In contrast, it warns the number of pensioners will grow by 70 million over the next 25 years while only five million new people will be added to the workforce. The problem for taxpayer-financed programs from workers directed to seniors is thus apparent, a pattern that has and will replicate itself in Canada.

Expressed differently, the OECD notes that in 1960 there was a worker to retiree ratio in OECD countries of four-to-one. That declined to three-to-one by 1998 and is forecast to be only two-to-one by 2030.[22]

In the case of Canada, the ratio of workers to retirees is expected to also drop, though behind the curve of some other OECD countries, from 4.9-to-one in 2001 to three-to-one in 2025, and 2.2-to-one in 2075.[23]

The Association of Canadian Pension Management (ACPM) – using a more comprehensive measurement of working taxpayers to those more dependent on taxpayers, i.e., non-working seniors – notes that the ratio of working taxpayers to non-working pensioners will fall in half from four-to-one today to two-to-one by 2030.

While non-working pensioners still pay some taxes (some income, some capital gains and sales) payroll taxes are not paid in large numbers given the relatively few post-65 workers. The consequence is that the tax burden will increasingly fall on a smaller ratio of workers in the future unless changes occur both to the incidence rate of earlier retirement and also to the expenditure side of some public programmes. This is more acutely the case as it concerns the CPP given the few post-65 workers that contribute to the plan.

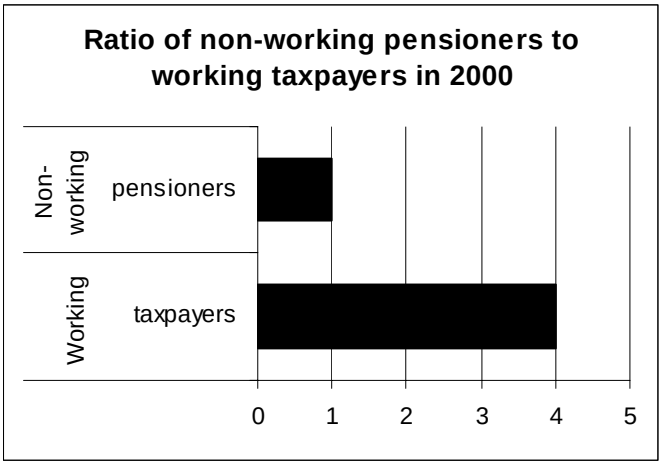
The OECD notes that in order for countries to grapple with the demographic challenge of an ageing society, several policy measures need implementation. One measure to be enacted is that incentives for early retirement be eliminated:

> Material standards of living, and hence the tax base, would also be higher if people worked longer. It is not a question of "forcing" older people to work longer. The current trend to early retirement is, in part, a reflection of a rising demand for leisure as societies become more prosperous as well as a response to high and persistent unemployment. But current public pension systems, tax systems, and social programmes interact to provide a strong disincentive for workers to remain in the labour force after a certain age. Removing these disincentives perhaps even providing positive incentives to work longer, coupled with effective steps to enhance the employability of older workers, could make an important contribution to sustaining the growth of living standards.
>
> But an increased willingness on the part of older workers to work longer will have to be matched by a sufficient number of job opportunities for them if higher unemployment is to be avoided. This in turn will require a major change in the attitudes of firms towards hiring and retraining older workers. Since these changes will have to be reflected in wage and labour cost structures, the co-operation of the social partners could play a very useful role in this process.[24]

The OECD recommends the following measure be enacted to further such reforms:[25]

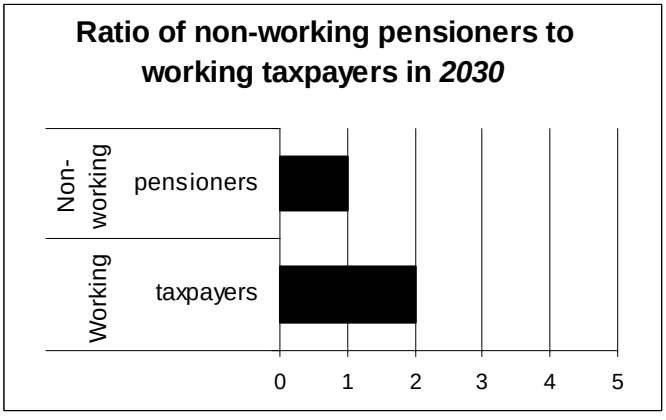
- Public pension systems, taxation systems, and social transfer programmes should be refined to remove financial incentives to early retirement and financial disincentives for later retirement.
- Increase the priority to lifelong learning for all – the operational means of investing in human capital.
- Develop effective active labour market programs to help older workers find jobs.
- Remove discrimination against hiring older workers.[f]

Pensioners and taxpayers: *2000* ratio



Graph 6. Source: Association of Canadian Pension Management

Pensioners and taxpayers: *2030* ratio



Graph 7. Source: Association of Canadian Pension Management

[f] Note that Prime Minister Paul Martin has made known his desire that the mandatory retirement age be ended.

Canadians are living longer and healthier lives; for the possibility for longer working lives to become a reality, government and employer policies must be structured so as to encourage -- not discourage -- working later in life.

Seven: The current structure of the CPP is unfair to younger contributors. The more mature the CPP recipient, the less likely they are to have paid into the CPP at a rate necessary to fund their own pension. The CPP pensions of the very first retirees cost them relatively little relative to their contributions.

One way to reduce the burden on the current generation of contributors to the CPP is through reducing the CPP's expenditure's costs. A prime reform to consider is a rise in the retirement age. In contrast to the near tripling of CPP taxes since 1966, the retirement age is exactly where it was almost four decades after the CPP first began to pay out retirement benefits.

To use one example, those Canadians born in 1950 garner real rates of return double that of later generations. For those born earlier, in 1930, the real rate of return on CPP contributions is almost five times that which will accrue to those born in 1990 or 2000.

CPP rate of return by birth year

Birth Year	Nominal	Real
1930	15.4	**9.4**
1940	10.4	**6.1**
1950	7.3	**4.0**
1960	5.9	**3.0**
1970	5.3	**2.3**
1980	5.1	**2.1**
1990	5.0	**2.0**
2000	5.0	**2.0**

Table C: Source: 18th Actuarial Report on the Canada Pension Plan as at 31 December 2000.

The federal government's justification for CPP tax increases

The 1997 rounds of reforms that boosted CPP taxes from 5.6 per cent to 9.9 per cent over seven years were justified on the grounds that such rate increases were necessary to make the plan actuarially sound:

> As a result of the actions taken by ourselves and the provinces ...we have now preserved the Canada Pension Plan for future generations of Canadians.[26]
> - *(Then) Finance Minister Paul Martin, Toronto Star, September 26, 1997.*

The result of such tax increases – assuming current actuarial assumptions are correct – did indeed make the CPP solvent. Also, had CPP taxes not been raised between 1997 and 2003, the pay-as-you-go system (had it continued and absent any expenditure reductions in the CPP) would have put an even higher payroll tax burden on younger contributors in the future. The 1997-2003 rate increases did force those nearing

retirement to contribute more to the plan than would have been the case under a strict pay-as-you-go scenario.

In that sense, the plan became marginally less unfair to newer CPP contributors, i.e., younger generations. However, the obvious need to find additional CPP tax revenues to finance current and soon-to-be-realized pensions of the already retired and soon-to-retire cohorts only underscores the inherent nature of the CPP as a partial "ponzi" scheme.

Conversely, had CPP contribution rates been scheduled on a actuarially sound basis for each year's retirees from the beginning of the plan, the CPP would instead have been a fully-funded plan where each age cohort contributed to the plan in equal proportion to that age cohort's retirement benefits.

If the CPP had actually been designed as a pension plan from the beginning, the rates would have been correspondingly higher to match the eventual benefits for those same, early contributors. Instead, the CPP was designed as a redistributive social welfare program, but with the looming demographic flaw that now demands that rates be as high as they are.

This is evident not only from the design of the CPP and stated assumptions about it from the Department of Finance recently (and from the beginning of the plan), but also from memorandums to the Minister of Finance from his own staff in 1997.

In 1997, in anticipation of criticism of the rate increases, Finance staff informed then Finance Minister Paul Martin of why a 9.9 per cent rate was necessary. The author of the memorandum noted that almost four-tenths of the contribution (3.8 per cent of the total 9.9. per cent contribution) was necessary to pay for the unfunded liability in the CPP:

> The steady-state rate of 9.9 per cent of the CPP **meets these obligations fully by adding a uniform 3.8 per cent** to the full cost rate of 6.1 per cent. The cost of meeting these existing commitments is kept as low as possible by spreading it uniformly across all generations who contribute to the CPP.[27] (Emphasis added.)

Note that the memorandum to the Finance Minister expressly points out that the unfunded liability exists and that it must be paid for, although the writer argues for "spreading it uniformly across all generations." In actual fact, because the CPP did not collect taxes from each age cohort in sufficient measure to pay for the pensions that cohort would receive, the recent rise in CPP taxes was a game of "catch-up" where all existing contributors pay much higher rates in order to make up for past shortfalls.

Thus contrary to the claim in the 1999 memorandum to the Finance Minister, the cost is not "uniform" to all age cohorts; in fact, full CPP pensions were promised to each retiree since 1966 but were not fully financed by the same contributors who would later receive the pensions. The bill for such pensions was deferred and the current generation of contributors is now forced to make up for that shortfall.

Eight: Retirement income of $24,000 equals $63,400 in working income. In addition, Canadians as a society also face a higher tax and debt burden than they did in 1966 when the CPP was created.

Some opposition to raising the retirement age or re-examining CPP benefits has been met with the claim that because those in retirement paid for the education of the young it is only fair that when the young grow to adulthood and pay taxes they in turn should pay for those in retirement. "We paid for your education; you pay for our retirement – that's the deal" is the explicit claim.

However, what should be noted about this claim is that it sets up a false set of responsibilities and burdens that are not unique to one generation. *In short, every generation must pay for the education of the young.*

The difference between this generation of taxpayers and past generations is that the current generation must not only pay for the education of the young *but their own future pensions and also the pensions of the past generations now in retirement, as well as federal and provincial debt repayment. In addition, current taxpayers are increasingly faced with the soaring health care costs associated with the demographic shift where a larger proportion of the population is elderly and thus requires – properly – more intensive and more frequent medical care.*

Every generation must pay for the education of the young. However, not every generation also pays for unusually large government debt repayment and larger-than-usual health care expenditures as a percentage of the economy. Also, many seniors are in a substantially better-off financial situation than in previous decades.

Snapshot of 1966 economic conditions *versus* recent statistics

Selected measurements	1966	Recent*
Total net debt as a % of the economy	19.4	40.4
Total interest payments as a % of total government spending*	11.4	21.8
Total government receipts as a % of the economy*	30.7%	41.9%
Life expectancy *males*/ females	*78.5* / 81.1	*82.3* / 85.7

Table D: 1966 and *2002 figures except where noted in sources.[28]
*Federal example only.

Home ownership conditions for seniors and non-seniors

Selected measurements	Seniors	Non-senior families
Own with no mortgage	60.6	20.3
Own with mortgage	6.6	38.5
Do not own	32.8	41.2

Table E: Finances in the Golden Years, Statistics Canada.[29]

Median income and personal debt for seniors and non-seniors

Selected measurements	Seniors	Non-senior families
Median income	$26,400	$44,400
In a position of net debt	6.5%	32%

Table F: Finances in the Golden Years, Statistics Canada.[30]

The differences in income, home ownership, and personal net debt are expected due to age differences; people earn higher incomes, and accumulate more savings and assets as they grow older. *The relevant point for a reformed CPP however, is that many seniors are better off than were seniors in previous decades,[31] while the younger generations face a tax and debt burden higher than that of the generation now in retirement*.

In addition, as the Association of Canadian Pension Management (ACPM) points out, the current retirement system in Canada is unfair. The ACPM notes the three pillars of the Canadian retirement system: Pillar #1 is OAS/GIS, Pillar # 2 is the CPP/QPP, and Pillar #3 is voluntary pension plan sector – registered pension plans for example. The ACPM makes the following observation:

> Pillar #1 of the system today provides seniors with larger after-tax benefits than working people are allowed to earn before they are subject to income and payroll taxes. At the same time, seniors collecting CPP/QPP pensions paid only a fraction of their true cost. All seniors' benefits are fully indexed while working people face automatic tax increases through bracket creep. In short, over-65 Canadians have already become an advantaged class, now better off financially than many younger working Canadians who sustain them. Where is the fairness in this?[32]

Since the ACPM's submission to the federal government in 2000, bracket creep has been eliminated on federal income tax but the larger point is still valid. While there are some seniors in poverty and need help, tremendous progress has been made in reducing senior's poverty over the last three decades, *and it is now single parent families, especially single mothers, that form the largest segment of Canada's poor*. Thus,

government policy should target help to that segment of the population and to families, as well as reforming senior's programs to target benefits to still-poor seniors, usually single seniors. A policy that ignores current realities and instead operates on assumptions from four decades ago is of little help to the reality many Canadian families face in the 21st century.

The "rule of thumb" for ideal retirement income is often touted as 70 per cent of final gross earnings. In a 2001 paper on the assets and debts of Canadians, Statistics Canada posits as reasonable, that two-thirds of pre-retirement earnings will be sufficient to maintain a similar standard of living compared to that obtained during working years.

However, the ACPM questions this figure, noting that a typical Canadian may in fact have lived on only 40 per cent of their gross incomes during their working lives, and thus the attempt to live on 70 per cent in post-retirement may be unrealistic and unnecessary. They note the work of actuary Malcolm Hamilton who shows that a "typical" Canadian parent raising kids and paying down mortgages and with a salary of $50,000, may only actually spend $20,000 on personal consumption.[33]

Given this reality, and once the expense of child-rearing and mortgage payments disappear in retirement for many Canadians, the 40 per cent rule is more realistic. Moreover, as it concerns incentives to save for retirement, the ACPM asks whether a retirement program that guarantees 70 per cent of income (or 100 per cent in some cases), might not have the unintended consequence of signalling to Canadians it is unnecessary to save for retirement as the expectation will be that government will replace the income stream through the tax system.

It is also worth noting that what is necessary for retirement income will depend largely on what one earned before retirement. *Replacing 70 per cent of income may well be impossible for very high-income earners and also unnecessary, whereas low-income Canadians will likely need to replace more than 70 per cent of their pre-retirement income, perhaps as much as 100 per cent or more in some cases.* But that difference in needs necessitates targeted income support programs, not a one-size-fits-all approach to tax transfers.

How $24,000 equals $63,400

There are particular costs of living associated with each stage of life and they are not equal. For example, someone in their early twenties is faced with the cost of higher education; a couple in their mid-forties may have financial demands such as mortgage payments and raising children. In contrast, seniors have (obviously) passed through such stages, and may have a paid-off home, no children at home, and their main costs are therefore retirement needs and retirement desires.

A 2003 Statistics Canada survey notes the following about senior's incomes, which leaves open the possibility for sensible increases in assistance to those seniors in need along with other Canadians in dire predicaments while avoiding the errant approach that assumes all seniors require additional cash transfers:

> The income of a senior family no longer saving for retirement, paying off a mortgage, or supporting young children is much more likely to go further than that of a young family with all those expenses. Indeed, according to some actuaries, a mortgage-free retired couple

living solely on CPP, OAS, GIS, and tax credits would have a 'consumable income' of $24,000, the equivalent of a middle-income family earning $63,400 after factoring in tax, retirement savings, and mortgage payments. The 1996 SFS indicates that almost 80 per cent of senior couples and 56 per cent of all senior families had an income of at least $24,000.[34]

Also, as one might expect, the financial assets of seniors are larger than those of other age cohorts, given the longer time they have had to build up nest eggs, pay off mortgages and save for retirement.

Median net worth of selected Canadian families

Family units	Median net worth $
All family units	109,200
Economic families	159,000
Elderly families	**302,800**
Non-elderly families	**138,600**
Couples	170,700
Couples with children	129,000
Lone parent families	17,900
Other non-elderly families	211,800
Unattached individuals	31,800
Elderly	123,500
Non-elderly	14,700

Table G. Source: Statistics Canada.[35]

In terms of the net worth of family units, the median net worth of all family units in 1999 was $109,200. In comparison, elderly families had a median net worth of $302,800, while couples with children had a net worth of $129,000. In contrast, lone parent families had a net worth of just $17,900. Even the single elderly category had a median net worth of $123,500, still above the median for all Canadian families.[36]

None of the above statistics should lead to a conclusion that poverty among some seniors is not a problem; it should lead to the conclusion that targeted income support for those seniors in need and all Canadians in such circumstances makes eminent public policy sense, as opposed to unfocused transfers.

Nine: Other countries are raising or plan to raise their official retirement age.

Countries that are moving to Canada's official retirement age (65)

- Japan is raising the flat-rate portion of old age pensions from 60 to 65 over a twelve-year period and will complete that change by 2013.[37]

- In Italy, Prime Minister Berlusconi has proposed a "real" retirement age of 65. Currently, after 35 years of paying into the pension system, Italians are able to retire as early as age 57.[38]

- Britain will raise the retirement age for women to age 65 from 60 over a ten-year period starting in 2010.[39]

- New Zealand completed a raise in that country's retirement age to 65 from 60 over nine years, an action that was complete by 2001.[40]

Countries that are moving official retirement *beyond* age 65 or already have

- In Norway, the retirement age is 67.[41]

- In Iceland, the structure of the pension system is such that pension rights accrue at the same rate over one's working life and a full pension is now earned at the age of 70. (Pension benefits increase at a rate of 0.8 per cent annually after age 65 and until age 70.)[42]

- In Germany, a commission studying the public pension system for the country's Social Democratic government has recommended a raise in the retirement age to 67 from 65.[43]

- The United States will raise the retirement age to 67 years from 65 over a 20-year period.[44]

Countries where the average effective retirement age is above that of the official retirement age

- In Japan, the official retirement age is 65 but the average effective retirement age for men is 69.1 years (compared to Canada at 62.2 years). The employment rate of Japanese men between the ages of 55 and 64 is 78 per cent compared to 58 per cent in Canada.[45]

- In South Korea, the official retirement age is 60 but the average effective retirement age for men is 67.1 years (compared to Canada at 62.2 years). The employment rate of Korean men between the ages of 55 and 64 is 68 per cent compared to 58 per cent in Canada.[46]

Ten: Other countries have made private retirement savings plans accounts mandatory as part of their retirement security programs. They use innovative combinations of government and private pensions to hep citizens provide for retirement and to avoid demographic shifts that place an undue burden on one generation.

Twenty countries have made private retirement savings plans accounts mandatory as part of their retirement security programs. All of them have a variety of approaches in their mandatory retirement pensions but in essence, they constitute a public-private partnership approach to retirement income, not "privatization" as is sometimes erroneously assumed.

They are: Argentina, Australia, Bolivia, Chile, Colombia, Denmark, El Salvador, Hong Kong, Peru, Hungary, Kazakhstan, Mexico, Poland, Sweden, Switzerland, Netherlands, United Kingdom, and Uruguay.[47]

Some, Australia for example, mandate private pensions for all except the young and lowest paid workers, but excluding the self-employed.

Sweden mandates that 2.5 per cent (of the 18.5 per cent contribution to mandatory public pension) be diverted to individual accounts with private mutual funds.[48] Great Britain has encouraged private sector provision and is reducing the attractiveness of the public pension system for all but the low income earners, and aims to switch from a 60:40 public: private mix to a 40:60 mix.[49]

Eight Proposals for CPP reform

Proposal # 1: ***There should be no change to CPP benefits or in the retirement age for those already in retirement.***

The reforms of the CPP proposed in this paper do not affect those already in retirement, including veterans. Current generations owe war-time Canadians a tremendous debt for their sacrifices. Instead, this paper focuses on reforms that would affect post-World War Two baby-boom pensioners and future "Generation X" pensioners, and how to ensure more equitable fairness and sustainability for their contributions. It does not propose changes to existing pensions.

Proposal # 2: ***Cost saving measures enacted in the CPP should be re-directed to current contributors in the plan. That money – and any investment returns in the CPP Investment Board fund higher than forecast – should be transferred to individual CPP accounts in the form of guaranteed portions of the assets of the CPP Investment Board***. ***This would help present-day contributors build their retirement savings and offset part of the actuarial unfairness built up in the CPP over the decades.***

Some of the money now in the CPP Investment Fund could be transferred to individual accounts over time if cost-saving changes were made to the CPP.

A raise in the retirement age would mean that a certain percentage of current contributions would be unnecessary – *money that could instead be allocated to an individual's own CPP account*. The rate of increase in the account for such a contribution should also be tied to the investment gains in assets managed by the CPP Investment Board, minus administration costs.

Thus, a contributor's portion over and above what is necessary to keep the CPP actuarially sound should be credited to the individual every year. That portion, and the interest would be guaranteed to that individual as their share of the CPP, retirement money that would form part of their retirement benefits *in addition to already guaranteed benefits*.

In essence, individual contributors to the CPP would "own a share" of the plan. Individual Canadians would thus be direct owners of the Canada Pension Plan.

This would accomplish three ends. First, it would help address part of the imbalance between age cohorts. Second, it would allow the CPP over time to more closely link contributions to actual pensions. Third, it would also allow for the eventual shift of some pension money into individual and mandatory retirement saving accounts.

While governments will always need to "top up" the pensions of lower-income Canadians via the tax system (and already do with OAS and GIS as well as provincial programs), there is no reason why, as the unfunded liability of the CPP is lessened, that a more equitable distribution of pension benefits between generations could not be achieved than is currently forecast in the 18th Actuarial Report on the CPP

Proposal # 3: ***In time, allow the individual CPP portions to be transferred to private sector RRSP-style accounts that cannot be withdrawn until retirement.***

Mandate that unlike RRSPs, such funds cannot be withdrawn until the official retirement age. In essence, such accounts would be Mandatory Retirement Savings Plans (MRSPs).

This transfer of personal CPP money could be concurrent with the above reforms or delayed until some period of time has passed.

Opposition to moving to mandatory individual RSP accounts have consisted of two arguments: First, those contributors to the CPP must fund their own pensions and the existing liability for those in or soon moving towards retirement. However, this study has shown that that problem can be partly overcome through a raise in the retirement age. Thus, a move to partial individual mandatory retirement accounts becomes possible over time.

Administration costs as a percentage of <u>expenditures</u>

The second objection is that of administrative costs and critics most often mention the example of Chile which moved to mandatory individual accounts over two decades ago.

For a comparison, CPP administration expenses were forecast at 1.8 per cent of the fund's expenditures in 2001-02. In the 2001-02 Annual Report on the CPP, the federal government notes that figure is reasonable given that some administration costs in the private sector average five percent of expenditures.

Administration costs as a percentage of <u>assets</u>

However, as pension expert James Estelle explains, most pension funds express their expenses in terms of a percentage of assets.

> …it is helpful to convert these one-time charges on contributions into their equivalent in terms of annual charges on assets, which is the way most mutual fund charges are assessed in the United States. Obviously, for accounts that have small accumulated assets (young workers with few years of contributions) this fee will be high relative to assets. However, for accounts that have built up substantial assets over the years, the fee will

> be small relative to assets. Simulations show that if the current fee schedule is maintained, the average Chilean worker who contributes for 40 years will pay the equivalent of less than 1 percent of assets per year.[50]

As it is, while fees as a percentage of assets were high in Chile in the early years (9 per cent in 1982) -- in large measure because of high start-up costs and frequent switching between plans – it has since dropped to 1.36 per cent in 1998.[51] Currently, for 2002, that compares to administration expenditures as a percent of assets of 0.7 per cent in the case of the CPP.[52]

That ratio will also drop in the future, but the large annual percentages attributed to some Latin American private pension programs such as Chile are sometimes a result of confusion between administration costs as a percentage of revenues or expenditures versus administration costs as a percentage of assets.

It should also be noted that it's difficult for government to make this cost-based argument since they impose significant costs on financial service providers in the form of regulations, which then must be financed through higher administrative fees.

A further problem with the comparison between the CPP and private pension plans is that it is a question not only of expenses – which as already noted are not as divergent as claimed – but of real returns. Between 1911 and 1999, the mean annual rate of real return on stocks in the United States was 6.9 per cent.[53] In Canada, the Canadian Institute of Actuaries noted the average annual real yield in private pension funds over a recent 25-year period was 5 per cent.[54] In comparison, the CPP Investment Board currently forecasts an annual real return on new investments of between 4.25 per cent and 4.59 per cent over the next 75 years.

Were the administrative argument used elsewhere, governments would in fact be forced to defend monopolies in the private or public sector on the grounds of administrative efficiency, i.e., that only one airline should be allowed to fly in Canada or that one grocery store chain should be allowed to sell food, and on the basis that administrative costs would be lower as a percentage of all transactions.

While there might indeed be administrative efficiencies in selected cases, including in the management of pensions, the costs incurred by the CPP Investment Board or by private funds, must also be compared with returns that either sector obtains. The "administrative" argument against moving some CPP money to the private sector over time is based on examining one side of pensions (the administrative cost) and not potential revenue gains that might outweigh the extra administrative costs associated with mandatory individual accounts.

Another way to avoid high administrative expenses

Estelle also notes that while concerns over administration fees should be noted when designing private accounts, a system of private pension accounts where it is mandatory and with constrained choice – the type put forward by this paper – can lower administrative costs further by operating through the institutional market.

> In other words, they can offer workers an opportunity to invest at much lower costs than would be possible on a voluntary basis. To accomplish this requires aggregating numerous small accounts of a mandatory system into large blocks of money and negotiating fees for the investment function on a group or centralized basis. Competition takes place in two stages. In the first stage, a competitive bidding process might be used to limit entry to asset managers charging the lowest fees subject to performance specifications. Limited entry avoids high start-up costs in the early years of a new system. Low fees create a disincentive for high marketing expenses. In the second stage workers choose from among funds that won the primary competition. The lowest fees are obtained when worker choice is constrained to low cost investment portfolios and strategies, such as passive investment. Still, enough choice could be retained to satisfy individual preferences and avoid political control…an "institutional" system would cost 0.14% --0.75% per cent of assets in the long run.[55]

Regardless of the exact approach taken for mandatory individual accounts at some future date, the CPP could, in the meantime, still accomplish two goals that would benefit current and younger CPP contributors even if a further step to private mandatory accounts was not taken immediately. First, raise the retirement age over time, and second, shift the savings from such an increased retirement age into personal CPP accounts of current contributors.

As an example, if two percentage-points[g] of the 9.9 per cent now contributed to the CPP could be diverted through a raise in the retirement age, that portion of annual CPP premiums could be credited to each contributor's account and credited annually with additional savings at interest equal to that in the CPP Investment Board's portfolio returns.

The actual savings will depend on a number of factors, including demographic changes, how quickly a raise in the retirement is enacted and over what period, and the actual new retirement age.

[g] Note that this is figure of two percent is for illustration purposes only. The actual rate that is over and above the amount necessary to pay current CPP liabilities will depend on a number of factors, including demographic changes, how quickly a raise in the retirement is enacted, whether the early retirement age is also raised, over what period, and the actual new retirement age.

Proposal # 4: ***The retirement age should be raised from 65 to 69 over a period of 16 years in three-month increments annually beginning in 2005 and finishing in 2020***.

Canadians, as with their counterparts in other OECD countries are living longer than ever but are also retiring earlier, a "double whammy" which exacerbates the pressure on public pension programs and the inter-generational transfer of wealth.

The raise in the retirement age would make a portion of CPP revenues available for redirection to all who are contributing to the CPP; the greatest benefit would accrue to younger contributors to the CPP (given that they would receive a greater number of years of redirected portions of the CPP) a move that would help offset some of the imbalance in future benefits for that group vis-à-vis the current and soon-to-retire generation of retirees. Moreover, a four-year rise in the retirement age would *only match the rise in life expectancy over the last four decades*, to say nothing of what it might be in addition in the next 25 years.

In addition, a CPP retirement age of 69 in 2020 would not affect current retirees or those currently nearing retirement. If the extension of the retirement age began in 2005 and proceeded at a pace of three months per year, the raise in the retirement age would be complete by 2020. The benefit of raising the retirement age over time is not only that it would match increased life expectancies and that current retirees would not have retirement expectations change, but critically, it would restore some inter-generational fairness to the CPP for current contributors.

Proposal #5: ***The early retirement age should be raised to age 64 but done in tandem with the gradual rise in the main retirement age, i.e., over 16 years. Also, the CPP should be made actuarially neutral at the age of retirement, as per recommendations from the Office of the Chief Actuary.***[h]

A raise in the early retirement age, as with the main retirement age, would need to be phased in over sixteen years. In addition, government policies will need to simultaneously remove any barriers to working later in life or incentives that artificially encourage earlier retirement. As is the case now, Canadians may and should retire at any age they choose, but should they choose to work later, there should be no impediment to work. Nor should taxpayer-financed programs serve to discourage later work by their very design.

[h] For more on this, see Office of the Chief Actuary, Canada Pension Plan: Actuarial Adjustment Factors Study. Actuarial Study No. 2. March 2003, Ottawa.

Proposal #6: ***In the case of CPP funds transferred to mandatory individual accounts, a balance should be struck between risk-taking and prudence and in favour of the latter, and mandatory individual accounts should be subject to strict regulations in terms of what type of equities are allowed in such portfolios.***

Proposal #7: ***The federal government should significantly lower Employment Insurance (EI) taxes to offset the steep rise in CPP premiums over the past sixteen years.***

The EI tax is the other major payroll tax and reductions in EI have not nearly compensated for higher CPP taxes. As the Auditor-General has noted, there is now a paper surplus of $45-billion in the EI account, far higher than the $15-billion recommended as necessary in the event of a significant economic downturn. Canadians have been charged-higher-than-necessary rates for EI while CPP taxes doubled over the past decade.

Proposal #8: ***Taxpayer-financed benefits should be targeted to those in need regardless of age.***

Statistics Canada has noted that "economic conditions for today's seniors are very different."[56] In specific, incomes rose faster for those aged 65 and over between 1981 and 1997 while the incomes of those between 15 and 64 declined during the same period.

Also, Statistics Canada noted two groups of seniors that face potential financial insecurity: single elderly women and those whose expenses exceed their income.

As it concerns seniors and income, Statistics Canada reports that *almost one-half (46 per cent) of Canada's seniors report that their income exceeded expenses;* only 10 per cent reported that their expenses were greater than their income.[57]

Tax transfers to low-income seniors and other Canadians of any age make sense from any perspective; but transfers should always be based on need as opposed to a "scattergun" approach of unfocused subsidies.

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