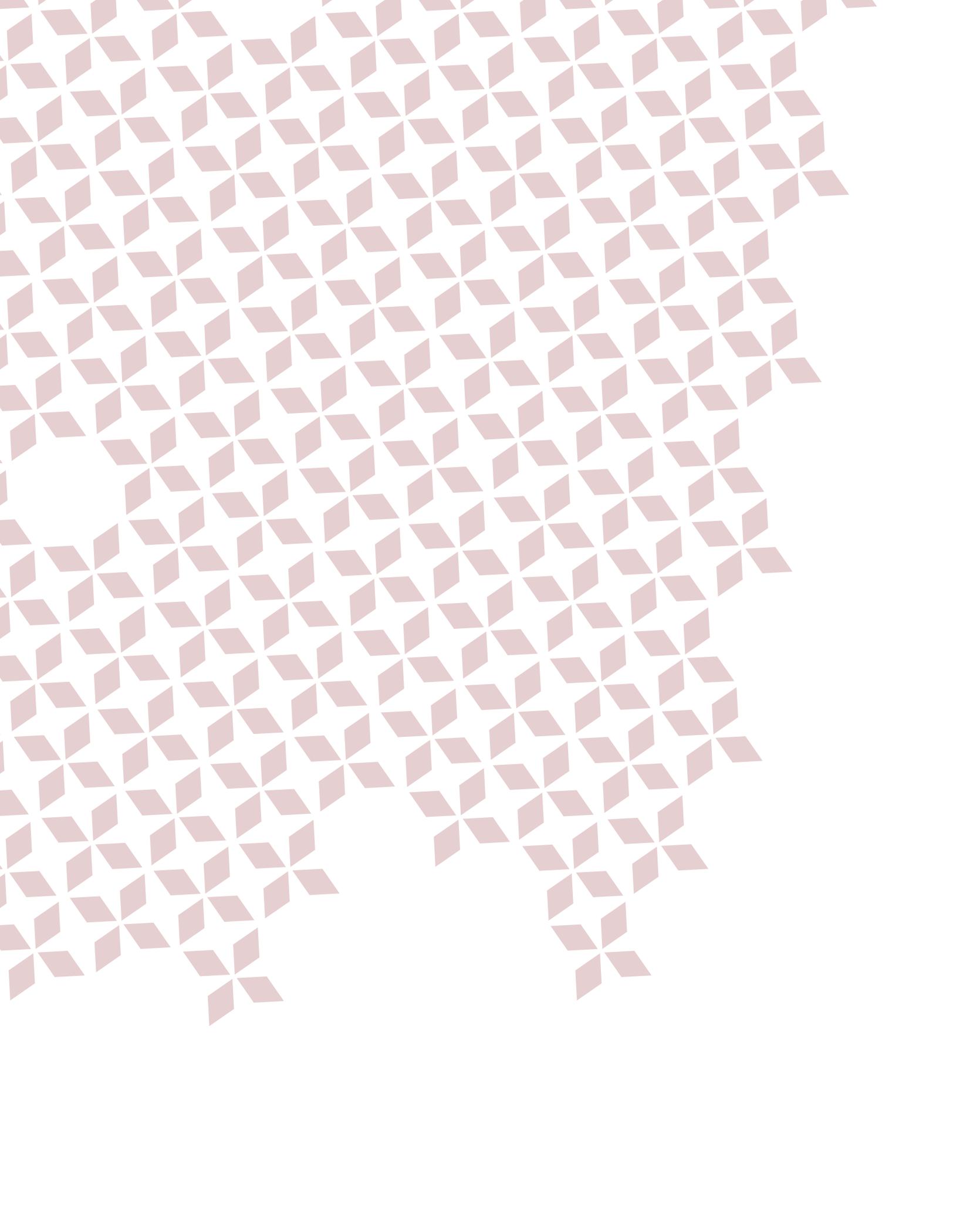




**RENEWING CANADA'S  
SOCIAL ARCHITECTURE**

**LOWER RISK, HIGHER REWARD:  
RENEWING CANADA'S RETIREMENT  
INCOME SYSTEM**

TYLER MEREDITH | AUGUST 2015



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## PROBLEM STATEMENT

Historically, Canada's retirement income system (RIS) has done a fairly good job of ensuring that seniors have sufficient sources of savings and income in order to avoid poverty and enjoy a standard of living comparable to that during their working lives. However, in recent years, a number of new stresses have emerged: a decline in the coverage and quality of workplace pension plans, a prolonged period of low-interest rates and rising life expectancy. Taken together, these phenomena have exposed Canadian savers to significant new risks in managing and preparing for their retirement. Over the next two decades, it is projected that between one-third and one-half of middle-income workers over the age of 40 today are at risk of diminished prospects as they move into retirement. This drop in consumption possibilities represents an important socio-economic challenge for Canada as we enter a period of significant population ageing.

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## POLICY OBJECTIVES

Composed of a number of different component programs, Canada's RIS supports two overarching objectives: 1) ensure a minimum level of income for all seniors in order to avoid poverty while in old age, and 2) provide Canadians with sufficient resources for saving to enable a predictable and adequate replacement of income in the transition between work and retirement.

Retirement income adequacy is commonly measured on the basis of income replacement ratios comparing how households transition between pre- and post-retirement. While the general approach used in retirement planning is to smooth consumption across life, experts differ greatly on the number of ways this is understood and operationalized, including:

- ▮ whether income replacement should be measured on a "gross" or "net" basis (see Box 1);
- ▮ what level of income replacement is optimal; and
- ▮ what constitutes the "pre-retirement" period (how long a period should be used for establishing an income baseline).

## BOX 1: GROSS VS. NET REPLACEMENT

In essence, gross replacement rates simply compare income pre- and post-retirement, without accounting for differences in consumption across the course of peoples' lives.<sup>1</sup> Changes in household size, shelter costs and the effect of differential taxation are all important factors that will change with age. Net replacement rates attempt to control for these various factors. In this respect, net and gross replacement are conceptually very different — one measures total income, while the other examines consumption possibilities. Because of their complexity, net replacement rates are obviously quite difficult for most investors to calculate and use in the context of their own financial planning.

For simplicity, most financial planners and policy analysts prefer to measure gross replacement based on some period of time in the latter half of one's adult working life. The preferred target gross replacement rate varies, but most experts advocate for something in the range of 60 to 80 per cent income replacement; pension plans usually assume 70 per cent.

Using data from Statistics Canada's LifePaths micro-simulation model, Michael Wolfson estimates that gross replacement rates of between 65 and 70 per cent of income in the two decades prior to retirement are associated with net replacement rates of between 65 and 95 per cent or, in other words, a drop in consumption of between 5 and 35 per centage points.<sup>2</sup> While this suggests there can be a lot of heterogeneity between individuals in terms of the pattern of consumption upon retirement, a target rate of gross replacement somewhat closer to 70 or 75 per cent, is probably adequate for most.

A recent paper by Malcolm Hamilton for the C.D. Howe Institute challenges whether such a target is in fact too high.<sup>3</sup> Using a stylized example of a two-earner, upper income household he argues that many retirees will be fine with a replacement target closer to 45-50 per cent of disposable income (similar to a net replacement rate, but not exactly the same) in the final years of working-life (ages 45-64). This replacement target would yield disposable income equal to about 80 per cent of what the same family enjoyed in its early working-life (ages 25-44), and could easily be absorbed because retirement removes the need for certain forms of saving or spending.

Hamilton's paper received substantial media attention so it is important for readers to have sufficient context to weigh his claims. While the lifecycle Hamilton describes is likely true for many Canadians, it discounts the need that retirees may have for saving related to things such as long-term care and disability insurance, or to bequeath assets to future generations. It also assumes that individuals can effectively achieve a smoothing of consumption over the life-course, a proposition which has not been well studied in Canada to date. Whether individuals would be satisfied with a retirement in which consumption is closer to what they experienced in their early working years rather than those just preceding retirement is yet another issue open for debate.

1 For a more detailed discussion see: Macdonald, B-J., and Moore, K. (2011). "Moving Beyond the Limitations of Traditional Replacement Rates". *Report for the Society of Actuaries, Pension Section*. Schaumburg, Illinois: Society of Actuaries. <<https://www.soa.org/research/research-projects/pension/research-moving-beyond.aspx>>; Wolfson, M. (2011). *Projecting the Adequacy of Canadians' Retirement Income: Current Prospects and Possible Reform Options*. IRPP Study, No. 17. Montreal: Institute for Research on Public Policy; and, Mintz, J. (2009), "Summary Report on Retirement Income Adequacy Research". *Prepared for the Research Working Group on Retirement Income Adequacy of Federal-Provincial-Territorial Ministers of Finance*. Ottawa: Department of Finance.

2 Wolfson, supra note 1, Figure A2.

3 Hamilton, M. (2015). *Do Canadians Save Too Little?* Commentary no. 428. (Toronto: C.D. Howe Institute).

The debate about income replacement will be discussed later on in this paper to help assess whether, and how, future cohorts are adequately prepared for retirement. Clearly, how one frames the optimal amount of income required for retirement has an important impact on the type of policy issues that need to be addressed. Unless otherwise noted, this paper references income replacement using measures of gross replacement. Although a net replacement concept is preferred, this reflects the prevailing practice within the literature.

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## CURRENT STATUS

Canada does not mandate a particular age at which individuals must be permanently withdrawn from the labour force. In 2014, the average individual self-identifying as having ‘retired’ within the last year was 63 years old.<sup>4</sup> This is slightly younger than in most OECD countries (the average retired American, for example, is aged 65).<sup>5</sup>

Although ‘retirement’ implies a formal break in one’s career in order to pursue leisure or other activities not related to formal employment, in practice, it is a very fluid concept. Some researchers interpret ‘retirement’ as a state of minimal or no employment earnings, while others suggest that it is the age at which pensionable income is taken. Though there is no formal definition, the RIS operates on the principle that individuals will at a certain age begin to receive income that is not derived from direct employment. Some who wish to continue working may do so, but a key purpose of the RIS is to help adequately prepare individuals for this choice by ensuring that income is available in older age when, or if, employment is no longer viable or desired.

Canada’s RIS operates as an interlocking system of multiple programs and income sources. It is often characterized as having three distinct ‘pillars’:

- **Basic income (pillar 1):** the Guaranteed Income Supplement (GIS) and Old Age Security (OAS) programs provide basic, means-tested, income support to all Canadians as of age 65<sup>6</sup> regardless of current or prior work history. These benefits are financed from general revenues on a pay-as-you-go basis.
- **Canada and Quebec Pension Plans (pillar 2):** since 1967 the Canada and Quebec Pension Plans have provided universal workplace pension coverage to all working Canadians aged 18 to 65.<sup>7</sup> Operated as parallel systems, the CPP/

4 Statistics Canada, CANSIM 282-0051.

5 OECD, Pensions at a Glance, Indicator 3.8. <[www.oecd.org/pensions/pensionsataglance.htm](http://www.oecd.org/pensions/pensionsataglance.htm)>.

6 In 2012, the federal government introduced legislation to gradually raise the age of eligibility for GIS/OAS from 65 to 67, beginning in 2023 and being fully phased-in by 2029.

7 Age 65 is considered the normal pensionable age – the age at which individuals can receive a full, unreduced benefit. Canadians can begin claiming CPP/QPP as early as age 60, while those who work beyond age 65 have the choice to suspend their CPP/QPP contributions or continue contributing up to age 70. Benefits taken earlier than age 65 are reduced by a factor of 6.96 per cent per year, and topped up at a rate of 8.4 per cent for each year a worker contributes between ages 65 and 70.

QPP provide pensions equal to 25 per cent of a worker's average earnings up to the maximum pensionable earnings threshold (\$53,600 in 2015), which is adjusted annually in line with the average industrial wage.<sup>8</sup> No replacement of earnings is provided above the average industrial wage. CPP/QPP is financed through payroll taxes which are split equally between employers and employees and based on a recurring 75-year actuarial projection for the solvency of each plan. In 2015, the CPP's total payroll tax was equivalent to 9.9 per cent of eligible earnings. Since 1997, all new benefits accruing within CPP have been paid for on a fully-funded basis, thereby ensuring there is no inter-generational transfer of liabilities between current workers and retirees.<sup>9</sup>

- **Private and voluntary retirement savings (pillar 3):** provincial and federal governments play an important role in setting regulations and tax policy in order to encourage savings. In general, this pillar comprises both privately-sponsored workplace pension plans that are offered by employers (in addition to CPP/QPP), as well as a number of tax-preferred savings vehicles which allow individuals to save on their own. These include Registered Retirement Savings Plans, Pooled Registered Pension Plans, and Tax Free Savings Accounts. Any additional discretionary savings (both liquid and non-liquid) an individual may have and use at the time of retirement are also found within this pillar.

## RISK AND RETIREMENT SAVING

Before assessing the effectiveness of the RIS, it is important to outline how individuals must think about and manage risks in the context of saving for retirement. Risk is all encompassing—it exists in both the pre- and post-retirement phases of life and comes in several forms:

- **Investment risk:** if assets under-perform, individuals may need to save more or adjust their planned retirement date.
- **Inflation risk:** if payouts are not indexed individuals may face a lower purchasing power over time.
- **Interest rate risk:** if retirement assets are annuitized (turned into a recurring stream of income, e.g. a defined benefit pension) a saver/pension manager must purchase the annuity based on an expectation of what interest rates will be in the future. This can significantly affect investment outcomes.
- **Longevity risk:** if payouts are not annuitized, there is a risk someone will live beyond their available savings.

<sup>8</sup> Someone who earns less than \$3,500 per year is exempt from having to contribute to CPP/QPP.

<sup>9</sup> Of the current 9.9 per cent payroll contribution rate, approximately 4 percentage points comprise benefits accrued prior to 1997 which were previously funded on a pay-as-you-go basis.

In a given RIS policymakers must decide on the appropriate allocation of these risks between individuals, employers and the collective. Each actor will have different biases and capabilities in terms of weighing, balancing and absorbing risks. As a function of choosing how to allocate risk, policymakers must select policy instruments across two dimensions: benefit design and the extent of obligation that will be imposed on participation (mandatory or voluntary).

Benefit design can take many forms, ranging from direct income transfers (pillar 1) to pre-funded pension benefits (pillars 2 and 3). While direct-income transfers are rather straightforward, the pension benefit spectrum is far more complex and increasingly diverse.<sup>10</sup>

At one end are traditional **defined benefit plans (DB)**, in which payouts run until the individual's death (and often include a reduced pension for surviving spouses), and are treated as a formal accrued benefit enforceable by law. In these plans employers are primarily responsible for funding actuarial shortfalls. Although they are often legally restricted from touching previously accrued benefits within these plans, employer sponsors retain the power to adjust a variety of factors for new employees or newly-accruing benefits in order to better manage costs over time. This can include changing the minimum age or contribution history upon which pensions can be drawn, the rate at which benefits are accrued, and the share of contributions between employers and employees.

At the other end are **defined contribution plans (DC)**, in which members have access to the total value of accumulated savings and where employer responsibilities are generally limited to making set contributions and managing employee enrolment. What distinguishes a formal DC plan from a self-directed RRSP, TFSA or taxable account is usually a combination of: matching employer contributions (generally higher than in group RRSPs); access to asset pooling and the group benefits this may bring (e.g. somewhat reduced fees); and some joint involvement on the part of employers and employees in the selection of eligible investments. In practice this model shifts the risk burden more heavily on to employees than is the case with DB plans, leaving employees primarily responsible for most of the major decisions in allocating capital and making supplemental contributions when shortfalls occur.

Between these two book-ends lie a number of variants, which allocate risks either in greater or lesser proportion to employers or workers. In recent years a number of "hybrid" alternatives have arisen as policymakers seek to find

<sup>10</sup> See Appendix, in: Baldwin, B. (2010). *Pension Reform in Canada: A Guide to Fixing Our Futures Again*. IRPP Study, no. 13. Montreal: Institute for Research on Public Policy.

alternatives that retain the best features of both: the predictability of retirement income offered by DB plans, with the affordability of DC plans.<sup>11</sup>

## HOW CANADA'S RIS IS DOING

By most standards Canada's RIS compares favourably to those in other developed countries. For example, in the 2014 Melbourne Mercer Global Pension Index, an index that compares countries across 50 indicators to assess the adequacy, sustainability and integrity of pension systems,<sup>12</sup> Canada received a grade of 'B', ranking seventh out of the 25 countries. Canada has consistently ranked within the mid- to upper-tier of global RIS' since the index began in 2009. While we have continued to out-class other OECD countries such as the United States and the United Kingdom, we persistently lag Australia, Netherlands and most Nordic countries.

### **WHAT EXPLAINS THIS 'MIDDLING' PERFORMANCE OF CANADA'S RIS?**

On the first and the most important policy objective of any RIS—poverty avoidance—Canada deserves significant credit. Since the introduction of the OAS/GIS and the CPP/QPP in the 1960s, the proportion of seniors living in poverty has declined dramatically (figure 1). While a certain cross-section of seniors, primarily those who live in unattached households (singles), remains at elevated risk of poverty, the widespread phenomenon of becoming poor upon retirement has dropped. So significant has this change been that poverty rates among seniors are now nearly half those of the population aged 18 to 64.<sup>13</sup> Canada's elderly poverty rate is also among the lowest in the OECD, a feat that has been accomplished with relatively minimal public expenditures (table 1).

In recent years there has been a divergence between measures of absolute (Low Income Cut-Off) and relative poverty (Low Income Measure) among seniors, with the latter having risen noticeably since the mid-1990s. This suggests that while OAS/GIS and other related taxes and transfers have helped to secure a basic income floor for Canada's elderly population these programs have not been enough for low-income seniors to keep up with improving income trends over

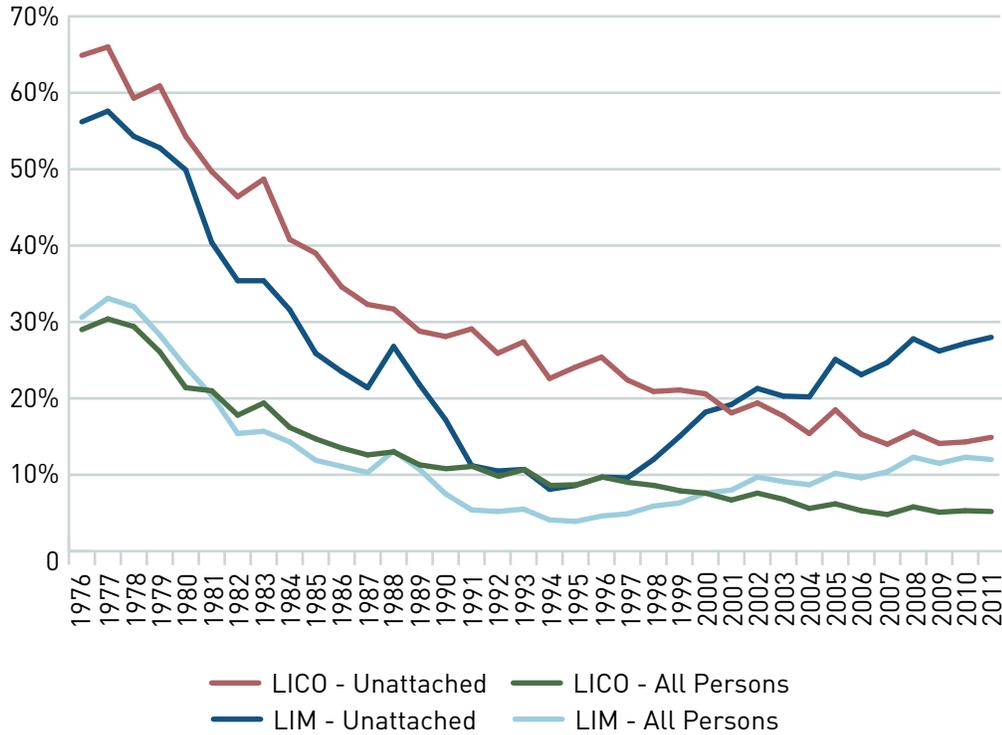
11 For a detailed discussion of various benefit models see: Brown, R. and Meredith, T. (2012). *Pooled Targeted Benefit Pension Plans: Building on PRPPs*. IRPP Study, no. 27. Montreal: Institute for Research on Public Policy; and Steele, J., Mazerolle, A., and Bartlett, M. (2014). *Target Benefit Plans in Canada: An Innovation Worth Exploring*. C.D. Howe Commentary, no 411. Toronto: C.D. Howe Institute.

12 Australian Centre for Financial Studies / Mercer. (2014). *Melbourne Mercer Global Pension Index 2014: Including Trust and Transparency in Pensions. 2014 Report*. Melbourne, Australia: Australian Centre for Financial Studies / Mercer.

13 In 2011, Low Income Cut-Off (LICO)-poverty rates stood at 9.7 per cent among Canadians aged 18-64, compared to 5.2 per cent among those aged 65+ (CANSIM 202-0802).

the last decade among younger and higher-income Canadians.<sup>14</sup> The extent to which an increase in relative poverty alone is a problem is open to debate.

FIGURE 1: INCIDENCE OF POVERTY AMONG CANADIANS AGE 65+, 1976-2011



Source: CANSIM 202-0802

Note: Both the Low-Income Cut-Off (LICO) and the Low-Income Measure (LIM) used here are calculated on an after-tax basis.

While Canada's RIS addresses the goal of poverty avoidance in a relatively efficient manner, it is important to note that mandatory, publicly administered saving programs such as the CPP/QPP play a much smaller role in retirement preparation than is the case in other OECD countries (table 1). Like the United States and, to an extent the U.K., Canada's RIS has generally preferred to emphasize the complementary role that private and voluntary savings can play in this process, a phenomenon which has only grown over time as an ever-greater number of tax-preferred savings vehicles (RRSP, TFSA, PRPP, etc.) have emerged.

14 For a more detailed discussion of this phenomenon, see: Mlligan, K and Schirle, T. (2014). *Simulated Replacement Rates for CPP and Reform Options*. SPP Research Papers. Vol. 7, No. 7 (March 2014). Calgary: University of Calgary, School of Public Policy.

TABLE 1: INTERNATIONAL COMPARISON OF RETIREMENT INCOME SYSTEMS ACROSS THE OECD

	Poverty Avoidance <sup>1</sup>		Post-Transfer/Post-Tax Replacement Rates (Public + Private Pensions) <sup>2</sup>		
	Poverty Rate (age >65)	Public expenditure on seniors benefits (share of GDP)	0.5x Average earnings	1x Average earnings	1.5x Average earnings
Australia	35.5%	3.4%	100.5%	67.7%	54.3%
Canada	7.2%	4.3%	90.7%	58.6%	40.8%
Denmark	8.0%	4.5%	117.5%	77.4%	67.4%
France	5.4%	12.8%	75.9%	71.4%	60.9%
Germany	10.5%	10.9%	55.2%	57.1%	56.1%
Japan	19.4%	9.5%	54.3%	40.8%	35.7%
Italy	11.0%	13.5%	83.9%	81.5%	83.3%
Netherlands	1.4%	4.7%	104.8%	101.1%	97.2%
Norway	5.5%	4.4%	91.1%	62.8%	51.3%
Sweden	9.5%	6.2%	68.8%	55.3%	72.9%
United Kingdom	8.6%	5.9%	67.2%	41.8%	30.5%
United States	19.9%	6.4%	58.7%	47.3%	42.9%
<b>OECD</b>	<b>12.8%</b>	<b>7.3%</b>	<b>81.7%</b>	<b>65.8%</b>	<b>59.7%</b>

Source: Author's calculations based on OECD (2013).<sup>15</sup>

Notes: 1) The poverty rate as reported by the OECD for Canada uses a LICO measure of poverty for persons aged 65+ that is slightly different than reported by Statistics Canada's CANSIM table 202-0802 (figure1). The results in this table are reproduced as per the OECD.

2) OECD simulation of the potential amount of income that new workers entering the labour market today (aged 20) would conceivably replace in retirement based on their average income level during working life, the standard age of eligibility in each country for pension benefits (age 65 in Canada), and their respective country's pension and income transfer arrangements. This simulation includes private occupational pension plans, but not personal savings (e.g. RRSPs in Canada).

Indeed, as illustrated in table 1, Canada's RIS is much more tightly focused on the income replacement needs of the bottom-half of earners than is true in other highly-developed economies. Workers who, over their career, earn one and a half times the average can expect to have only about 40 per cent of their income replaced by the major components of Canada's RIS, compared to more than 90 per cent among those who earn half the average. This decline reflects the fact that CPP/QPP provides no replacement of earnings above the average industrial wage.

15 OECD (2013). Pensions at a Glance: OECD and G20 Indicators. Paris: OECD. Available at: <http://www.oecd.org/els/public-pensions/pensionsataglance.htm>.

While the current structure of Canada's RIS largely removes the need for lower-income workers to save beyond what is provided for by OAS/GIS and CPP/QPP, the sharp drop in income replacement across the earnings profile places significant expectations on many middle-income earners to participate in an employer-provided workplace pension plan (if available) and/or set aside their own savings (not shown in table 1).<sup>16</sup> Research conducted for the 2009 federal-provincial working group on retirement income policy estimated that when factoring in RRSP wealth, average income replacement among workers earning between 1.5 and 2 times the average industrial wage rises to approximately 65 per cent. For higher earning workers replacement is closer to 50 per cent.<sup>17</sup>

Up to this point we have considered income replacement as a fixed number, regardless of how the level and sources of income change over the course of retirement. Depending on how individuals stage the drawdown of their personal retirement savings they may have more or less income at different points in retirement. Added to this is the significant impact that extended longevity will play in potentially depleting retirement assets. If people live beyond their retirement savings, dependency on public sources of retirement income will rise.

Following cohorts of retirees from 1986 to 2008, a recent research paper for the Canadian Labour Market and Skills Researcher Network by Ross Finne, David Gray and Yan Zhang<sup>18</sup> observes a significant increase in the receipt of GIS as people progress through retirement. On average they estimate an increase in GIS incidence of 15 percentage points between age 65 and age 81, with nearly half of all seniors receiving a portion of the benefit after their 80th birthday. While this change in the composition of retirement income is not picked up in aggregate income replacement rates, it represents an important public liability as life expectancy improves and population ageing accelerates.

Considering that health and living expenses increase substantially in the later stages of life, these results suggest that Canadians may not fully appreciate the costs of retirement, either by under-saving or misallocating their resources during the period of retirement. Both outcomes can be influenced by a combination of poor financial literacy; uncertainty about health status and life expectancy later in life; and the design of key policy parameters, such as how and when RRSP assets are drawn-down.<sup>19</sup>

16 Clawback of OAS benefits is also an important consideration for middle and higher-income groups. Unlike CPP/QPP, OAS clawbacks are set higher than the average industrial wage and are reduced on a gradual basis. In 2014, individuals who earned \$71,592 or more faced a partial or full claw-back of OAS benefits. Benefits were fully reduced for those earning \$116,103 or more.

17 Mintz, supra note 1.

18 Finnie, R., Gray, D., and Zhang, Y. (2013). "The Receipt of Guaranteed Income Supplement (GIS) Status Among Canadian Seniors: Incidence and Dynamics". CLSRN Working Paper No. 115. Vancouver: Canadian Labour Market and Skills Researcher Network.

19 Robson, W. B., and Laurin, A. (2014). "Outliving Our Savings: Registered Retirement Income Fund Rules Need a Big Update". *C.D. Howe E-Brief*, No. 175. June 4, 2014. Toronto: C.D. Howe Institute.

## WHO FACES CHALLENGES TODAY?

In assessing the RIS it is important to distinguish between the state of affairs today, based on the experience of those who have already retired, and what may happen in the future among those who are still working. Much of the commentary on Canada's RIS looks only at the former group, without considering whether the latter will be any different. These two things need to be separated analytically.

Looking at current and past cohorts of retirees a growing body of research from Statistics Canada demonstrates that on average most Canadians who entered retirement over the past several decades were adequately prepared for this transition. Among the most comprehensive studies to date, Sébastien Larochelle-Côté, Garnett Picot and John Myles use longitudinal tax data to calculate the level of income replacement achieved by different cohorts of Canadians as they age beyond their mid-fifties, tracking them through the period pre and post-retirement.<sup>20</sup> While their data suggests that income replacement has improved somewhat over time, on average Canadians born between 1929 and 1942 replaced between 80 to 90 per cent of the income they earned at age 55 (adjusted for equivalency of household size) when they were in their 60s and 70s. For individuals in the middle and top quintiles of the income distribution, average income replacement rates were 75 and 70 per cent respectively.

As much as these broad averages suggest that most Canadians can and do achieve fairly high levels of gross income replacement, this same body of research also observes that a small but consequential pocket of savers do not meet this objective. In their own study, Larochelle-Côté, Picot and Myles note that 20 per cent of middle-income retirees experienced replacement rates below 60 per cent. (The separate and equally important question of what retirement income prospects look like for future retirees is discussed in the following section).

Because definitions of target saving vary from study to study, it is not possible to precisely and cleanly decompose the population of under-savers into discrete groups. However, a large body of evidence has identified the following groups as those at elevated risk of a diminished retirement.

### **SINGLES**

As with working-age Canadians, those most at risk of poverty in old age are single-person households. Being single often results in a number of significant fixed costs within life that drain the ability to save while working and expose individuals to greater precarity when retired. Keith Horner

20 Larochelle-Côté, S., Myles, J., and Picot, G. (2010). *Replacing Family Income During the Retirement Years: How are Canadians Doing?* Analytical Studies Branch Research Paper Series, no. 306. Ottawa: Statistics Canada.

estimates that approximately 60 per cent of those considered to be ‘under-saving’ during their working-lives are single. As shown in figure 1, both absolute and relative measures of poverty show poverty-incidence more than twice as high among singles as for the rest of the elderly population.<sup>21</sup> The increase in relative poverty in recent years, as taken by the Low-Income Measure, has also been much steeper among singles than it has among the elderly population as a whole.

It is important to note that one can be classified as single or unattached for a number of different reasons, which may include having never formed a couple, as well a change in family status due to death, separation or divorce. Though circumstances may be treated differently by various retirement programs, being single represents an added insecurity due to the economy of scale that one benefits from when there are multiple incomes in a household.<sup>22</sup> The extent of accommodation that is offered to singles will vary based on a number of factors related to current or past marital status.

Both OAS/GIS and CPP/QPP currently provide special entitlements for surviving spouses and common-law partners. The survivor pension offered within CPP/QPP is equal to approximately 60 per cent of the deceased spouse’s entitlement. Although survivors can combine this benefit with their own pension, total combined payouts cannot exceed \$1,264.59 per month, and the payout is subject to adjustment based on age and income conditions.<sup>23</sup>

Support for those who are single but not widowed is more limited. OAS/GIS does differentiate the benefit structure based on household type, but only for those whose family income is modest enough to qualify for some portion of the GIS. For those who receive only OAS (i.e. a single person who is not widowed and whose income is above \$17,123 per year) the benefit is treated as a flat payment regardless of marital or household status — everyone receives \$564.87 per month.<sup>24</sup>

This raises a very important issue of equity. University of Waterloo economist Tammy Schirle notes the maximum OAS/GIS benefit is at least sufficient for married couples to replace nearly all of the income needed to match the LICO poverty threshold in most large Canadian cities, thereby eliminating what we

21 Mintz, J. (2013). “Pensions for the Poor, or Why Governments Should Focus Reform Efforts on those who have the Least”. National Post. October 16, 2013. <<http://business.financialpost.com/2013/10/16/jack-mintz-pensions-for-the-poor-or-why-governments-should-focus-reform-effort-on-those-who-have-the-least/>>.

22 LaRochelle-Côté, S., Myles, J. and Picot, G. (2012). *Income Replacement Rates Among Canadian Seniors: The Effect of Widowhood and Divorce*. Analytical Studies Branch research paper no. 343. Ottawa: Statistics Canada.

23 Service Canada (2015a). “Canada Pension Plan payment amounts”. March 24, 2015. <<http://www.servicecanada.gc.ca/eng/services/pensions/cpp/payments/index.shtml>> Accessed May 15, 2015.

24 OAS benefits must be partially repaid by individuals earning more than \$72,809 a year and fully repaid once earnings reach \$117,909 a year or higher (2015).

would typically define as absolute poverty.<sup>25</sup> Singles, however, are still left far below the poverty line and need at least some additional income from CPP or other sources in order to avoid poverty.<sup>26</sup>

In addition to this, it is open to debate why the top-up for singles exists exclusively for GIS recipients and is not at least available for more modest income individuals who, while not officially poor, are still at much greater risk of under-saving relative to couples. In this context, it is important to remember that retirement and saving decisions are often a function of household-level decisions. Two-person families are in a much better position to share and transfer wealth and expenses in a way that is simply not possible for unattached individuals. As a rudimentary illustration, the adult equivalency measure commonly used in income statistics (square-root of household size) suggests a 41 per cent differential in the relative value of per capita income between single and two-person households.

### ***THE UN-PENSIONED***

Those without access to a workplace pension plan face a far greater challenge in being able to set aside the necessary funds for retirement. While it is possible for workers to achieve comparable levels of retirement income by saving on their own, this is not the case for the median saver. For most, non-participation in a pension plan is associated with both less accumulated wealth over the course of life<sup>27</sup>, and lower income replacement upon retirement (figure 2).

At a household level, even partial access to a pension can be significant. Looking at married and common-law retirees in 2006, Yuri Ostrovsky and Grant Schellenberg find that couples with at least one member covered by a pension plan in 1991-92 had substantially higher gross income replacement upon retirement than those where neither spouse was covered.<sup>28</sup> In the middle quintile, for example, they find that 43 per cent of couples with no RPP member in the household had income replacement rates below a 60 per cent target. This compares to 29 per cent and 21 per cent respectively among couples where only the husband or the wife were covered.<sup>29</sup>

25 Schirle, T. (2013). "Senior Poverty in Canada: A Decomposition Analysis". *Canadian Public Policy*. Vol. 39, No. 4 (December 2013). P. 517-40.

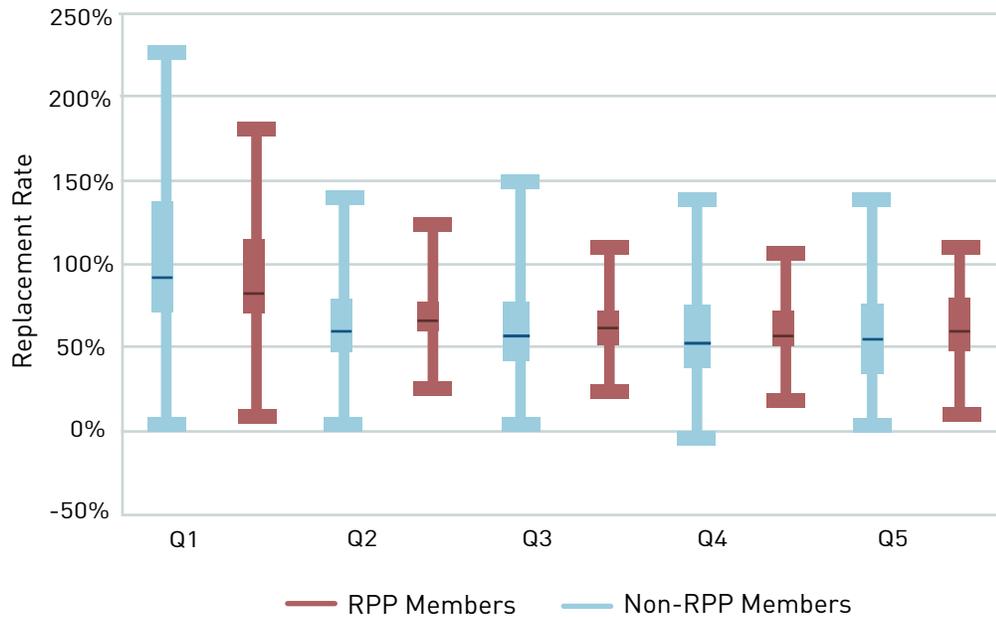
26 Ibid.

27 Messacar, D. and Morrisette, R. (2015). *Employer Pensions and the Wealth of Canadian Families. Insights on Canadian Society (January 2005)*. Catalogue, 75-006-X. Ottawa: Statistics Canada.

28 Ostrovsky, Y. and Schellenberg, G. (2010), *Pension Coverage and Earnings Replacement Rates Among Canadian Couples*. Analytical Studies Branch Research Paper Series, no. 327. Ottawa: Statistics Canada.

29 Ibid, table 3.

FIGURE 2: POST-RETIREMENT EARNINGS REPLACEMENT RATES AMONG MEMBERS AND NON-MEMBERS OF PENSION PLANS



Source: Alexander, Bishop and Fong (2010).<sup>30</sup>

In addition to differences in the amount of income available upon retirement, pension coverage can also have important effects on wealth and saving behaviour within households. In a paper released earlier this year researchers at Statistics Canada found that even after controlling for differences in family and income characteristics, households with at least one member participating in a registered pension plan had substantially higher median net wealth in 2012 compared to households with no workplace pension coverage: \$353,140 versus \$177,500 respectively. Of these differences in wealth the researchers estimated that approximately 40 per cent could be explained by the presence of a pension plan.<sup>31</sup> The larger unexplained difference may suggest that workplace pensions play an important and intrinsic role in supporting pro-saving behaviour, which would not be picked up simply by observable characteristics.

Herein lies an important issue about the way in which saving and investing behaviours interact, and the way in which these are accommodated inside and outside an occupational pension plan.

One of the invaluable aspects of either a pension or group savings plan is that it sets the default to save, thereby making the habit simple and easy to repeat.

30 Alexander, C., Bishop, G., and Fong, F. (2010). *Retirement Income Security Reform: Rush Prudently, Don't Run Blindly*. TD Special Report. Toronto: TD Economics.

31 Messacar and Morrisette, *Supra* note 27.

Indeed, as demonstrated by a growing body of behavioural and psychological research, automatic and passive contributions are among the easiest and most significant mechanisms for building long-term wealth. Because behaviour is passive, the potential for substitution is lower and individuals are less likely to opt out of the default behaviour.<sup>32</sup>

At another level we must also ask how effectively do-it-yourself (DIY) investors are positioned to manage risk and build wealth compared to those who might be part of a pension plan. By virtue of their size and scale, pension funds have access to expert managers they can hire to invest according to the long-term interests of members. By contrast, individual investors must possess sufficient financial literacy in order to choose among a multitude of investment options and do so in a way that effectively balances a variety of potential risks (interest rate, investment and longevity, among the most important) and preferences.<sup>33</sup>

In making these decisions, individual investors must also contend with a number of behavioural biases that naturally arise in something as emotional as investing. The desire to chase short-term performance; time markets; and the potential to either excessively take-on or avoid risk—are all common challenges that DIY investors face in some measure. While institutional investors may also fall prey to the fallacy of active management, they arguably have deeper capabilities and expertise at their disposal.

Individual investors can overcome some of these asymmetries through the use of a financial advisor, but this too is arguably an imperfect substitute. A large cross-section of Canadians still do not use advisors and those who do often encounter prices that are much higher than what is charged to institutional investors.<sup>34</sup> Investors do need to be mindful of cost and the impact that it has on long-term capital accumulation. For this reason passive, low-turnover investing is often the best solution for most. But this needs to be approached in a balanced way. Though passive index and exchange-traded funds (ETFs) are a simple, low-cost way for many investors to start accumulating wealth, the design and allocation of a portfolio must still reflect the age, need and risk profile of each investor.

The challenges faced by the DIY investor do not end with the transition to retirement. Unlike pension funds, individual investors do not have access to a

32 Chetty, R. et al. (2012). “Active vs. Passive Decisions and Crowdout in Retirement Saving Accounts: Evidence from Denmark”. NBER Working Paper No. 18565. (Boston, MA: National Bureau of Economic Research).

33 For a more detailed discussion of the differences in capability between DIY investors and pension funds, see: Brown and Meredith (2012), *supra* note 15.

34 Montmarquette, C. and Viennot-Briot, N. (2012). “Econometric Models on the Value of Advice of a Financial Advisor”. Project Report. Montreal: Centre Interuniversitaire de Recherche en Analyse des Organisations.

large and efficient market in which to annuitize their assets.<sup>35 36</sup> This inability to easily convert accumulated savings into a predictable stream of income for retirement means that older individuals must continue to manage the allocation and drawdown of assets in a way that is both appropriate for their life expectancy and that is tax-efficient.

### ***THOSE WHO INVEST IN COSTLY INVESTMENT PRODUCTS***

Regardless of how one saves for retirement, the ability to build and grow capital over time is influenced in great measure by the risk-adjusted performance of assets and the underlying costs of holding those assets. Though it is performance that savers focus on most, cost is just as important. Canada's private savings market, long dominated by retail mutual funds, has consistently been ranked by Morningstar Fund Research as among the most expensive jurisdictions for mutual fund products in the developed world.<sup>37</sup> This is concerning.

The impact of high-cost investing is cumulative. Since most fee arrangements are charged on the basis of total assets under management, they are paid for from the top, not the bottom line. Over the working life of a saver this foregone capital reduces the potential compounding value of interest and capital appreciation. As noted by Robert Brown and Tyler Meredith in a paper for the Institute for Research on Public Policy, a worker earning \$50,000 per year and working for 40 years would enjoy \$9,000 more per year in retirement (and a replacement rate 18 percentage points higher) if their savings were held in a fund charging a management expense ratio (MER) of 0.4 per cent per year compared to the same worker whose savings were managed with an MER of 1.5 per cent.<sup>38</sup>

For most retail investors this illustration is not trivial. In 2011, the typical Canadian equity mutual fund had an MER of 2.3 per cent of assets under management while fixed income funds had an MER of 1.48 per cent.<sup>39</sup> By

35 Nielson, N. (2012). *Annuities and Your Nest Egg: Reforms to Promote Optimal Annuitization of Retirement Capital*. C.D. Howe Commentary, no. 358. Toronto: C.D. Howe Institute.

36 A number of large pension plans have started to undertake group annuitization as members move from active work to retirement. This is part of a broader trend of pension plans in Canada and the United States "de-risking" by offloading the underlying investment risk associated with benefit payouts once members retire. See: Sadkova, Y. (2014). "5 Pension Trends to Watch". 21 November, 2014. Benefits Canada. <<http://www.benefitscanada.com/pensions/db/5-pension-trends-to-watch-59557>>. Accessed: 18 February, 2015. A very recent example of this was undertaken in March between BCE and Sun Life Financial: See: Nelson, J. (2015). "Sun Life to Take on \$5 Billion BCE Pension Risk". *The Globe and Mail*. 3 March, 2015. <<http://www.theglobeandmail.com/report-on-business/streetwise/sun-life-to-take-on-5-billion-bce-pension-risk/article23266031/>>

37 Morningstar Fund Research. (2013). *Global Fund Investor Experience: 2013 Report*. New York: Morningstar.

38 Brown and Meredith (2012), supra note 15.

39 Investor Economics. (2012). *Mutual Fund MERs and Cost to Customer in Canada: Measurement, Trends, and Changing Perspectives*. A study for the Investment Funds Institute of Canada. Toronto: Investment Funds Institute of Canada.

comparison, the Canada Pension Plan, Canada's largest institutional investor, operated in 2011-12 with direct management expenses equal to 0.85 per cent of average assets, and 1.30 per cent when including costs incurred by the government of Canada to collect revenues and remit payments.<sup>40</sup> Even when accounting for the differences in asset allocation across different asset classes, large institutional investors such as the Canada Pension Plan Investment Board (CPPIB) consistently operate more efficiently.

Over the last decade Canadian investors have benefited from significantly greater choice and competition across different product offerings within the private savings market, some of which (e.g. ETFs) now offer much lower fees than traditional mutual funds, and are even cheaper than the CPP/QPP.<sup>41</sup> In spite of these changes, MERs in Canadian mutual funds remain largely the same today as in 2006<sup>42</sup> while new fund flows continue to prefer higher-cost products.<sup>43</sup>

40 Cross, P. (2014). *Accounting for the True Cost of the Canada Pension Plan*. Fraser Research Bulletin, Centre for Fiscal Studies (September 2014). Vancouver: Fraser Institute.

41 It is important to emphasize, however, that CPPIB and other large pension funds invest in a number of asset classes not easily accessible within traditional financial markets and for which a simple index fund is either not available or not sufficiently diversified in order to operate like a traditional passive investment. In some cases this strategy will impose higher operating costs, but also affords the potential (it is argued) for greater diversification within the overall portfolio.

42 Figure 20, *Investor Economics* (2012), supra note 45.

43 In 2014, Canadian mutual funds reported net sales of \$57.6 billion, equivalent to more than three-quarters of the entire ETF assets in Canada. See: IFIC. (2015). *IFIC Industry Overview: December 2014 (Revised)*. Toronto: Investment Funds Institute of Canada. < <https://www.ific.ca/wp-content/uploads/2015/01/2014-12-Industry-Overview.pdf/9611/>>; and CETFA. (2015). *CETFA Monthly Report: December 2014*. Toronto: Canadian Exchange Traded Funds Association. < [>](http://www.cetfa.ca/files/1421167116_CETFA%20Dec%202014.pdf).

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## DRIVERS OF CHANGE

Overall, Canada's RIS has performed adequately in recent decades to support what is generally a comfortable retirement experience for most Canadians. Indeed, today's generation of retirees enjoys a retirement that is less vulnerable to poverty, and provides a standard of living more consistent with prior working life than in the past. That Canada has accomplished this all while committing relatively little in the way of public expenditures to old-age income transfers is a major achievement of public policy. It is also, as Schirle notes, a testament to how significantly education and income prospects have improved through each succeeding generation of workers as they prepared for their own retirement.<sup>44</sup>

While this is undeniably the picture for most retirees today, the question is open as to whether the future will be as secure for subsequent cohorts. A number of factors make this a salient policy question:

### INCREASING LONGEVITY RISK

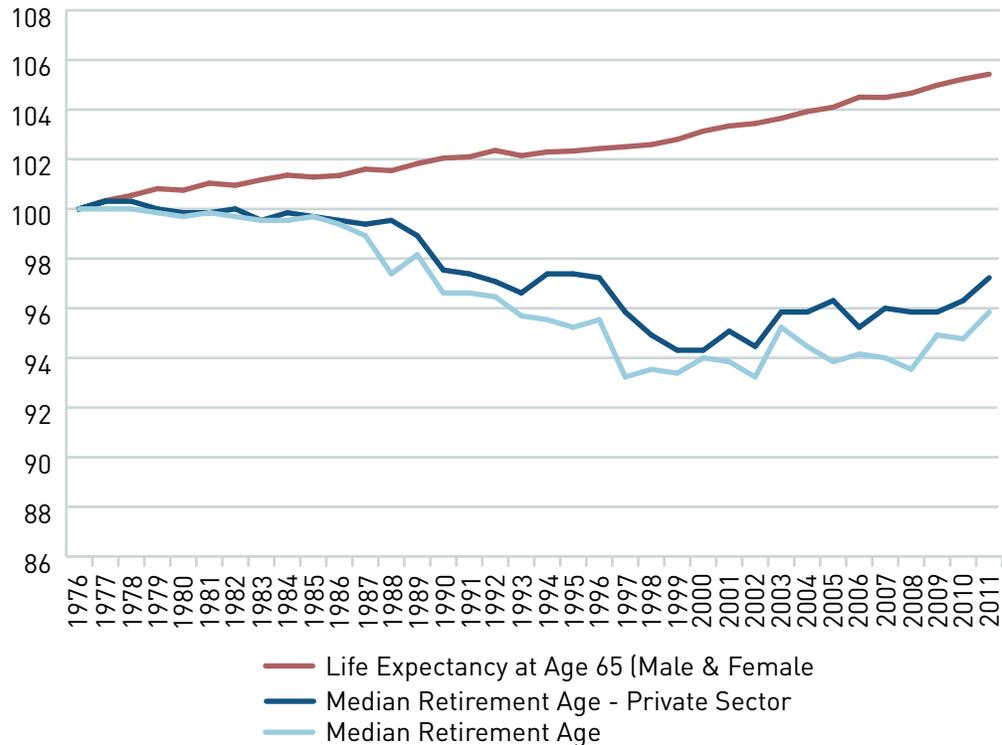
In 1976, not long after Canada's RIS was implemented in its modern form, the typical Canadian retired at the age of 65, having worked approximately 45 years. This retiree would be expected to live for another 16.5 years. By 2011, the median retirement age had dropped to 62.3 years, while the life expectancy of a 65 year-old had increased to 20.5 years (figure 3). Moreover, due to increases in the average education level of successive cohorts, the median retiree in 2011 was not only living longer and retiring earlier, but they were also working fewer years than in the past.<sup>45</sup>

With fewer working years in which to accumulate capital, and a longer period of time over which capital will be required, investors face a multi-dimensional challenge to dealing with longevity. If retirement patterns cannot keep up with improvements in health and technology that are prolonging life, then all things being equal a greater savings burden will shift on to the period of working life. Such a phenomenon will inevitably require individuals to increase savings and contributions rates, or face a reduction in the relative value of retirement benefits over time.

<sup>44</sup> Schirle, *supra* note 31.

<sup>45</sup> Expert Committee on the Future of the Quebec Retirement System. (2013). *Innovating for a Sustainable Retirement System: A Social Contract to Strengthen the Financial Security of All Quebec Workers*. Summary Report. Montreal: Régie des Rentes du Québec.

FIGURE 3: CHANGES IN RETIREMENT AND LIFE EXPECTANCY, 1976-2011 (1976 = 100)



Source: Meredith (2014)<sup>46</sup>

## CAN RETIREMENT PATTERNS IMPROVE?

In several important respects, they are already. Though the median retirement age is still lower today than forty years ago, there has also been a slow but important reversal in the trend toward ever-earlier retirement. Beginning in the early 2000s retirement patterns shifted progressively as new cohorts decided to work later in life. While this has not been sufficient to offset gains in longevity, it has eased some of the growing pressure on the RIS. An important side-effect, as Peter Hicks has noted, is that this reversal in trend has also complicated traditional lifecourse pathways as some individuals prefer to take a staged retirement, or even return to work in older age after a break in their primary career.<sup>47</sup>

Just as the psychological milestone of age 65 has begun to change in many different realms of society, greater heterogeneity in lifecourse pathways has introduced new complexity that did not exist when the RIS was put in place fifty

46 Meredith, T. (2014). "Breaking the Political Taboo over Longer Life Expectancy". 11 November, 2014. *Policy Options Blog*. <<http://policyoptions.irpp.org/fr/2014/11/11/breaking-the-political-taboo-over-longer-life-expectancy/>>. Accessed 4 March, 2015.

47 Hicks, P. (2015). *The Enabling Society*. IRPP Policy Horizons Essay. Montreal: Institute for Research on Public Policy.

years ago. For those who continue to follow a linear pathway into retirement at or before age 65, and for those who are unable to work longer — the adequacy of retirement will be challenged by longevity risks. For those who can and do prefer to work longer, the outlook is more nuanced.

Going forward, governments will need to reconsider whether a standard eligibility age is appropriate for public entitlement programs such as GIS/OAS and whether there are additional reforms within pillar 2 or pillar 3 of the RIS that can help savers better address the risk of outliving savings in retirement.

## DECLINING PENSION COVERAGE AND PENSION QUALITY

As noted earlier, access to a workplace pension represents an important determinant in how one's retirement experience will unfold: when one is likely to retire, how 'secure' the sources of retirement income are likely to be, and how easily and effectively someone is able to put aside the capital in order to retire when they want. To the extent that the 'unpensioned' face elevated risks and difficulties in saving adequately for their retirement, approximately 62 per cent of working Canadians fall into this category today, up from 54 per cent in 1976. This number masks a lot of variation below the surface. In the private sector, and among those who work in small business, participation in a formal pension plan is almost non-existent today (figure 4).

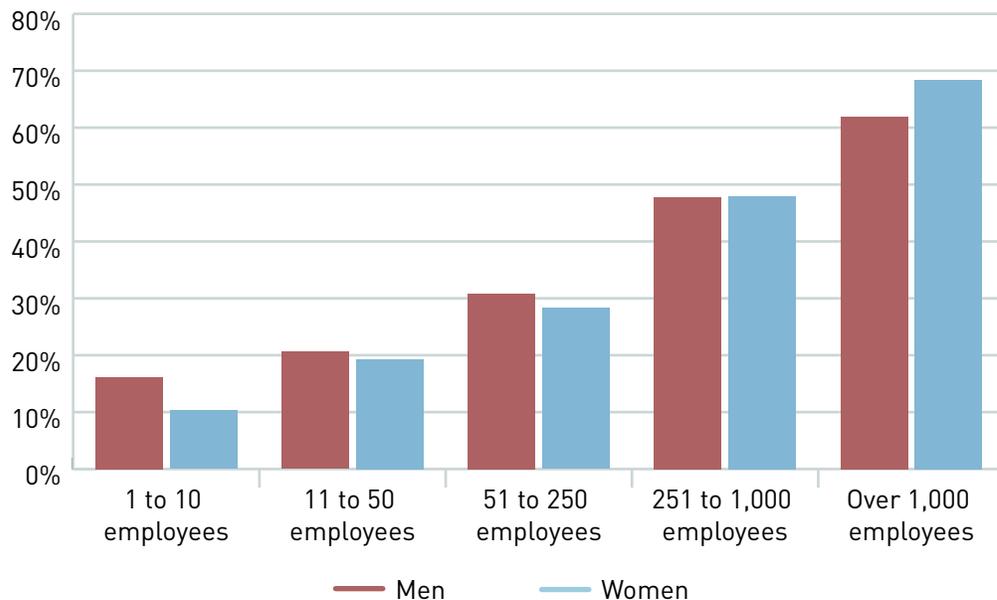
The decline in pension coverage throughout the labour market has not, of course, been uniform. Although total coverage among all workers has declined, the rising employment participation of women over the last two decades has somewhat insulated the labour market against these declines at the household level. Among couples, Schirle estimates that the proportion of households with at least one member enrolled in a registered pension plan rose from 51 per cent in 1991 to 55 per cent by 2010. This was entirely a result of higher RPP membership among women.<sup>48</sup>

Encouraging as this is (particularly considering that spouses often make joint decisions about savings and retirement), the decline of pension coverage among all workers remains a concern. In noting that the gains in female employment over the last two decades have been particularly strong in areas of the labour market with high rates of pension coverage (e.g. public and broader-public sectors)<sup>49</sup>, there are broader questions to be raised here about the role of pensions within the social and employment contract.

48 Schirle, T. (2015). "The demise of the male breadwinner, and his pension". *Policy Options Blog*. 29 June, 2015. <<http://policyoptions.irpp.org/2015/06/29/the-demise-of-the-male-breadwinner-and-his-pension/>>. Accessed 29 June, 2015.

49 Indeed, in 2013, approximately 2/3rds of women participating in a registered pension plan were members of a public-sector plan, compares to about 38 per cent among men. (CANSIM 280-0011).

FIGURE 4: PRIVATE-SECTOR PENSION COVERAGE BY GENDER AND SIZE OF FIRM, 2011



Source: Adapted from Drolet and Morissette (2014): Table 5.<sup>50</sup>

At the same time there has also been a deterioration of pension quality. Among those who are members of a pension plan there has been a noticeable increase in the prevalence of DC pension plans as many large firms have sought to convert DB plans and remove long-term pension liabilities from their balance sheets. Though DB plans remain the most common form of pension by total number of members, this statement needs to be carefully understood. In the process of converting to DC plans many companies have grandfathered previously accrued benefits and their respective members into separate DB plans, which although in operation are no longer actively accepting new members or building new benefits.<sup>51</sup> Someone joining an employer today would likely be enrolled in a DC or a group RRSP plan, if such benefits exist at all.

Almost all the decline in pension coverage and pension quality has taken place in the private sector, the consequence of both a change in employer practices

50 Drolet, M. and Morissette, R. (2014). "New Facts on Pension Coverage in Canada". *Insights on Canadian Society*. (December 2014). Statistics Canada catalogue, no. 75-006-X. P. 1-9.

51 Though the exact proportion of plans open and closed to new members is not easily tracked, one recent survey of 139 pension plan sponsors in Canada (representing 2 million pension members) suggested that 75 per cent of DB plans offered by publicly traded companies are already closed to new members, and 15 per cent of those still open are actively considering freezing or closing their plan. See: Aon Hewit. (2013). *2013 Global Pension Risk Survey – Highlights: Canada Findings*. Toronto: Aon Hewit. <[http://www.aon.com/canada/attachments/thought-leadership/report\\_Global\\_Pension\\_Risk\\_Survey\\_2013\\_EN\\_highlights.pdf](http://www.aon.com/canada/attachments/thought-leadership/report_Global_Pension_Risk_Survey_2013_EN_highlights.pdf)>.

toward lower-cost benefits<sup>52</sup> and, to a lesser extent, growth in industries where pension benefits have not been the historical norm. These trends have collectively resulted in a major transfer of risk back on to individual workers.

## ARE CANADIANS SAVING ENOUGH?

Future income adequacy depends largely on two factors: how much is being contributed over time to savings, and, in turn, the net, tax-adjusted performance of those assets.<sup>53</sup> Because of these interacting factors, there is no easy formula to determine whether a saver, at a given age, in a given period of time, will be successful or not in reaching their retirement goals. Much will depend on market performance and how people adjust to these and future considerations about the retirement they envision.

With these considerations in mind, what can be said about the kind of environment that future cohorts of retirees — today's workers — are facing as they prepare for retirement?

Overall, the share of earnings contributed for retirement has increased somewhat since the mid-1990s. In a recent paper, Hamilton estimates that total contributions to personal and employer-based retirement savings nearly doubled between 1990 and 2012, rising from 7.7 per cent of earnings to 14.1 per cent (not including CPP/QPP).<sup>54</sup> A lot of what has driven this increase, however, comes from contributions to workplace pension plans (figure 5), flows that include special payments intended to cover unfunded liabilities in a DB pension. In 2012, such solvency funding constituted 1.5 per cent of total earnings in the Canadian economy.

These are not immaterial considerations. Over the past two decades the decline in interest rates and increase in financial market volatility have undoubtedly challenged the ability of all investors to efficiently accumulate capital. Indeed, as Hamilton notes, the yearly return on retirement assets dropped considerably during this time, falling from an average of 9.0 per cent in 1990 to 3.6 per cent in 2012.<sup>55</sup> In this sense, everyone has had to pay more for their retirement benefits.

It is important to note that figure 5 only includes special payments made with respect to DB pensions. Supplementary contributions individuals may make to a DC pension or personal RRSP to offset losses in financial markets are not captured by Statistics Canada, but would also be significant. In this context, the fact that personal contributions to retirement savings did not materially increase over this period when workplace pension coverage also declined is worrying.

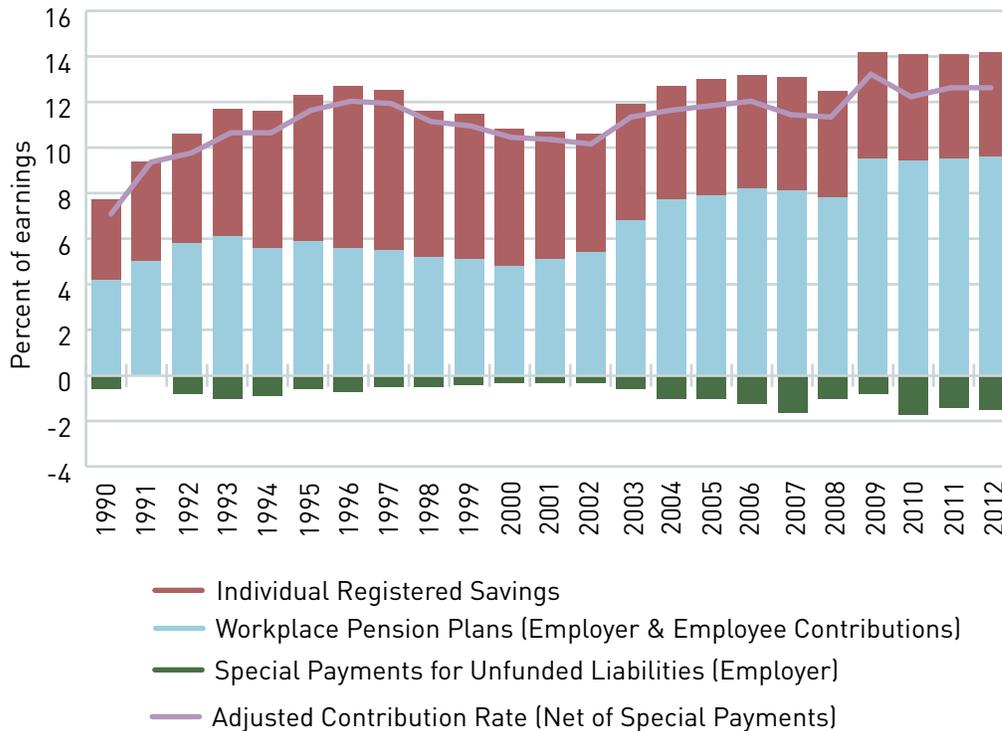
52 Gougeon, P. (2009). "Shifting Pensions". *Perspectives* (May 2009). Statistics Canada Catalogue no. 75-001-X. p. 16-23.

53 Cost will affect net performance.

54 Hamilton, supra note 3.

55 Ibid.

FIGURE 5: CONTRIBUTIONS TO RETIREMENT SAVINGS OUTSIDE OF CPP/QPP, 1990-2012



Source: calculations by author, Hamilton, and CANSIM 280-0026.

Some analysts have argued the stagnancy of personal contributions to retirement savings is offset, at least partially, by the substantial increase in housing equity that Canadian households have experienced since the 1990s. Whether housing and other “durable” assets are an effective substitute for retirement savings is open to significant debate.<sup>56</sup> To the extent real estate is used as such, the significantly illiquid nature of this form of capital and its potential sensitivity to shocks in valuation and borrowing terms are major risks that must be accounted for in retirement preparation. This may not be fully appreciated by Canadians.

Taken together, what do these various trends suggest about the kind of retirement realities that future cohorts are likely to experience?

Separate projections by the former Assistant Chief Statistician of Canada, Michael Wolfson, and management consulting firm McKinsey, suggest that a certain portion of today’s mid-career working population are likely to see a drop in consumption possibilities upon retirement. Though these two sources vary in terms of the magnitude of drop forecast, both suggest that much of the future

<sup>56</sup> For arguments in favour of housing wealth and other forms of equity being used to fund retirement see: Lee, I. and Jog, V. (2013). “No Pension Crisis: Canadians have \$7.1 trillion in net worth savings”. *Financial Post*. May 14, 2013. <<http://business.financialpost.com/2013/05/14/no-pension-savings-crisis/>>.

challenges of retirement income adequacy will be concentrated among middle- and upper-income groups.

If nothing is done, Wolfson's work estimates that approximately half of middle-income workers between the ages of 45 and 60 today will see a drop in living standards of 25 per cent or more as they transition between work and retirement (figure 6). Since his calculations automatically adjust for changes in expenditure needs and taxation as people age and withdraw from the labour market (including housing), this drop represents a real decline in the effective consumption available to future retirees.<sup>57</sup>

FIGURE 6: PROJECTED SHARE OF BIRTH COHORTS WHOSE POST-RETIREMENT CONSUMPTION WILL DROP BY 25 PER CENT OR MORE COMPARED TO PRE-RETIREMENT, BY AVERAGE ANNUAL LIFETIME EARNINGS



Source: Wolfson (2013)<sup>58</sup>.

McKinsey's analysis indicates that approximately one quarter of middle- and high-income households still in the labour force today are not sufficiently prepared for retirement based on their asset and age profile. They define this group based on those who would not achieve a net income replacement of 65 per cent upon

57 For more detail on the calculations made by Wolfson, see MacDonald and Moore (2011), supra note 1.

58 Wolfson, M. (2013). *Not-So-Modest Options for Expanding the CPP/QPP*. IRPP Study, no. 41 (July 2013). Montreal: Institute for Research on Public Policy.

retirement.<sup>59</sup> If adjusted to the 75 per cent target used by Wolfson, the share of middle-income Canadians under-saving rises to one-third.<sup>60</sup>

Some will argue with the choice of setting the target income replacement threshold at either 65 or 75 per cent. While some Canadians would certainly find this level of absolute income acceptable, the important thing to underline here is that both are based on net rather than gross replacement concepts. In either case, the drop in consumption possibilities would be quite substantial compared to the period of working life. A policy target of at least 75 per cent net income replacement is likely more reasonable (see Box 1).

Of the middle-income group of under-savers examined in both papers, the vast majority either participates in a pension plan with relatively low contribution rates or has no pension plan at all and is not saving enough on their own. These figures continue to demonstrate the significance of participation in a pension plan, particularly one with high-quality benefits, for enhancing a household's preparedness for retirement.

It is difficult to reconcile the somewhat different estimates of Wolfson and McKinsey, since the latter provides only very general information regarding the specific methodology and calculations used. One important difference may relate to McKinsey's apparent use of self-reported information about income and wealth.<sup>61</sup> This is important as respondents may not fully understand their precise earnings history or net worth, and could potentially underestimate current consumption, while overestimating existing assets.

If the estimates of Wolfson and McKinsey are to suggest a problem that is, at best, confined to one third, and at worst (and more likely) closer to one half of middle- and upper-income earners today, either scenario would result in a significant deterioration from the norm of prior cohorts of retirees. Considering that about 80 per cent of current retirees in the middle-income category achieve adequate income replacement, the more conservative estimate of McKinsey would still imply a 65 per cent increase in the proportion of future retirees who under-save.<sup>62</sup> This is not an issue to be easily dismissed.

## **“NEW NORMAL” OF LOW-RETURNS?**

Another factor contributing to a potentially worsening outlook for the RIS is the state of financial markets in recent years. While declines in output are inevitable over the course of a business cycle, the source of the 2008-09 recession

59 McKinsey and Company. (2015). *Building on Canada's Strong Retirement Readiness*. Montreal: McKinsey.

60 Unpublished estimates performed by McKinsey for Michael Wolfson. See: Wolfson, M. (2015). *What, Me Worry? Income Risks for Retiring Canadians*. Toronto: Canadian Centre for Policy Alternatives.

61 Ibid.

62 33 per cent / 20 per cent.

and its aftermath have raised important questions about whether the long-run trajectory of economic growth and the return on assets is changing.

For one, recessions induced by crises in the financial sector, as occurred in 2008–09, tend to result in much slower growth post-recovery than is the case with other downturns.<sup>63</sup> This is arguably what we see today, seven years later. In much of the developed world economic growth is anemic. Though equity markets have performed robustly in recent years much of this has come at the expense of real interest rates, which continue to sit at or near zero-per cent in many countries (in some, even negative) because of slow job and output growth. This has left savers, both individuals and major institutional investors alike, with a difficult choice: either take on greater risk (in the form of greater exposure to equities) or accept substantially lower yields.

How permanent this period of low-growth and low-interest rates will be is unclear, although the probability is slim that global demand will accelerate significantly in the next two or three years.<sup>64</sup> The longer this situation persists, the more significant adjustment that will be required on the part individual workers as they prepare for retirement. Since younger workers have a much longer time to plan for these considerations, much of this impact is likely to be felt by near-retirees who have far fewer years over which to increase saving or extend working-life.

How large and significant this effect could be on future retirement adequacy is addressed in a recent paper by Dalhousie University economists Bonnie-Jean Macdonald and Lars Osberg. Assuming a continuation of current retirement patterns they estimate the vast majority of Canadians aged 49 to 64 today would experience a drop in income available upon retirement of between 12 and 25 per cent if, over the course of the next decade and a half, portfolio returns remain at the level seen in 2012 (approximately 3 per cent annual return between stocks and bonds).<sup>65 66</sup> Notably for governments, this decline is measured in aggregate income — and includes a 6 per cent projected increase among middle- and upper-income individuals in the amount of income drawn from OAS and GIS transfers as a result of the inadequacy in private savings.

While market shocks and low returns inevitably affect all investors (and pension plans will have significant implications in terms of the smoothing of long-term liabilities), investment risk can be harder to absorb for the

63 Reinhart, C. and Kenneth Rogoff. (2009). *This Time is Different: Eight Centuries of Financial Folly*. Princeton: Princeton University Press.

64 International Monetary Fund. (2015). “World Economic Outlook Update: Cross Currents”. January 20, 2015. <<https://www.imf.org/external/pubs/ft/weo/2015/update/01/pdf/0115.pdf>>.

65 See Table 7a in: MacDonald, B-J. and Lars Osberg. (2014). “Canadian Retirement Income: How Much Do Financial Market Returns Matter?” *Canadian Public Policy*. Vol. 40, No. 4 (December 2014). P.315-338.

66 This range of estimates covers different groups above the 36<sup>th</sup> percentile.

individual investor. Unlike a larger investor, the individual saver may not have the specialist knowledge to craft an investment strategy over a multi-decade horizon, cannot easily access “uncorrelated” investments to help diversify and reduce risk, and may be prone to making poor decisions when shocks occur.<sup>67</sup>

## WHERE THE RIS IS HEADED

The RIS is in a much different place today than when major component programs like OAS/GIS and CPP/QPP were developed five decades ago.

While there has been a remarkable improvement in the standard of living of many retirees thanks to these earlier policy reforms, a number of structural changes in recent years are beginning to undo this progress. Though many Canadians working today remain generally well placed to enjoy a comfortable retirement, the risks involved in retirement planning are much more significant than in earlier times. Individuals are more exposed to longevity and investment risks, at the same time as they are more responsible for their own retirement saving. With simultaneous declines in the propensity to save in traditional retirement assets, the RIS is under stress.

Although the proportion of future retirees forecast to be in danger of experiencing a drop in their standard of living upon retirement is primarily limited to a cross-section of middle- and upper-income earners, the challenge to government is still daunting. Given the demographic bulge of retirees just on the horizon, even a small drop in consumption possibilities among this group poses a major challenge to future economic growth.

As noted recently by former Bank of Canada Governor David Dodge and his co-author Richard Dion, in a major report for the Ontario government on the macro-economic implications of retirement saving, “unless the economy generates higher labour productivity growth than is currently projected, governments in the future will be under great pressure to tax an almost static population of workers to support transfers to a very fast growing population of elderly.”<sup>68</sup> If individuals are unable to properly prepare for their own retirement before they reach old age, the risk of having inadequate private savings becomes a collective one. Ensuring Canadians are better prepared for retirement in advance is thus a pressing challenge both for macro as well as fiscal policy.

67 For a summary of research on the behaviour of individual investors see: Barber, B. and Odean, T. (2011). “The Behaviour of Individual Investors”. Working Paper. <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1872211](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1872211)>.

68 Dodge, D. and Dion, R. (2014). *Macroeconomic Aspects of Retirement Savings*. Toronto: Bennett Jones., p. 1.

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## POLICY OPTIONS

The challenges facing Canadians in saving for retirement are not isolated to one issue or one group; indeed, they are multiple and overlapping.

Whether it is income adequacy, longevity, pension coverage, costs or financial literacy, the common theme throughout each is risk and how it is managed. As such, the policy challenge facing the RIS today is not so much about increasing savings to a particular optimal level, but about how the system as a whole can better assist Canadians to manage and reduce the risks they are exposed to in saving and planning for retirement.

What this calls for is a much broader discussion about retirement preparation than we have seen in recent years. While the recent debate over whether retirement savings should be enhanced as part of reforms in either pillar 2 (i.e. bigger CPP/QPP) or pillar 3 (a voluntary savings vehicle) is an important one, it avoids the bigger vision. To help strengthen both the capacity to save and the resilience of savings, proactive policy changes are needed in every area of the RIS.

### HELPING SINGLES

Though seniors poverty is no longer the major social phenomenon it once was, poverty rates remain quite high among the unattached. And for those who do not fall directly into poverty, the unattached are also disproportionately represented among the population of under-savers — people most at risk of a substantial decline in their standard of living upon retirement.

By far the most significant way to reduce senior poverty, particularly among singles, is to raise pre-retirement earnings and education.<sup>69</sup> While governments should continue to look to investments in training and education with an eye to the life-course dividends it will eventually pay, we cannot rely exclusively on these levers to help current or future retirees avoid poverty. We must also look to how income supports are designed.

<sup>69</sup> Schirle, *supra* note 31.

As noted earlier, it is important for policymakers to distinguish between the needs of people who naturally become single later in life due to the death of a spouse, and individuals who were single prior to retirement and may have had a more difficult time saving. While there are undoubtedly improvements that could be made to CPP/QPP to help smooth consumption for widows, a broader question that should be examined is whether the risk of poverty and under-saving among the unattached elderly is better addressed as part of changes to OAS/GIS than in occupational pensions.

In recent years, successive federal governments have enhanced the GIS in order to provide greater support to low-income Canadians, both singles and couples. Enhancements to the GIS do help bolster income support to those most at risk of poverty, but it should also be remembered that many seniors sit just at or above the LICO threshold.

To achieve greater equity between households, policymakers should consider reforms of two kinds. The first would be to enhance the top-up within GIS to help bring the lowest-income singles closer to the LICO poverty threshold. This would ensure GIS provides a similar level of support to singles in avoiding poverty as it does for families.

The second, and arguably bolder step, would involve extending the top-up for singles partway into the income categories covered exclusively by OAS (above \$17,123 for single non-widows). This would ensure that seniors who have just enough income to no longer qualify for GIS also receive an OAS benefit that at least partially reflects the additional expenditure burden they face as a single-person household. In practice, this would mean ending the notion of OAS as a uniform benefit agnostic to marital status.

Both top-up measures need to be carefully designed in order to avoid perverse incentives regarding family formation and household taxation. The associated fiscal cost of providing such top-ups could be recouped as part of a broader effort to reduce the already very high income thresholds at which OAS applies.

## **ENCOURAGING LATER RETIREMENT AND LONGEVITY DE-RISKING**

A retiree turning 65 today is expected to live until about age 85, with a one in four chance of surviving as late as age 91. As these gains in life expectancy continue, a young worker aged 25 today should expect to live an additional four years longer once they reach retirement.<sup>70</sup>

<sup>70</sup> Gains in life expectancy at age 65 have progressed at a rate of approximately 1 year per decade since the late 1970s.

To deal with increased longevity risk, workers have essentially three choices: work longer, save more or annuitize their savings so that they are guaranteed a predictable stream of income over the course retirement.

While Canadians are already beginning to stay in the labour force longer, the public policy response has been slow and haphazard. Over the last decade, various actuarial incentives have been introduced within CPP/QPP in order to encourage later retirement. These have had some success in supporting the trend toward later retirement we are now beginning to see.<sup>71</sup> It is important to note, however, that the normal pensionable age within CPP/QPP (which is in turn integrated with many private-sector pensions) has remained fixed at 65. In 2012, the federal government introduced changes to gradually increase the age of eligibility for OAS/GIS by two years, from age 65 to age 67, between 2023 and 2030.<sup>72</sup> As much as there is a need to ensure benefit eligibility reflects current realities about retirement and life expectancy, the decision to solely adjust OAS/GIS without a related change in the pensionable age within CPP/QPP is puzzling. This rather perverse outcome would unfairly penalize many low and modest income workers who are unable to continue working later in life due to poorer health.<sup>73</sup>

What is needed is a more comprehensive approach that looks at the standard pensionable age across the various different components of the RIS, including private pensions, CPP/QPP, OAS/GIS and even the conversion parameters for RRSPs and RRIFs. One factor to consider is the need to arrive at a more predictable mechanism for adjusting pension entitlements to rising life expectancy. Announcing one-off changes in pensionable ages every few years exposes the RIS to significant political risk and introduces uncertainty for individuals as they plan for retirement over the course of working life. Instead, policymakers should consider a method of automatic adjustment so that pension eligibility moves in line with long-run improvements in life expectancy. Once implemented this would remove the need for recurring political battles, while providing an important signal to workers as to the longevity risk that should be incorporated into their own retirement planning.

At the same time, governments can also move to more aggressively promote policies that help to better smooth the de-accumulation of retirement assets. Recent changes announced in this year's federal budget, for example, reduce the minimum portion of funds that must be withdrawn from RRIF accounts each

71 Laurin, A., Schirle, T. and Milligan, K. (2012). *Comparing Nest Eggs: How CPP Reform Affects Retirement Choices*. CD Howe Commentary No. 352. Toronto: CD Howe Institute.

72 Estimated to save approximately \$7 billion a year once fully implemented. See: Clavet, N-J, Duclos, J.Y., Fortin, B., and Marchand, S. (2014). "Reforming Old Age Security: Effects and Alternatives". Working Paper. Industrial Alliance Research Chair on the Economics of Demographic Change. Quebec: Laval University. < [https://www.cedia.ca/sites/cedia.ca/files/reforming\\_old\\_age\\_security\\_14-10.pdf](https://www.cedia.ca/sites/cedia.ca/files/reforming_old_age_security_14-10.pdf)>

73 Clavet et al, estimate the senior's poverty rate will increase from 7 to 12 per cent during the two years in which OAS/GIS eligibility is delayed.

year, allowing retirees to keep more of their retirement funds longer. These are positive steps forward. Efforts to promote greater access to annuity options within group RRSPs and self-directed plans would also help individuals remove the risk of managing de-accumulation and longevity. This should wait until interest rates normalize and annuities become more affordable.

## A GRAND BARGAIN TO ENHANCE PENSION COVERAGE

How to fix the growing gap in pension coverage within the labour market is perhaps the most hotly debated policy issue facing the RIS today. This debate comes down primarily to two inter-connected issues: how broadly additional coverage should be targeted (i.e. either: all Canadians, just those who do not currently participate in a registered pension plan, or a specific income group); and whether participation should be compulsory or voluntary.

As evidenced by the vast body of research presented in this paper those most at risk of inadequate savings are primarily those who do not participate in a private occupational pension already and, to a lesser extent, those who are single. The latter has already been discussed at length. Clearly there remains a need to fill structural gaps in the labour market with broader access to a formal occupational pension plan.

Over the last several years the federal government has introduced a number of measures to increase voluntary, tax-preferred retirement savings, including Tax-Free Savings Accounts (TFSA) and Pooled Registered Pension Plans (PRPP). In recent weeks, the federal Finance Minister has also announced consultations to consider allowing Canadians to make voluntary, supplementary contributions to the CPP.<sup>74</sup>

While the TFSA and PRPP are each conceptually interesting — the TFSA, for example, is well suited for low-income Canadians — by design and implementation neither effectively addresses the underlying problems facing the RIS today. To date participation in TFSAs, and the recently announced enhancement of contribution limits, has disproportionately favoured higher income and wealthier families at a substantial cost to government revenues.<sup>75</sup> PRPPs, at least as designed in the federal enabling legislation, simply replicates options already available to employers through group RRSPs, with the sole benefit being potentially lower-cost as a result of asset pooling.<sup>76</sup>

For decades governments have continued to push further and further on voluntary measures in the hope that Canadians would somehow save more.

74 Curry, B. and Chase, S. (2015). "Tories propose voluntary expansion of the Canada Pension Plan". *The Globe and Mail*. 27 May, 2015. <<http://www.theglobeandmail.com/report-on-business/conservatives-propose-voluntary-canada-pension-plan-expansion/article24621263/>>

75 Kesselman, R. (2015). *Behind the Headlines: Who's Really Benefiting from Higher TFSA Limits?* Toronto: Broadbent Institute.

76 Brown and Meredith, supra note 15.

Judged at least on the basis of contributions to personal savings vehicles this has not been particularly successful. Even TFSAs, which have seen a fairly wide take-up, still boast relatively low median balances among modest and middle-income Canadians, particularly those who are still working.<sup>77</sup> This is partly because contributions have been small among many groups, while withdrawals have been fairly robust, consistent with its much broader application for saving rather than simply retirement preparation.

If the goal is to enhance retirement-related savings in a meaningful way then perhaps it is now time to try something different: mandatory saving.

Among the counter-arguments to mandatory retirement saving are two concerns:

- The potential to crowd-out additional private savings as Canadians substitute registered and non-registered investments for pension wealth.
- The effect that additional employer contributions would have on an already expensive labour cost structure.<sup>78</sup>

The potential substitution of savings is indeed an important consideration for policy design. Looking at Canada's experience during the 1990s when CPP/QPP contributions were substantially increased (with no net increase in pension benefits), Derek Messacar estimates that each additional \$1 contributed to CPP/QPP reduced investments in private savings by approximately \$0.50.<sup>79</sup> If we assume that any increase in contribution rates associated with increased benefits would behave similarly, the implication is that net savings would have increased \$0.50 per dollar contributed to CPP/QPP. Messacar's findings are consistent with other international research showing that substitution effects are usually small when increased saving is mandatory. In this sense, the crowd-out effect, while present to some extent, is mostly overstated.<sup>80</sup>

<sup>77</sup> Kesselman, *supra* note 83.

<sup>78</sup> Ontario Chamber of Commerce. (2015). "Getting It Right: The Business Perspective on the Undersaving Challenge in Ontario". Submission to the Ministry of Finance on the proposed Ontario Retirement Pension Plan. Toronto: Ontario Chamber of Commerce.

<sup>79</sup> Messacar, D. (Forthcoming). *Do Workplace Pensions Crowd out other Retirement Savings? Evidence from Canadian Tax Records*. Analytical Studies Branch Research Paper Series. Ottawa: Statistics Canada

<sup>80</sup> In a recent paper, Vaillancourt et al. suggest, based on an econometric analysis of prior increases in CPP contribution rates that the substitution effect could be as high as 0.90. While potentially valid given their model, this number is misleading. It includes the mid-point estimate across savers in all income categories, including low-income groups who quite rationally should reduce their voluntary savings because 1) they have limited disposable income and 2) already experience high levels of income replacement from existing OAS/GIS and CPP/QPP benefits. Looking specifically at mid- and high-income savers—the key target group of most proposals for increased mandatory saving—their estimates broadly conform with Messacar's findings. Indeed, to quote the paper: "The exceptions are in the lowest income group, where estimates are large and confidence intervals are relatively wide, and the highest income group, where confidence intervals do not rule out zero substitution." The authors also do not cite Messacar's work. See: Vaillancourt, F. et al. (2015). *Compulsory Government Pensions vs. Private Savings: The Effect of Previous Expansion to the Canada Pension Plan*. Vancouver: Fraser Institute.

As for the impact on business competitiveness, it is worth noting that pension contributions are often treated as a form of deferred compensation to employees. To the extent that employers provide this benefit to employees, contributions are often withdrawn from future wage gains, leaving total effective compensation relatively unchanged.<sup>81</sup> This is not to dismiss the concerns about unit labour costs, but simply to suggest that employers can adjust to these pressures differently than would be true of most other payroll taxes.

Assuming, therefore, the path forward should involve some form of mandatory enhancement in pension coverage, how should it be designed? In the absence of a constitutionally sufficient majority to enhance the CPP/QPP at this time, several provinces have pursued alternatives in their own jurisdiction.

Ontario is currently in the midst of developing a provincial supplementary pension to the CPP/QPP that would be mandatory for all workers who do not currently participate in a DB pension plan. Under the proposed plan, firms and employees covered by the pension would be required to each contribute 1.9 per cent of earnings (3.8 per cent total) up to \$90,000 per year. Whether coverage will start at the existing earnings exemption level of \$3,500 in CPP/QPP, or a higher level, is still under review.<sup>82</sup>

Quebec has taken a slightly more flexible approach as part of its own implementation of the federal Pooled Registered Pension Plan (PRPP) framework. Under Bill 39 all firms employing five or more workers will soon be required to enroll their employees in one of the Voluntary Registered Savings Plans (Quebec's name for PRPPs) authorized for sale by the Régie des Rentes. Employer contributions are optional, and firms whose employees are already enrolled in DB, DC or Group RRSP/TFSA plans are grandfathered under this obligation. Approximately 40 per cent of workers will be affected.<sup>83</sup> While employees retain the right to set contributions at zero, plans will be required to specify a default contribution rate and investment product so as to effectively nudge workers in the direction of greater saving.

Quebec's framework of mandatory coverage in either a formal occupational pension or a substitute private savings vehicle is similar, in principle, to the approach taken in the last two decades in Australia to create mandatory participation in a series of nationally regulated DC plans from which employees

81 Kesselman, R. (2013). "Ignore the 'Job-Killing' Mantra. It's Time to Expand CPP Benefits". *The Globe and Mail*. 8 November, 2013. <<http://www.theglobeandmail.com/globe-debate/ignore-the-job-killing-mantra-its-time-to-expand-cpp-benefits/article15345374/#dashboard/follows/>>.

82 Ontario Ministry of Finance. (2014). "Chapter IV: Strengthening Retirement Security in Ontario".

*Building Opportunity, Securing Our Future: Ontario Budget 2014*. Toronto: Government of Ontario. P. 295-318.

83 Meredith, T. and Brown, R. (2012). "Un Progres Enorme". March 28, 2012. *La Presse*. Accessed March 5, 2015. <<http://www.lapresse.ca/debats/votre-opinion/2012/03/27/01-4509946-un-progres-enorme.php>>.

choose.<sup>84</sup> While employer contributions are mandatory in the Australian model, the overall experience of mandatory private savings participation has been mixed. Savings and pension coverage have both increased substantially, but in spite of this consumers have not witnessed a substantial reduction in the costs associated with investing.<sup>85</sup> Of the VRSPs registered in Quebec to date it would appear the options available to consumers are indeed cheaper than traditional mutual funds, but could still go much farther to replicate the efficiency of ETFs or CPP/QPP.<sup>86</sup>

For those worried about economic competitiveness, the model adopted by Quebec offers great promise. Though it may result in a lower-quality, higher-cost alternative compared to CPP, it minimizes the direct cost to employers. Some will counter that this largely replicates features of RRSPs. However, the fact that participation is mandatory and members are placed in basic, lower-cost default investments represents key improvements over the present realities of DIY investing. The individual choice that investors retain in deciding how their assets are allocated may even be desirable for some policymakers given the already significant size of CPP today and its constraint in designing individualized retirement accounts.

Ontario's proposal will provide higher-quality pension benefits compared to Quebec's VRSP but the transition cost of creating a new standalone pension plan will still be significant in the short term. It is possible that once the pension is eventually implemented in 2017 federal political interest in enhancing the CPP/QPP will eventually materialize so that the two initiatives can be merged. This is certainly the provincial government's hope.

In the interim, policymakers should think about the choice before them as a question of how best to balance several factors, including: individual choice, the risks and obligations that should be allocated to individual investors, and the potential quality and cost of retirements that will eventually be produced. Expanding Quebec's model of the VRSP to other provinces, or enhancing CPP/QPP can potentially lead to the same objective, but with different attributes and risks. In both cases careful design is warranted in order to properly identify those who are truly in need of greater retirement saving. What is needed is a more concerted effort toward mandatory saving.

84 Kirchner, S. (2013). "How Australia Reformed Its Fiscal System, Retirement System and Labour Laws". *Policy Reforms in Australia and What they Mean for Canada*. Vancouver: Fraser Institute, p. 1-36.

85 Ibid.; Sy, W. (2011). "Redesigning Choice and Competition in Australian Superannuation." *Rotman International Journal of Pension Management*. Vol.4, no. 1. P. 52-63.

86 MERs range from approximately 100 to 200 basis points depending on provider and asset class. See: Régie des Rentes. (2015). "VRSPs Registered with the Régie". N.d. <[http://www.rrq.gouv.qc.ca/en/retraite/rver/rver\\_enregistres/Pages/RVER\\_enregistres.aspx](http://www.rrq.gouv.qc.ca/en/retraite/rver/rver_enregistres/Pages/RVER_enregistres.aspx)> Accessed: 4 March, 2015.

For those interested in pursuing the option of CPP/QPP enhancements — arguably the simplest and relatively popular solution<sup>87</sup> — let me comment briefly on possible design.

Various proposals have been made regarding the range of earnings that should be covered, how much additional replacement is needed, and the parameters as to how an enhancement should be implemented. Since low-income earners already achieve high and sufficient earnings replacement from the combination of OAS/GIS and CPP/QPP, a properly targeted enhancement would exclude them in order to discourage over-saving.

A relatively simple yet effective approach would be to double the current yearly maximum pensionable earnings threshold within CPP/QPP so that all earnings up to 2x the average industrial wage are replaced at a rate of 25 per cent.<sup>88</sup> Additional replacement could potentially be justified, but this simple approach would go far in effectively targeting the income adequacy problem concentrated among middle- and upper-income households.

The implementation of any enhancement to CPP/QPP should be cognizant of how and when benefits accrue and the opportunity this presents to adapt benefit eligibility to trends in life expectancy. Under the current framework of the Canada Pension Plan Act any enhancement of benefits must be phased-in as new capital accumulates to meet payouts, a process that would take 40 years to complete. This is done in order to preserve a stable contribution-rate structure over time and, thus, preserve an equal value of benefits and contributions across generations of workers and retirees.

As Wolfson noted, the assumed phase-in of 40 years would likely be inadequate to avoid the impending drop in income available to the next wave of workers approaching retirement between 2015 and 2035.<sup>89</sup> To address this, he proposes a “grand bargain” in which a new tranche of benefits would be phased-in more rapidly (20 years) in exchange for raising the normal pensionable age on this new component of CPP/QPP. By his estimates an eligibility age of between 68 and 70 (up from 65) would be sufficient to implement a faster benefit enhancement while still maintaining a stable contribution structure over time.<sup>90</sup>

The virtue of this approach is obvious. Not only will it help better address the income adequacy problem facing the RIS, but it would also help to begin a

87 A recent Forum poll suggests that a clear majority of Canadians support enhancing CPP/QPP, recognizing the additional contributions this would impose on them: Vincent, D. (2015). “Majority of Canadians agree CPP contributions should rise, poll says”. *Toronto Star*. June 9, 2015. < <http://www.thestar.com/news/canada/2015/06/09/majority-of-canadians-agrees-cpp-contributions-should-rise-poll-says.html> >

88 Milligan, K and Schirle, T. (2014). *Simulated Replacement Rates for CPP and Reform Options*. SPP Research Papers. Vol. 7, No. 7 (March 2014). Calgary: University of Calgary, School of Public Policy.

89 Wolfson, supra note 65.

90 Ibid.

process of aligning the RIS with trends in longevity and life expectancy. Since the CPP/QPP is heavily integrated into all aspects of an individual's retirement planning, it would likely have a far more significant impact on helping encourage longer labour force attachment on the part of older workers than any change governments seek to make to OAS/GIS or adjustments in the underlying actuarial incentives toward later retirement. This should be seen as a major advantage.

In sum, whichever of these two paths policymakers pursue, an effective approach is one which addresses the problem of mandatory saving in ways that are creative and well targeted. These should be judged based on the key elements described in table 2.

TABLE 2: POLICY MATRIX FOR EVALUATING OPTIONS FOR PENSION ENHANCEMENT

	Policy Criteria	Assumptions/Guidance
<b>Participation</b>	Mandatory	May include auto-enrolment with option to opt-out
<b>Target group(s)</b>	Middle- and high-income workers	
	Those not currently a member of an occupation pension plan (DB or DC)	
<b>Contribution rate</b>	Default is set meaningfully high	Minimum 3 to 4 per cent (combined)
<b>Investment cost</b>	MER < 100 basis points	Sufficient regulatory oversight/directives to ensure competitive pricing
<b>Investment options</b>	If individuals are able to control asset allocation then default options must be simple and enable workers to easily track passive benchmarks	
<b>Withdrawal provisions</b>	Fully locked-in until retirement period	
<b>Retirement age</b>	>age 65 for new tranche of benefits	Not necessary in DC plan (e.g. VRSP)
<b>Phase-in</b>	Faster than standard 40 year provision (if through CPP/QPP or other DB plan)	Some ability to exchange later retirement for faster phase-in of benefits.
		Not possible in DC plan (e.g. VRSP)

## IMPROVING THE GOVERNANCE OF PENSION POLICY

Although scholars of intergovernmental relations often cite the CPP/QPP as a model for policy cooperation between federal and provincial governments,<sup>91</sup> the recent political impasse between Ottawa and various provinces interested in enhancing the pension plan illustrates that the current arrangement is far from perfect. Indeed, when considering that pension and retirement policy operate on a much longer planning horizon than do most other policy domains, the failure to achieve consensus is significant.

In the 1990s, provincial and federal Ministers of Finance were able to achieve a workable arrangement for policy reform by linking the assessment of the contribution structure with actuarial reviews conducted by the Chief Actuary. When, or if, the Chief Actuary reports that the current contribution structure is insufficient to support benefits over the next 75 years, this information triggers an automatic process of policy review. This underscores the value of a mutually-recognized independent authority providing information to help frame policy analysis.

In the context of the current debate over income adequacy, a key aspect of the political impasse has come in part from an inability to reconcile competing forecasts about the state of future retirees.<sup>92</sup> This difficulty with projection will likely get worse in coming years given the recent elimination of funding for Statistics Canada's LifePaths micro-simulation model.<sup>93</sup> The LifePaths model has been an integral component of evaluating the nature and distribution of future income adequacy, and has been widely used by analysts and policy-makers throughout this debate.

If policymakers are to effectively manage the RIS this recent experience suggests a need for the Chief Actuary to provide additional information to Finance Ministers above and beyond the scope of a standard actuarial valuation. Extending the responsibility and resources to the Chief Actuary to regularly assess income replacement trends and prospects could improve the capacity of the RIS to respond in a timely and effective manner as the retirement needs of Canadians change.

91 Wood, D. and Klassen, T. (2011). *Improving the Governance of Employment and Training Policy in Canada*. Mowat EI Task Force. Toronto: Mowat Centre.

92 Wolfson, supra note 67.

93 McFarland, J. "Statscan takes criticism for cutting funding to LifePaths database". *The Globe and Mail*. 14 July, 2015. <<http://www.theglobeandmail.com/report-on-business/statscan-takes-criticism-for-cutting-funding-to-lifepaths-database/article25487398/>>.

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## RECOMMENDATIONS

Working together, provincial and federal Ministers of Finance should:

1. Enhance OAS/GIS benefits for singles with the goal of providing a minimum benefit equal to the LICO poverty threshold.
2. Make efforts to ensure that eligibility for pension and retirement benefits better reflects long-run changes in longevity, and also includes mechanisms to assist those who cannot work longer. This should include:
  - a. Shifting the age of eligibility for OAS/GIS from a fixed year (65 / 67) to a formula that automatically adjusts over time in response to mortality trends.
  - b. Raising the normal pensionable age within CPP/QPP on any new benefits that are added as part of a mandatory enhancement and, in exchange, adopting a more rapid phase-in of benefits (20 years rather than 40).
  - c. Providing a bridge within OAS/GIS that allows individuals to begin their benefit several years earlier than the normal pensionable age, but on an actuarially-reduced basis. This would be similar to what is now available within CPP/QPP.
3. Introduce a coordinated plan of increased mandatory retirement savings specifically focused on individuals not currently members of a private workplace pension. This can be done either by:
  - a. Enhancing the CPP/QPP nationally. As noted in the paper, there are various ways in which such an enhancement could be implemented. This can be done simply by doubling the yearly maximum pensionable earnings threshold from \$53,600 (2015) to \$107,200. A slightly less ambitious, but more practical alternative would be to harmonize a national enhancement with the Ontario Retirement Pension Plan now being implemented. (As noted above, any enhancement of CPP/QPP should include a combination of accelerated phase-in and later eligibility for the new tranche of benefits.)

- b. Revamping the federal enabling structure of the Pooled Retirement Pension Plan, with the goal of implementing Quebec's Voluntary Retirement Savings Plan on a national basis. These standards would ensure that PRPP participation is mandatory in all workplaces not currently offering a registered pension plan, and that default contributions are set at a meaningful level.
4. Expand the mandate and resources of the Chief Actuary to report regularly to the Ministers of Finance on the state of income replacement for both current cohorts of retirees, and what is projected to be the case for future cohorts.

# LOWER RISK, HIGHER REWARD: RENEWING CANADA'S RETIREMENT INCOME SYSTEM

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## RENEWING CANADA'S SOCIAL ARCHITECTURE

Renewing Canada's Social Architecture is a collaborative project involving researchers from the Mowat Centre, the Caledon Institute for Social Policy, the Institute for Competitiveness and Prosperity and the Institute for Research on Public Policy. The purpose of the project is to advance public dialogue on our social architecture, and highlight areas where our core social programs and policies require modernization to meet Canadians' needs. Each report contributed to the project is the responsibility of the authors alone, and does not necessarily reflect the views of the other contributors or organizations.

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