Approaches to Strengthening Canada’s Retirement Income System

Keith Horner*

PRÉCIS
On considère que le régime de revenu de retraite du Canada est bien structuré, et il s’est bien acquitté de ses tâches au cours des dernières décennies. Il doit toutefois relever de nombreux défis qui menacent sa capacité continue d’offrir aux Canadiens un revenu de retraite adéquat. Parmi ces défis figurent un accroissement de la longévité et une population vieillissante, le déclin de la protection offerte aux travailleurs dans les régimes de retraite privés et la faiblesse de l’épargne-retraite des particuliers. L’inquiétude que soulèvent les conséquences de ces tendances a rendu nécessaire un examen complet du régime et des propositions pour la création de nouvelles caisses d’épargne parrainées par les pouvoirs publics.

Le présent article brosse un tableau et fournit une analyse des défis à relever et de certains des enjeux politiques que ces défis soulèvent. On y décrit aussi différentes approches pouvant être envisagées afin d’aider le régime à s’adapter à des besoins nouveaux, et on y présente une analyse préliminaire des forces et des faiblesses de ces options. Des études récentes montrent que la faible protection en matière de retraite touche surtout les secteurs économiques où sont concentrées les petites et moyennes entreprises, et que les grands régimes de retraite offrent des avantages marqués par rapport aux plus petits régimes de retraite et aux régimes d’épargne-retraite individuels. Ces résultats remettent en question les avantages que l’on peut tirer des encouragements à l’obtention d’une protection accrue en matière de retraite au moyen de régimes de retraite conventionnels. Ils donnent aussi à penser que la bonification des incitations à l’épargne aura une utilité limitée. Et ils invitent tous ceux qui sont intéressés par la refonte du régime à se pencher plutôt sur la possibilité de créer de nouveaux régimes d’épargne-retraite ou d’épargne à grande échelle parrainés par les pouvoirs publics.

ABSTRACT
Canada’s retirement income system is considered to be well structured, and it has performed well over the last several decades. The system faces important challenges, though, that threaten its continuing ability to provide Canadians with satisfactory

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retirement incomes. These challenges include increasing longevity, an aging population, declining coverage of the workforce in private pension plans, and weaknesses in individual retirement saving. Concern about the implications of these trends has led to calls for a full review of the system and proposals for new government-sponsored savings institutions.

This article provides information and analysis on the challenges facing the system and some of the policy issues that they raise. It also outlines different approaches that could be considered in helping the system to accommodate changing needs, and provides a preliminary analysis of the strengths and weaknesses of the various options. Recent research indicates that low pension coverage is centred on small-employer sectors of the economy, and that large-scale pension plans offer striking advantages over small pension plans and individual savings plans. These findings cast doubt on the likely benefits of trying to encourage higher pension coverage in traditional pension plans. They also suggest that enriched savings incentives would be of limited value. Rather, the research supports the calls for those concerned with reform of the system to look carefully at the possibility of creating new large-scale government-sponsored pension or savings plans.

**KEYWORDS:** PENSION PLANS ▪ RETIREMENT PLANS ▪ SAVINGS PLANS ▪ SOCIAL POLICY ▪ SOCIAL SECURITY

**CONTENTS**

Introduction 421

Canada's Retirement Income System: Performance and Challenges 422
   Performance of the System 422
   Challenges 426
      Increasing Longevity and Population Aging 426
      Lower Investment Returns 427
      Declining RPP Coverage 428
      Lower RRSP Saving 429

Policy Issues 429
   Employer Size and Pension Coverage 430
   The GIS and Saving Incentives 432
   Saving Incentives and Pension Coverage 435
   Locking In and Pension Coverage 436
   DB Versus DC Plans 438
   Hybrid DB-DC Pension Arrangements 440
      Fixed Cost Sharing 440
      Benefit Conditionality 440
      Self-Insured Annuities in DC Plans 441
      Variable Contribution Plans 442
      Cash Balance Plans 442
   Problems with Saving in Individual Plans 442
      Questions About Individual Decision Making 443
      Low Rates of Return 444
   Scale Versus Choice in Savings Plans 445
   Is Government Action Necessary? 446
   Should Participation Be Compulsory? 447
   Should Annuitization of Savings Be Required? 448
INTRODUCTION

The development of Canada’s retirement income system over the past several decades has been a success story. As the system has matured, the incidence of low income among seniors has fallen dramatically, and rapidly rising pension incomes have supported a trend to earlier retirement. Strong growth in private savings and a move to partly pre-fund benefits under the Canada and Quebec pension plans (C/QPP) have left the system less vulnerable to the demands of an aging population than other systems that continue to be dominated by largely unfunded state pension plans.

As important as these achievements are, they do not ensure that the system will continue to provide the retirement incomes that Canadians want and expect. While the majority of those nearing retirement now appear to be saving enough to meet standard earnings replacement targets, this is not the case for perhaps one-quarter of modest- and middle-income earners. Moreover, trends such as increasing life expectancy, declining investment returns, and a continuing decline in private pension coverage threaten to widen this gap. In recent years, the challenge of declining pension coverage in particular has led to the appointment of three provincial task forces to examine ways of encouraging and sustaining the health of these plans.1

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This article aims to provide background for public discussion of policy alternatives. To this end, it discusses some of the identified challenges and explores possible approaches to strengthening the system to meet them. The first section below outlines the components of the system, summarizes evidence on its current performance, and comments on several of the challenges it faces. The second section discusses some of the key policy issues in order to throw more light on the challenges and to set the stage for considering alternative approaches. The third section presents a preliminary analysis of several approaches that might be followed to strengthen the system. The main points are summarized in the final section.

**CANADA’S RETIREMENT INCOME SYSTEM: PERFORMANCE AND CHALLENGES**

Canadian government policy relating to retirement income security has two basic goals: to guarantee a basic minimum income for all seniors, and to enable Canadians to avoid serious disruption of their living standards upon retirement.2

Our retirement income system is often described as having three pillars. In pillar 1, the old age security (OAS) and guaranteed income supplement (GIS) programs provide flat rate and income-tested benefits primarily directed to the “income guarantee” goal. In pillar 2, the contributory public plans—the C/Qpp—provide earnings-related benefits that advance both goals. Pillar 3 consists of private savings focused on earnings replacement to maintain living standards. It includes savings in employer-sponsored, registered pension plans (RPPs) and deferred profit-sharing plans (DPSPs),3 and individual savings in registered retirement savings plans (RRSPs) and, beginning 2009, tax-free savings accounts (TFSA).4 Federal and provincial/territorial governments in Canada regulate registered plans and provide favourable tax treatment to encourage their use.

**Performance of the System**

The retirement income system has grown substantially over recent decades. In 1985, the total amount of income flowing from the public pension plans (OAS/GIS and the C/QPP), RPPs, and RRSPs combined was about $28 billion, or 4.7 percent of Canada’s gross domestic product (GDP). By 2006, the total had risen to $136 billion, or 9.4 percent of GDP.5

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2 These goals are stated, for example, in Canada, Department of Finance, *Pension Reform: Improvements in Tax Assistance for Retirement Saving* (Ottawa: Department of Finance, 1989), 5.

3 In DPSPs, employer contributions are often tied to employer profit levels.

4 In this article, references to RPPs should generally be read as including DPSPs, and forward-looking references to RRSPs should be read as including TFSA. For information on TFSA, see Canada, Department of Finance, 2008 Budget, Budget Plan, February 26, 2008, 273-78. Home ownership and other forms of household saving are generally excluded in describing the retirement income system, though they obviously contribute to retirement income security.

5 These data are derived from several sources. For benefits from OAS/GIS and the C/QPP, see Canada, Department of Human Resources and Skills Development, *The CPP & OAS Stats Book*
As the system has matured, pension payments from the C/QPP, RPPs, and RRSPs have grown the fastest, leaving fewer seniors dependent on OAS/GIS benefits. In 2006, seniors received about $97 billion in income from public pensions, RPPs, and RRSPs. Between 1985 and 2006, the share of C/QPP benefits in this total rose from 20 percent to 24.5 percent; the RPP and RRSP share jumped from 25 percent to 44 percent; and the OAS/GIS share dropped from 55 percent to 31.5 percent. Canada’s system thus provides retirement income from a diversity of sources, with a good balance between public and private plans, and between pre-funded plans and unfunded or pay-as-you-go benefits. Analysts applaud this structure, since it limits the risks associated with each particular type of plan and makes the system as a whole more sustainable. Reforms in other countries (notably within the OECD) during the last two decades have tended to move in this direction.6

Strong growth in pension benefits has greatly reduced the incidence of low income among Canadian seniors. Between 1970 and 1985, the proportion of seniors with incomes below Statistics Canada’s after-tax low-income cutoffs declined by one-half, from 29.0 percent to 14.7 percent. Since 1985, it has fallen by a further two-thirds, to 4.8 percent in 2007.7

It is more complicated to assess how well the system has performed in providing satisfactory earnings replacement levels. Note first that the stated goal of the federal government is to enable Canadians to save enough to maintain their living standards in retirement—not to ensure that they do. Nevertheless, it is useful to examine the extent to which individuals’ or families’ retirement savings levels are high enough to allow them to maintain their living standards after retirement. This rests on two basic questions.

First, how much retirement income is needed to maintain living standards upon retirement? A replacement rate of 100 percent (pension income equal to pre-retirement earnings) is not necessary. Replacement rates of 50 to 75 percent can suffice, depending on individual circumstances. The reason is that, while post-retirement consumption depends simply on pension income less income taxes (which are generally lower than in working years), pre-retirement consumption levels are based on


earnings less income taxes, payroll taxes, work-related expenses, and retirement savings.\(^8\)

Second, how much saving is needed to achieve a target replacement rate? Table 1 provides an example based on a replacement rate of 60 percent. It demonstrates that, because OAS/GIS and C/QPP benefits decline in importance as earnings increase, the need for private pension income from RPPs and RRSPs rises strongly with earnings.

In table 1, the required rate of saving in RPPs and RRSPs rises from almost zero at earnings of $30,000 to over 11 percent of earnings at earnings of $100,000.\(^9\) This relationship is critical in assessing the adequacy of savings. For example, while it is often remarked that only a minority of taxpayers contribute to an RRSP, a closer look at the statistics presents a different picture. In 2006, among 19.8 million tax filers under age 65, those belonging to an RPP and/or contributing to an RRSP accounted for 8.7 million, or 43 percent. However, if we consider only those tax filers who clearly do need private savings to maintain their living standards in retirement—the 8 million C/QPP contributors with incomes over $30,000—we find that 6.9 million, or 86.6 percent of them, were RPP/RRSP savers.\(^10\)

Several studies have examined whether Canadians are saving enough for retirement.\(^11\) The studies employ a variety of data sets—single-year and longitudinal tax records, a survey of household assets and debts, and a series of surveys of household consumption levels until the children are no longer supported. Home ownership contributes to retirement income security and reduces the need for pension income.

\(^8\) There are other factors as well. Parents have child-related expenses that reduce their personal consumption levels until the children are no longer supported. Home ownership contributes to retirement income security and reduces the need for pension income.

\(^9\) This example may underestimate the increase in savings needs with increased earnings for two reasons. First, if earnings rise more quickly than the average wage throughout an individual’s career, higher savings rates will be needed when earnings are high in late career. Second, there is evidence that longevity (and thus the length of the pension payment period) increases with income. In 1996, the gap in life expectancy at birth between high- and low-income groups was 5.0 years for males and 1.6 years for females. See Russell Wilkins, Jean-Marie Berthelot, and Edward Ng, “Trends in Mortality by Neighbourhood Income in Urban Canada from 1971 to 1996,” in Statistics Canada, Health Reports: How Healthy Are Canadians? Annual Report, 2002, vol. 13, Supp., catalogue no. 82-003-SIE 2002001, 45-71.

\(^10\) See Canada Revenue Agency, supra note 5, table 12. The population of C/QPP contributors is used as a base to avoid including tax filers who have no earnings, and thus no income to be replaced at retirement.

spending. Although the approaches and results vary, most of the studies appear to agree that

- while the majority of modest- and middle-income Canadians—those, say, with individual incomes between $30,000 and $100,000—are saving enough to avoid a significant drop in their living standards at retirement, a sizable minority of perhaps 25 percent are not; and
- savings inadequacy is concentrated on those without RPP coverage.\(^\text{12}\)

\(^{12}\) Lise’s study, supra note 11, which looked directly at consumption levels before and after age 65, found no evidence of declining consumption at retirement. The results appear to be affected, however, by a shift toward the consumption of durables (homes and automobiles) as the family...
A limitation of the studies is that because they necessarily focus on individuals in late career, they do not indicate whether or not today’s younger workers are likely to attain the same earnings replacement rates as earlier cohorts.

**Challenges**

Several trends in our retirement savings system and its environment threaten the continuing ability of the system to provide a satisfactory level of retirement income security for Canadians. These include increasing longevity and population aging, lower investment returns, a continuing decline in RPP coverage, and a recent decline in RRSP saving.

**Increasing Longevity and Population Aging**

Since the framework of Canada’s retirement income system was established in the mid-1960s, life expectancy at age 65 has increased by 4.4 years, or over 25 percent. The Office of the Chief Actuary of Canada projects a continuation of this trend in the decades to come.13 (However, the chief actuary’s report also includes scenarios in which projected life expectancies in 2050 are increased or decreased by about 2 years, indicating the level of our uncertainty about future mortality rates.)

Increasing longevity adds directly to the cost of the pensions promised in public pension plans and defined benefit (DB) RPPs. In the same way, it increases the contribution level required to attain a given level of annuity income in RRSPs and defined contribution (DC) RPPs.14

Increasing and uncertain longevity has increased the cost and riskiness of DB plan sponsorship, discouraged the provision of RPPs, and contributed to a worldwide shift from DB to DC plans.15

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13 Canada, Office of the Chief Actuary, *Actuarial Report (23rd) on the Canada Pension Plan*, catalogue no. IN 3-16/1-2006E (Ottawa: Minister of Public Works and Government Services, 2007), 16 and 87. Between 1966 and 2007, life expectancies from age 65 increased from 13.8 to 18.2 for men and from 16.8 to 21.2 for women. The Office of the Chief Actuary projects these life expectancies to increase to 22.3 and 24.6, respectively, by 2075.

14 A defined benefit pension plan is one that promises a fixed level of benefits, often defined as a percentage of covered earnings per year of service in the plan. In a defined contribution plan, benefits are determined directly by the amount of (employer plus employee) contributions to the plan together with the investment income earned on them.

The effect of increasing longevity on the age structure of the population has been compounded by the aging of the baby boom generation, those born between 1946 and 1966. The ratio of the senior population (age 65+) to that of the working age population (age 20-64) rose from 15.2 percent to 21.3 percent between 1971 and 2007; it is projected to double to 41.5 percent by 2030 and to continue increasing to 48.6 percent by 2075.\(^\text{16}\)

With the aging of the population, the levels of both pension benefits and plan assets are rising much faster than the level of contributions. This trend is making the financial health of DB plans increasingly vulnerable to adverse investment results, since it now takes a considerably bigger and more sustained contribution increase to make up for a funding deficit than in the past.\(^\text{17}\)

These problems have been exacerbated by a trend to shorter careers among men, owing to later labour force entry (increased education) and earlier retirement (although the trend to earlier retirement has reversed in recent years). Shorter careers increase demands on the retirement income system, as higher levels of saving are needed to replace earnings at retirement. Strong labour force growth among women has accompanied the trend to shorter careers for men but has not fully offset its effects, since women’s earnings also need to be replaced at retirement.

**Lower Investment Returns**

The stock market crash of 2008 has made everyone aware of the possibility of low investment returns. However, longer-term forces are more important for pension planning than short-term market swings. The past 30 years have seen slow wage growth and historically high investment returns, but the demographic projections suggest that these conditions will be reversed in the years to come. A dramatic decline in the rate of growth of the working age population is occurring now and will continue through 2020. By making labour scarce relative to capital, this should create upward pressure on wage rates while depressing investment returns.\(^\text{18}\)

Slow wage growth coupled with high investment returns has made it easier to meet earnings replacement targets and made DC plans look more attractive to savers than DB plans. A reversal of these forces will raise the cost of meeting earnings replacement targets under both types of plan. As an offsetting trend, it should also encourage increased labour force participation, including later retirement.

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\(^\text{16}\) Office of the Chief Actuary, supra note 13, table 43, at 90.

\(^\text{17}\) See, for example, Ontario Teachers’ Pension Plan, 2008 Annual Report (online: http://www.otpp.com). In 2008, benefits paid out of the plan were close to twice the level of contributions ($4.2 billion versus $2.3 billion). The investment loss of $19 billion in 2008—admittedly an extreme investment outcome—was over eight times the total contribution level.

Declining RPP Coverage

RPP coverage among men has declined steadily over the past three decades, from 55 percent of employees in the late 1970s to 41.4 percent in 2007. Coverage in the private sector explains much of this trend, declining from 45 percent in the late 1970s to 31.9 percent in 2007. Public sector coverage is much higher but has declined as well in recent years, from 95 percent in 1995 to 86.3 percent in 2007.19

Among female employees, RPP coverage increased in the early 1990s but then fell back and has since been stable at about 40 percent.

Since self-employed individuals are not eligible to belong to pension plans, RPP coverage of the total labour force is lower than that of employees; and, because the incidence of self-employment has grown, RPP coverage of the labour force has declined faster than that of employees. For men and women together, RPP coverage of employees dropped from 45.6 percent in 1976 to 37.2 percent in 2007; over the same period, labour force coverage dropped from 40.5 percent to 32.1 percent.

The effects of the coverage declines have been offset to some extent by the growth in the labour force participation of women. For example, the growth in two-earner families has helped to maintain the proportion of families where at least one spouse has an RPP.20 Because of the increase in women’s labour force participation, RPP coverage of the population aged 15-64 (rather than employees or the labour force) rose from 25.2 percent in 1976 to a peak of 27.7 percent in 1992 before declining to 25.1 percent in 2007. However, this statistic is a little misleading since it ignores the fact that the earnings of women joining the labour force also need to be replaced at retirement. Between 1996 and 2006, RPP saving measured by pension adjustment amounts declined from 5.0 percent of earnings to 4.2 percent.21

Several forces have produced the drop in RPP coverage. Employment has shifted toward types and sectors—part-time, small business, high technology, as well as self-employment—where RPP coverage has always been low. Increasing longevity and population aging have increased the costs and risks of pension plan sponsorship for employers, leading some of them to discontinue their RPPs. Increasingly rapid

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19 RPP coverage statistics calculated from data on the labour force, employees, and RPP members in Statistics Canada, CANSIM database, tables 2800008, 2800022, and 2820012, various series.


21 RPP saving is measured by reported pension adjustment (PA) amounts rather than total employer and employee contributions because employer contribution rates were inflated in recent years by “catchup” contributions needed to reduce plan funding deficits. These catchup contributions are not associated with the accrual of additional pension benefits. To make the measures consistent between the two years, the 1996 PA total was adjusted upward by $340 per reported PA, reflecting a change in the calculation of PAs for members of DB RPPs that took effect for the PA reported in 1997. See Canada Revenue Agency, supra note 5, table 12 for PA amounts and table 2 for aggregate earnings.
changes in corporate ownership and growing uncertainties about the longevity of individual firms have contributed to the trend.

Since it seems unlikely that these forces will be reversed, a continuing decline in RPP coverage must be expected. This decline could be tempered over the longer term, however, by pressures to enrich compensation packages arising from labour shortages in an environment of slow labour force growth.

**Lower RRSP Saving**

Up to the mid-to-late 1990s, RRSP saving grew strongly enough to offset the decline in RPP coverage and raise the total rate of retirement saving. From 1996 to 2006, though, the RRSP contribution rate declined, from 6.0 percent of earnings to 4.8 percent, and this drop was spread across age and income groups.

This decline appears to be explained at least in part by a shift to other forms of savings. Contributions to registered educational savings plans (RESPs) increased substantially with the introduction of the Canada educational savings grant (CESG) in 1998. Also, some people appear to have shifted some of their savings into home equity and other non-financial assets following the stock market decline of 2000-2002. Regardless of the cause, the decline does not appear to be transitory. The RRSP contribution rate has been relatively stable at its lower level since 2003.

RRSP savings are also used to cushion income fluctuations during working years, and for other purposes than providing retirement income. RRSP withdrawals by working age Canadians (taken here as those under age 60) amounted to about 1 percent of earnings in both 1996 and 2006. Net of these withdrawals, the RRSP saving rate fell from 5.0 percent of earnings to 3.9 percent. Looking at RPP and RRSP savings together (net of RRSP withdrawals before age 60), the retirement saving rate fell from 10.0 percent of earnings in 1996 to 8.0 percent in 2006.

**Policy Issues**

A better understanding of some of the current trends and policy challenges should help in the search for effective policy responses. Why, for example, is private sector pension coverage low and declining? Why has there been a worldwide shift from DB to DC plans? Is it realistic to seek measures to encourage more employers to sponsor traditional RPPs? Alternatively, can we rely on increased individual saving in RRSPs and TFSAs to compensate for declining RPP coverage?

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22 In the current recession, it seems safe to predict an acceleration of RPP terminations or conversions to lower-cost DC plans. However, there were strong increases in coverage rates during the recessions of the early 1980s and early 1990s because employment rates fell more sharply among individuals who were not members of RPPs than among RPP members.

23 The introduction of the CESG made the tax treatment of contributions to RESPs more generous in many cases than the treatment of contributions to RRSPs. For details of the measure, see Canada, Department of Finance, 1998 Budget, Budget Plan, February 24, 1998.
This section examines some key policy issues that could help us to see strengths and weaknesses in different policy approaches. These are

- employer size and pension coverage,
- the GIS and saving incentives,
- saving incentives and pension coverage,
- locking in and pension coverage,
- DB versus DC plans,
- hybrid DB-DC arrangements,
- problems with saving in individual plans,
- scale versus choice in savings plans,
- whether government action is necessary,
- whether participation should be compulsory, and
- whether annuitization should be required.

**Employer Size and Pension Coverage**

There are advantages to saving in RPPs as opposed to individual RRSPs. Saving in group plans offers economies of scale and market power in the purchase of financial services. It reduces adverse selection effects that drive up the cost of individually purchased annuities.\(^{24}\) Depending on their design, RPPs can also offer other forms of risk pooling that benefit plan members. RPPs generally involve an element of forced saving that increases their effectiveness in delivering retirement income. And there is evidence that RPP members are often encouraged to supplement their pension saving with saving in RRSPs or other vehicles.\(^{25}\)

The rate of RPP coverage is affected by employment trends such as changes in the incidence of self-employment or in the relative number of public sector and private sector jobs. Employer size is another factor in pension coverage that deserves examination. Pension plans are costly to administer, with fixed-cost elements (in the costs of regulatory compliance, investment services, employee communications, etc.) that impose particularly heavy burdens on small employers. Consequently, small employers are less likely to sponsor RPPs than are larger ones.

Table 2 shows just how important this factor is. As well as providing the incidence of RPP coverage by employer size, it shows the distribution of RPP members and non-members across employer size categories.

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\(^{24}\) In an open market for life annuities, individuals with an above-average life expectancy are the most likely to purchase such annuities, potentially driving up prices to levels that are unattractive to those with a lower life expectancy and, in the extreme, threatening the existence of the market.

\(^{25}\) This effect was identified by Philip Cagan, *The Effect of Pension Plans on Aggregate Saving: Evidence from a Sample Survey*, Occasional Paper no. 95 (New York: National Bureau of Economic Research, 1965). It is also evident in recent Canadian income data, which indicate that over 50 percent of RPP members make RRSP contributions, and these joint RPP/RRSP savers account for over 40 percent of all RRSP contributors: see Canada Revenue Agency, supra note 5, table 12.
The incidence of RPP coverage rises dramatically with employer size, from 2.6 percent of employees in firms with fewer than 50 employees to 79.6 percent in firms with 500 or more employees. The challenge for expanding coverage under employer-sponsored plans is very clear. Firms with fewer than 100 employees account for only 4.0 percent of RPP members but two-thirds of the non-member population.

The concentration of the population of employees without RPP coverage among small employers strongly suggests that it would be unrealistic to seek major increases in coverage through options designed to encourage employer sponsorship of RPPs. Not only do small employers face high administration costs to run an RPP, but the uncertain longevity of many small businesses makes them poor candidates to undertake the long-term commitments associated with pension plan sponsorship.

This does not mean that we should give up on the idea of extending pension coverage to small-business employees, but only that we should look to other options than single-employer sponsorship and administration of such pension arrangements.

If small employers are poorly placed to sponsor RPPs, should we not see RPPs covering groups of small-business employees? Indeed, quite a few such multi-employer pension plans exist. They are generally union-administered plans applicable to specific industries such as construction. In these plans, an employer’s obligations are usually limited to contributing a certain dollar amount per hour of service for each employee. Employers are not obligated to make up funding shortfalls in the plans.

However, multi-employer plan coverage is not widespread in the small business sector. In the absence of strong industry-wide unions that would be willing to undertake administration of such plans, it is hard to imagine increased use of these arrangements without government sponsorship.

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26 See Statistics Canada, CANSIM database, tables 2810042 and 2800010.
The GIS and Saving Incentives

Benefits under the OAS and GIS programs provide a base level of earnings replacement, as well as playing the main role in guaranteeing a minimum standard of living for seniors. However, the income testing of GIS benefits provides a strong disincentive to save among low- and modest-income workers who may expect to receive them in retirement.

For each dollar of private retirement income, GIS benefits are reduced by 50 cents. This clawback of benefits creates an effective marginal tax rate (EMTR) of 50 percent on private income, which reduces the rate of return on RPP or RRSP saving. If the private income is also taxable, the EMTR can be even higher. Table 3 provides examples based on an annual pre-tax rate of return (after inflation adjustment) of 3.5 percent.

Table 3 presents three scenarios to illustrate how the rate of return can vary according to the saver’s income level in retirement. In the lowest-income scenario, where the saver receives the GIS, the saver’s retirement income is subject to the 50 percent GIS benefit reduction rate; however, owing to the personal, age, and pension income credits, the saver pays no personal income tax (PIT). In the second scenario, where the saver has more private income but still receives the GIS, the income is subject to both the GIS reduction and PIT (50% + 21% = 71% tax rate). In the third scenario, the saver does not receive the GIS, and the RPP/RRSP income is subject to PIT alone (at the assumed rate of 21 percent). Under each scenario, four cases are considered, defined by the length of the retirement savings holding period (the time between contribution and withdrawal) and whether the saver is in the first (21 percent) or second (30 percent) tax bracket when the contribution is made.

The reference situation is the one where no GIS benefits will be received. Here, the after-tax rate of return is the same as the pre-tax rate of return for savers in the first tax bracket but higher for savers in the second bracket. The income-averaging benefit provided for second-bracket savers is relatively more important for shorter holding periods, raising the net rate of return to 4.00 percent per annum for a 25-year holding period and 4.34 percent for a 15-year period.

For a GIS recipient, the rates of return are much lower. For a non-taxable recipient, the rate of return is cut in half for long-term savings and is even lower for shorter-term savings. For taxable GIS recipients, the effect is much stronger, leading to after-tax rates of return substantially less than zero.

The case of taxable GIS recipients may be the more important one since, as we saw earlier, individuals with low pre-retirement earnings have high income replacement rates from public pensions and little incentive to save. Individuals at modest earning levels need to supplement their public pension benefits with some RPP/RRSP saving, yet they are most likely to be affected by the GIS benefit reduction rate, and they may be subject to income taxes as well.

The theoretical effects of income-tested benefits on saving (and post-age-65 employment) are quite clear. As table 3 demonstrates, the 50 percent benefit reduction rate under the GIS reduces or makes negative the rate of return on saving, creating a substitution effect that discourages the deferral of income past age 65. In addition, the GIS benefit itself provides an alternative to private retirement income, and so
produces an income effect that reinforces the substitution effect in discouraging savings and post-65 employment.

However, it is reasonable to question the strength and importance of such incentive effects, particularly since retirement benefits are far in the future for younger people, and many workers, even in mid- or late career, demonstrate little knowledge of public pension plans. Unfortunately, there do not appear to be any econometric studies of the effect of the GIS on saving. Baker et al. apply econometric estimates to simulate the effect of structural changes in Canada’s public pension system on retirement age, but they do not consider saving. In my own research, I have used parameters estimated in the econometrics literature on saving to simulate OAS/GIS program changes and have found, for example, that including behavioural effects on saving could increase the estimated cost of a GIS benefit increase by 40 percent.27

There is also little econometric evidence from other countries. The general public pension model in most OECD countries, including the United States and the United Kingdom, involves substantial earnings-related benefits but no large-scale income-tested benefit like the GIS. Blundell et al. mention an estimate that the enrichment of the earnings-related state pension in the United Kingdom displaced private savings equal to about two-thirds of the benefit increase.29 However, since this policy change involved no income testing, it had only an income effect and not the substitution effect that a GIS increase would have.

<table>
<thead>
<tr>
<th>Holding period and tax bracket at time of contribution</th>
<th>GIS alone</th>
<th>GIS + PITb</th>
<th>PIT alone</th>
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<td>25-year holding period</td>
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</tr>
<tr>
<td>21% tax bracket</td>
<td>1.68</td>
<td>−0.57</td>
<td>3.50</td>
</tr>
<tr>
<td>30% tax bracket</td>
<td>2.12</td>
<td>−0.08</td>
<td>4.00</td>
</tr>
<tr>
<td>15-year holding period</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>21% tax bracket</td>
<td>0.48</td>
<td>−3.20</td>
<td>3.50</td>
</tr>
<tr>
<td>30% tax bracket</td>
<td>1.20</td>
<td>−2.41</td>
<td>4.34</td>
</tr>
</tbody>
</table>

a Assuming a pre-tax rate of return of 3.5 percent (after adjustment for inflation).

b Personal income tax, assumed to be 21 percent.

Source: Author’s calculations.


There is anecdotal evidence on the effect of the GIS on saving and post-65 employment. To begin with, there is the simple fact that a program originally intended as temporary continues to provide benefits to over a third of seniors. The high rate of takeup of C/QPP benefits at age 60 is also a predictable result, given the 50 percent effective tax rate on post-65 C/QPP benefits under the GIS. High rates of RRSP withdrawal by modest earners nearing age 65 are another predictable outcome.

With regard to effects on the behaviour of younger workers, it is argued below that GIS income testing combines with other more immediate concerns to make home ownership or RRSPs preferred over savings that are locked in to retirement.

What are the boundaries of GIS effects on saving? In 2009, GIS eligibility extends to those with total pension income, including OAS and C/QPP benefits, of $21,864 or less for singles and $33,092 or less for couples. If we assume a retirement income target of two-thirds of earnings, we can consider prospective GIS eligibility to extend to single workers with earnings up to about $33,000 and couples with earnings up to $50,000. However, the population of workers whose saving incentives are affected by the GIS may be greater than these earning levels suggest, for two reasons. First, we have seen that a substantial proportion of workers can expect to achieve income replacement rates considerably below 67 percent. Second, those making decisions on saving confront considerable uncertainty about their future earnings, the duration of their careers, and the investment performance of their retirement savings. Thus, the saving disincentives associated with the potential receipt of GIS benefits may be expected to affect a substantial number of workers with earnings above these levels.

The chief actuary projects a substantial decline in the proportion of seniors eligible for the GIS, from 35.8 percent of the 65+ population in 2004 to 31.3 percent in 2025 and 26.1 percent in 2050. However, this projection is based on continued price indexation of OAS and GIS benefit levels, despite assumed real wage growth of 1 percent per annum or higher. Over a 25-year period, this implies a reduction of at least 22 percent in the basic income guarantee in relation to average wage levels. There has been a historical decline in the incidence of the GIS, from almost 52 percent in 1981 to 40.7 percent in 1992 to the current rate of 35.8 percent (although, since 2000, the rate has been stable or increasing). This historical trend was produced by several factors, including the maturation of both the C/QPP and private pension plans, a strong increase in female labour force participation rates, regulations mandating improvements in RPP benefits (such as mandatory survivor benefits), and strong increases in RRSP contribution rates. It also covers a period in which price growth, and thus the increase in OAS/GIS benefit rates, fully matched the growth in wage rates. None of these factors may be expected to apply as strongly in the future. Accordingly, it would be more realistic to project only a modest decline, or none at

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30 In comparison, the income levels at which federal income tax becomes payable by seniors in 2009 are $18,728 for singles and $37,456 for couples—assuming that the $2,000 pension credit amount, which is transferable between spouses, is fully used.

all, in the incidence of the GIS among seniors, particularly if one assumes that, in order to prevent a rise in relative poverty among seniors, the minimum income guarantee under the OAS/GIS will be increased from time to time to keep pace with real wage growth.

In fact, there is reason to be concerned about an increase in the importance of the saving disincentive of the GIS. Since the late 1970s, all increases in the OAS/GIS minimum income guarantee (beyond the regular inflation adjustments), including recent increases in 2006 and 2007, have been effected through increases in GIS benefits alone. Relying on GIS increases alone to maintain the basic income guarantee in relation to real wage levels tends to increase the share of the population exposed to GIS disincentive effects. Other approaches to maintaining the guarantee might have better effects on savings. 

Finally, it should be noted that the GIS creates no disincentive to contribute to the new savings vehicle, the TFSA, because withdrawals from these accounts are not to be included in income for the purpose of determining GIS benefit levels. This should have a positive effect on saving by modest income earners. It could also result in a shift away from RPP and RRSP savings toward the new vehicle, and pressure the government to provide a parallel exemption of RPP/RRSP benefits from GIS income testing.

**Saving Incentives and Pension Coverage**

As noted earlier, about two-thirds of employees without pension coverage work for small employers (under 100 employees). It is also interesting to look at the income distribution of RPP non-members and to consider how that distribution might influence pension coverage.

Table 4 shows the distribution of RPP members and non-members by broad income groups, based on taxation data for 2006. The population base consists of tax filers with C/QPP contributions (and thus earnings over $3,500), after adjustment to remove self-employed contributors. Those reporting a pension adjustment amount on their tax returns are identified as RPP members.

RPP coverage is shown for three broad income groups: under $30,000, $30,000-60,000, and over $60,000. The under-$30,000 group is taken as a proxy for those for whom RPP/RRSP savings could be unattractive, either because their public pension income is expected to satisfy the replacement requirement or because of the disincentive effects of the GIS. 

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32 I have made a start at analyzing possible responses in my earlier study, supra note 28.

33 The $30,000 threshold might overestimate the group with low saving incentives. For example, it includes about 41 percent of C/QPP contributors, whereas the incidence of the GIS among seniors is about 36 percent. Some of those earning under $30,000 will have spouses whose earnings bring the couple’s total earnings above $50,000, which is roughly the threshold at which GIS disincentives may apply. Also, some low earners will have higher earnings in the future. However, as noted in the previous section, uncertainty about future earnings and investment returns may extend the disincentive effects of the GIS beyond the population that will end up receiving it.
Table 4 suggests that RPP savings may be of doubtful benefit to about 17 percent of existing RPP members. On the other hand, about 3.6 million employees earning $30,000 or more would benefit from increased RPP coverage. Extending coverage to this group would raise the coverage rate from about 41 percent to 67 percent of employees (32 percent to 54 percent of those in employment or self-employment).

Perhaps the most interesting observation from the table is that about 54 percent of employees without RPP coverage are in the low-income group—those who may not find RPP membership advantageous. This raises the question of how employers and employees choose whether employee compensation will include pension benefits. If employers are responding to employee desires regarding compensation structure, this statistic might help explain Canada’s relatively low level of pension coverage. For example, in a firm with employees divided as indicated in the broader employee population without pension coverage—that is, 54 percent, 32 percent, and 14 percent across the three income groups—the majority of employees might not favour having a pension plan. If so, the result could be no pension plan or one targeted only to higher-earning employees.

**Locking In and Pension Coverage**

People save not only for retirement but also as a precaution against income drops or unforeseen expenses before retirement, and to provide for gifts and bequests.

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34. About the same percentage of low income earners (17 percent) contributes to RRSPs. However, the disincentive effect is not as great in this case since there is greater scope to withdraw RRSP assets before age 65. Other strategies have been suggested to minimize the effect of the GIS clawback. One is to make RRSP withdrawals every few years following retirement rather than annually. The same sort of latitude is not available in the case of RPP pension income, or where RPP assets are transferred to a locked-in RRSP.

35. However, note that among these “potential RPP members,” younger, mobile employees may shy away from the risk of DB plans (see the discussion of DB versus DC plans), while small-business employees with uncertain earnings may prefer the greater liquidity offered by RRSP savings.
Savings that are not locked in or restricted in form (for example, required to be annuitized) are particularly valuable since they can serve multiple purposes, depending on the saver’s wants and needs. Savings ostensibly intended for retirement can be used to finance additional education in the event of job loss or marriage breakdown. After retirement, non-annuity savings serve as a reserve against unexpected longevity but, if not so needed, can fund a bequest to children.

While it is natural for policy makers to be concerned about the effect of pre-retirement RRSP withdrawals on the income security of seniors, and to favour restrictions on access to tax-deferred savings before retirement, they should also consider the effects of such restrictions on the level of demand by employees for RPP coverage and on the takeup of voluntary saving schemes.

How costly to individuals are restrictions on the use of savings? How far will people go to avoid them? These are questions that are difficult to get a handle on, so it is easy to ignore them. However, recent experience with Quebec’s simplified pension plans (SIPPs) suggests that dislike of locking in may be a significant deterrent to increased pension coverage. In response to employee requests, Quebec eliminated the lock-in on employee contributions to SIPPs. The result was a 34 percent increase in SIPP coverage in one year (from an admittedly small base).

I have explored the costs of locking in with a simple lifecycle model in which an individual lives through three periods—young working age (period 1), older working age (period 2), and retirement (period 3).36 Earnings uncertainty in period 2 provides a motive for period 1 saving for precautionary purposes as well as for retirement. Cases are compared where period 1 savings are accessible in period 2 or locked in to retirement. In the model results, locking in leads to a marked reduction in the level of savings and in consequence is completely ineffective in increasing retirement income levels. The disincentive effects of locking in are likely greatest for individuals who

- are young and thus have relatively high pre-retirement risks;
- work for small employers and therefore have considerable earnings uncertainty; or
- have relatively low incomes and so are least able to save separately for precautionary and retirement purposes.

Employee concerns about locking in have likely contributed to the shift in saving from RPPs to RRSPs. Note that the areas where RPP coverage is strongest—the public sector and industry-wide plans—are those where uncertainty regarding earnings and job tenure is lowest, so locking-in costs are least important.

36 See Keith Horner, “Should Retirement Savings Accounts Be Locked In?” paper presented at the 64th Congress of the International Institute of Public Finance, Maastricht, the Netherlands, August 23, 2008 (online: http://editorialexpress.com/conference/iipf64/program/iipf64.html#39).
DB Versus DC Plans

As noted above, there has been a widespread shift from DB pension plans to DC plans. Is this a concern, and should any measures aimed at expanding RPP coverage favour DB plans?37

DB pension plans have several advantages. By providing a specified level of retirement income, they facilitate retirement planning, and also encourage supplementary RRSP saving to reach pension targets. In contrast, employees participating in DC plans may overestimate the pension income that their contributions are likely to generate.

DB plans facilitate a degree of cross-subsidization that can have social benefits. For example, they usually provide the same benefit rates to women as to men, despite the higher cost of funding pensions for women (owing to their greater longevity). In addition, DB plans are easily adapted to providing survivor and disability benefits, as well as pension credits for periods of unpaid leave relating to education or maternity.

Most important, DB plans allow for the pooling of risks across age cohorts.38 The experience of 2008 provides ample proof that adverse investment results, especially when they occur close to retirement age, can leave members of DC plans with much lower retirement incomes than they expected. Under DB plans, plan members are better insulated—at least in principle—from unexpected fluctuations in investment returns. DC plan members may be able to reduce investment risks by choosing increasingly conservative investment portfolios as they approach the age of retirement (although, in doing so, they may sacrifice higher investment gains).

DB plans also have disadvantages. Their benefit structures are considerably more complicated, less transparent, and harder to explain to plan members than the simple accumulation of individual assets in DC plans.

37 For a more formal analysis of these questions, see David McCarthy, “The Rationale for Occupational Pensions” (2006) vol. 22, no. 1 Oxford Review of Economic Policy 57-65. McCarthy begins with the argument that if all markets were complete (no uncertainty, no taxes, perfect capital markets), there would be no role for pension plans, since workers could provide their own retirement annuities at a cost no higher than that of an employer plan. He then examines various market failures affecting employees and employers, and considers how they may provide incentives for pension plan provision, including incentives for the choice of one plan type over another. Market imperfections on the employee side include preferential tax treatment of pension saving over other investments, longevity risk, employer default risk, high transaction costs, and liquidity constraints. Imperfections on the employer side include transaction costs relating to employee contracts. Employers can use pension provisions (especially in DB plans) to discourage employee mobility, to encourage hard work, or to encourage older workers to retire. McCarthy notes that market imperfections, such as high marginal tax rates among seniors, can make pension plans less attractive than current compensation, and concludes that the rationale for pension plans, and for favouring one type of plan over another, will vary with the circumstances of particular employers and employees.

DB plans are also much more costly to administer than DC plans. As well as obtaining investment and legal services, running a DB plan requires determining benefit accruals according to often complicated formulas; obtaining actuarial estimates of expected future liabilities based on various contingencies relating to mortality, disability, employee turnover, and so on; and preparing detailed reports for regulators and corporate financial statements. Plan complexity also raises the cost of employee communications. Many of these cost items are reduced or eliminated under DC plans, for which decision making, regulatory compliance, and employee communications are simpler.

DB plan members, particularly in single-employer private sector plans, face the risk of significant benefit loss if they change jobs or become unemployed before reaching retirement age.39 For a young, mobile employee, this risk can easily exceed the risk of investment loss in a DC plan.40 This helps to explain why DC plans, or group RRSPs, are favoured in sectors like high technology, where many employees are young and mobile and firm longevity is uncertain. DB plans, on the other hand, operate most successfully in the public sector or as multi-employer private sector plans.

Another issue is that the intergenerational risk pooling promised in DB plans may be restricted in practice. Risk pooling between age cohorts is obtained by the maintenance of scheduled benefit rates despite fluctuations in the funded status of the plan. This may not be possible, however, where the working age population is growing very slowly, so that plan benefits and expected annual investment income are high relative to contributions. In this situation, reasonable adjustments to contribution rates may be insufficient to address plan deficits resulting from investment losses. It has also been argued that the implicit contracts between younger and older employee groups in DB pension plans can easily break down as parties to the contracts quit or redefine the deal to advance their interests.41 The use of plan surpluses to enrich benefits, for example, could produce an income transfer from younger to older employees that is incompatible with the original risk-sharing bargain. But the

39 Benefit losses attributable to job change can be avoided where there are reciprocal arrangements between DB plan sponsors that allow periods of service with one employer to be recognized in the plan of the succeeding employer. Such arrangements are much more common between public sector plans than private sector plans.

40 Defined benefits are typically based on an average of earnings in the years immediately preceding retirement. For someone in mid-career—at age 40, for example, with an expected retirement age of 65—the present value of the benefit earned to date is based on the individual’s current salary projected forward to age 64. However, in most DB plans in the private sector, termination benefits for individuals leaving the plan before retirement age are calculated without any salary projection. This can reduce the value of the benefit dramatically—by 40 to 50 percent for someone leaving in mid-career.

option of quitting a plan gives younger employees the power to end deals that they find unfair.

These issues with DB plans have several implications. Notably, the high administration costs of these plans make it unrealistic to seek their expansion with small employers as plan sponsors. Single-employer DB plans are also ill suited to sectors where employees are mobile or where the longevity of the company is uncertain. Some have gone further to argue that single-employer DB plans make no sense anywhere in the private sector. Peter Drucker’s 1950 comment on the issue seems prescient:

For such a plan to give real security, the financial strength of the company and its economic success must be reasonably secure for the next forty years. . . . But is there any one company or any one industry whose future can be predicted with certainty for even ten years ahead? . . . The recent pension plans thus offer no more security against the big bad wolf of old age than the little piggy’s house of straw.42

In light of the drawbacks described above, perhaps some form of hybrid pension plan, with DB and DC features, might be preferable to traditional plans of either type.

Hybrid DB-DC Pension Arrangements

Various modifications of DB and DC plans provide ways of overcoming weaknesses in the classic forms of employer-sponsored pension plans. Five such plan variations are fixed cost sharing, benefit conditionality, self-insured annuities in DC plans, variable contribution plans, and cash balance plans.

Fixed Cost Sharing

In some public sector DB plans, a fixed sharing of costs (such as 50/50) between employer and employee contributions is central to the plan. This makes the cost of benefits (and benefit adjustments) more transparent to employees and shares investment risks between employees and the plan sponsor. To the extent that surpluses are maintained to protect against adverse investment returns, and deficits are amortized over a number of years, the plan continues to provide for risk sharing among age cohorts of employees.

Provision has been made in the tax rules governing RPPs to accommodate plans with fixed cost sharing. There does not appear to be any regulatory barrier to their expansion.

Benefit Conditionality

Making benefits conditional on investment performance or the funding status of the plan can help to limit the size of the contribution rate adjustments needed to

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maintain plan funding levels where benefits are high relative to contributions. Analysts have concluded that pairing benefit and contribution rate adjustments to maintain funding levels is the fairest way to share risks among working and retired plan members, and the one most likely to ensure sustainability of the plan.\textsuperscript{43}

One longstanding example of this approach is “excess interest indexing,” under which the annual inflation adjustment of pensions in pay depends on the achievement of an investment return in the year that is above a defined floor. The arrangement can also provide for special adjustments to make up for missed adjustments in prior years. As an alternative, inflation adjustments are sometimes made conditional on the funding status of the plan rather than the current investment return.

An expanded version of this approach is found in plans in which benefits are defined as a percentage of updated career-average earnings (as under the C/QPP), but the updating of past earnings is conditional on investment performance or the plan’s funding status. This makes the initial pension level, as well as its subsequent inflation adjustment, conditional on the financial health of the plan, thus sharing the costs or benefits of adjustments between active and retired plan members. One RPP that has employed this approach is the Nova Scotia Association of Health Organizations (NSAHO) pension plan, which covers some 20,000 health care workers.\textsuperscript{44} In this plan, both benefit upgrading and contribution rates (with fixed cost sharing) are adjusted periodically to reflect the financial situation of the plan. This approach has also been used in industry-wide plans in the Netherlands.\textsuperscript{45}

While this type of plan offers great advantages in the sharing of investment risks, the issues of benefit and contribution adjustment are very complex. Consequently, the success of these plans depends critically on their governance (both setup and performance) and on how well the policies are communicated to plan members.

**Self-Insured Annuities in DC Plans**

Providing life annuities in DC plans involves the pooling of assets among retirees in the plan and so provides a limited degree of risk sharing. For many years, some larger DC plans have provided self-insured annuities. Presumably a main goal has been to avoid the cost of financial intermediation. The inflation adjustment of benefits in such plans typically involves excess interest indexing. The Teachers Insurance and


\textsuperscript{44} For details, see the NSAHO Web site at http://www.nsahopensionplan.ca/.

Annuity Association—College Retirement Equities Fund (TIAA-CREF) in the United States has this feature, as do some university plans in Canada.\(^\text{46}\)

**Variable Contribution Plans**

Another way of bridging the gap between DC and DB plans is to operate a DC plan but with contribution rates that are designed to achieve a given benefit rate and are adjusted periodically in response to surpluses or shortfalls resulting from variations in investment returns. Proposals by Ambachtsheer contain this feature.\(^\text{47}\) There are some practical difficulties with it. In attempting to mimic DB results, the plan design sacrifices much of the simplicity of DC plans; indeed, the contribution rate changes may be even harder to explain to plan members than those in a pure DB plan. Additional problems could arise in a multi-employer context. Would an employer welcome a new employee if the employee was currently below his or her target benefit rate and, as a result, the employer’s matching pension contribution would be elevated?

**Cash Balance Plans**

A cash balance plan has the form of a DC plan but is really a type of DB plan. There is a fixed rate of contribution, but the return on investment is predefined by the employer, who accepts the benefit or cost of returns that exceed or fall short of the expected return. The benefit defined under the plan is an accumulated asset amount at retirement. In the United States, where such plans are popular, this amount may sometimes be taken as a lump sum rather than being converted to an annuity. A variant of such a plan would be a DC plan where the plan sponsor guaranteed a minimum rate of return. This would remove some downside risk from the employee without eliminating the possibility of higher-than-expected returns. In Canada, neither cash balance plans nor DC plans with guaranteed rates of return are currently accommodated under the Income Tax Act.\(^\text{48}\) It is not clear that either of these plan forms would offer sufficient advantages to generate an expansion in RPP coverage.

**Problems with Saving in Individual Plans**

A growing number of studies of saving by individuals cast doubt on whether we can rely on RRSP and TFSA savings to offset the decline in employer-sponsored pension coverage. The concerns relate to individual decision making and to the rates of return obtained on savings in individual plans.

\(^{46}\) See, for example, Queen’s University, *Queen’s University Revised Pension Plan* (Kingston: Queen’s University, Pensions and Benefits Unit, Department of Human Resources, 2008) (online: http://www.hr.queensu.ca/pdf/pension_guide08.pdf); and University of British Columbia, *Faculty Pension Plan* (online: http://www.pensions.ubc.ca/faculty/index.html). Some university plans are also hybrid DB-DC plans in the sense of combining a DC form with a DB guarantee. The Queen’s University plan is an example.

\(^{47}\) See Ambachtsheer, supra note 41.

\(^{48}\) RSC 1985, c. 1 (5th Supp.), as amended.
Questions About Individual Decision Making

The great strength of individual saving is that it provides maximum flexibility for individuals to tailor their savings to meet their particular needs. However, any system that relies heavily on individual choice and initiative in retirement saving demands that individuals have the information and understanding required to evaluate their savings needs, and that they act on that information in a rational and timely manner.

There is increasing evidence that these conditions are far from being met. Surveys show that many individuals have little awareness of their income prospects on retirement, including the nature of public pension plans or the level of benefits that they should expect from those plans; whether their employer-sponsored pension plan is a DB or a DC, and what pension income it should provide; what rate of return they might get over the long run on their individual savings; and what level of savings is needed in order to achieve a given level of pension income. Individuals often seem to be satisfied with the simple fact of plan participation, and overestimate the retirement income that can be derived from a modest level of contributions.

Individual saving behaviour has been examined through studies of participation in employer-sponsored savings arrangements, particularly 401(k) plans in the United States. In these DC plans, employees are generally given choices about whether to participate, how much to contribute, and how the funds should be invested. The studies have produced several interesting findings.49

Individual choices appear to depend heavily on how the choice is framed—that is, how the alternatives are presented. Given the complexity of retirement saving issues and the general lack of public awareness, many employees tend to shrink from making an independent choice and rely instead on the advice or implicit guidance of their employer. The most important example concerns plan participation. When employees are automatically enrolled in a plan but given the choice to opt out, participation rates are much higher than when the employee must choose to participate—a jump from 49 percent to 86 percent in one reported case.50

Other research suggests that automatic enrolment has considerably greater effects than employer contribution matching. Beshears et al. found only a modest drop in participation—between 5 and 11 percentage points, from a base level of


89 percent—when employer matching at a 50 percent rate was eliminated. Since employer contribution matching effectively increases the rate of return on employee contributions, in much the same way as a tax credit or government matching grant increases individual savings, this evidence is relevant to the assessment of such options.

Employees have also been found to rely strongly on employer-chosen default options regarding contribution rates and investment options. This behaviour can have either positive or negative effects. For example, Choi et al. found that the default contribution rates accepted by employees are sometimes lower than the level of previous contributions, and employees can be led to accept unduly conservative investment portfolios.

Finally, people appear quite reluctant to sacrifice current consumption to meet future needs. They plan to save but put off starting. Thaler and Benartzi found that employees preferred a savings scheme with contribution rates that started at a low rate of 3.5 percent and then ramped up automatically over time to 13.5 percent, to a scheme that started at a higher rate but increased less over time.

Low Rates of Return

The concerns about high administration costs in small employer-sponsored RPPs apply with even more force to individual savings plans. Individual plans tend to have high fee levels, and individuals often increase fee costs by changing funds when investment performance is poor. Reflecting these factors, Ambachtsheer reports a 2.5 percentage point difference between the net annual rates of return on investment obtained by pension funds and those obtained by individual purchasers of mutual funds.


54 Ambachtsheer, supra note 41.
In the United States, Munnell et al. found average returns on saving in individual retirement accounts (IRAs) of 3.8 percent per annum, compared with rates of 6.6 percent for DB pension plans and 5.6 percent for 401(k) plans.\footnote{Alicia H. Munnell, Mauricio Soto, Jerilyn Libby, and John Prinzivalli, \textit{Investment Returns: Defined Benefit vs. 401(k) Plans}, Center for Retirement Research at Boston College Brief no. 52 (Chesnut Hill, MA: CRR, September 2006).} Canadian estimates using a similar methodology have found that the average annual rate of return on RRSPs from 1999 to 2005 was about 1.5 percent per annum, compared with a reported return of 6.7 percent for RRPs.\footnote{Estimates for Quebec were derived from Quebec, Régie des rentes, “Revenus de retraite au Québec : une projection sur 30 ans,” presentation to the 9th Global Conference on Ageing, International Federation of Ageing, Palais des congrès, Montreal, September 7, 2008. Parallel results for Canada as a whole have been obtained from unpublished computations by Human Resources and Skills Development Canada.}

Over a full career, shortfalls in rates of return on savings make a big difference. Consider the case used to calculate the required saving rates in table 1 above (savings over a 35-year period to finance a 20-year indexed annuity and earning a rate of return of 3.5 percent above inflation). At that rate of return, the annual savings rate needed to finance a pension of 30 percent of pre-retirement earnings is 7.8 percent of earnings. If the rate of return were one percentage point less (2.5 percent above inflation), however, the required savings rate would jump by almost one-third to 10.3 percent.

**Scale Versus Choice in Savings Plans**

Plan scale affects rates of return among employer-sponsored pension plans, and between those plans and individual accounts. The 1 percent additional return earned by DB plans over 401(k) plans in the Munnell results reported above reflects both the fact that DB plans are generally larger than 401(k) plans and the tendency of 401(k) plans to offer employees a choice among investment portfolios.

In the United Kingdom, the Pensions Commission (the Turner commission) examined this issue closely in formulating proposals for a national pension savings scheme.\footnote{United Kingdom, Pensions Commission, \textit{Implementing an Integrated Package of Pension Reforms: The Final Report of the Pensions Commission} (London: The Stationery Office, 2006), 28-34. The UK government has enacted the Pensions Act 2008 (UK), 2008, c. 30, to implement the proposed savings scheme (renamed “personal accounts”) beginning in 2012: see the text below following note 63 for further discussion. See also United Kingdom, Department for Work and Pensions, “Pensions Reform—2010 Onward” (online: http://www.dwp.gov.uk/policy/pensions-reform/).} The commission recognized some potential advantages of competition and consumer choice in the supply of investment services, namely, better customer service (more responsive call centres, fewer errors in account maintenance) and better investment management performance (though they doubted whether individuals, or even employers, were sufficiently astute buyers of investment services to take advantage of this). The commission concluded, however, that a single national
plan would provide the best results for savers. It argued that the choice of investment funds might be affected more by costly brand advertising than by results; that private suppliers would likely discriminate against smaller accounts; and that high charges related to moving between funds would offset the advantages of competition. The commission noted that management expense ratios (MERs) remain fairly high under Australia’s compulsory savings scheme, with charges averaging 0.6 percent of assets for large multi-employer superannuation funds and 1.1 percent for retail funds. However, it estimated that the MER of a single national plan in the United Kingdom would be under 0.5 percent of assets, and possibly as low as 0.3 percent.

In light of the reasoning of the UK Turner commission and the US evidence on the power of default options, Australian analysts have proposed the creation and promotion of well-defined default options as a means of reducing administration costs and improving investment returns under Australia’s compulsory but decentralized superannuation plans.58

Is Government Action Necessary?

Is government intervention (either government provision or the mandating of private sector plans) required to extend pension coverage significantly?

In principle, private multi-employer pension arrangements could provide coverage in the small business sector of the workforce, with plans of sufficient scale to provide good rates of return. As noted above, this approach has worked in unionized industries, with unions administering the plans. It also seems to work in the case of the TIAA-CREF plan in the United States. However, union coverage applies only in some industries, and the TIAA-CREF plan covers workers only in the non-profit sector.59 Beyond these cases, there is not much evidence of pressure for RPP coverage on the part of employees without plans, or of private sector initiatives to provide pension plans to the small business sector in a way that benefits from economies of scale.

All three provincial pension reviews referred to in the introduction proposed, or at least called for the consideration of, new government-sponsored pension plans (or an expansion or second tier of the CPP) to address the issue of low and declining RPP coverage.60 This is remarkable, particularly since consideration of such an approach was not included in the terms of reference of any of these task forces.

58 See Josh Fear and Geraldine Pace, Choosing Not To Choose: Making Superannuation Work by Default, The Australia Institute Discussion Paper no. 103 (Manuka, ACT: The Australia Institute, 2008); and Wilson Sy, “Towards a National Default Option for Low Cost Superannuation” (Australian Prudential Regulation Authority working paper, August 18, 2008).

59 TIAA-CREF is a non-profit insurance corporation founded with a $1 billion endowment by the Carnegie Foundation. It provides pensions and IRAs to 3.2 million clients in the academic, research, medical, and cultural industries.

60 See supra note 1: the Ontario report at 187 and 188; the Alberta/BC report at v and 180-94; and the Nova Scotia report at 40-42.
Should Participation Be Compulsory?

The question of voluntary versus compulsory participation is a major policy issue, and one that involves a tradeoff between competing goals and values. The UK Turner commission considered three broad approaches to expanding DC pension coverage:

1. voluntary enrolment;
2. automatic enrolment with “contingent compulsory” employer contributions; and
3. mandatory employer and employee contributions, as in Australia.61

The commission rejected the purely voluntary approach as having proved to be ineffective. On the other hand, it noted that, while the compulsory contribution approach was preferred by certain social groups and some experts, it would entail costs in cases such as those where individuals have high assets in other forms, or where they would be better off concentrating on building home equity or paying down high-interest debt. It also observed that compulsory contributions are more often considered to be taxes rather than investments.62 Much of the commission’s work in this area consisted of polling and focus group analysis. They found majority support (74 percent) for automatic enrolment with the choice to opt out.

The automatic enrolment approach recommended by the Turner commission has been advanced by the UK government in two white papers and is embodied in the personal accounts savings scheme (UK PAs) created in the Pensions Act 2008.63 The UK PAs have a default employee contribution rate of 4 percent on a band of earnings (£5,035-33,540 per annum, wage-adjusted from a 2006-7 base). This is to be matched by a 3 percent employer contribution that is compulsory unless the employee opts out.64 The automatic enrolment mechanism will not apply if the employer already maintains a pension plan of equal or greater generosity. Employees who opt out of the UK PA scheme must renew that choice every three years.

61 Australia has an income-tested state pension like the GIS but no equivalent to the OAS or the C/QPP; essentially, its compulsory superannuation scheme can be viewed as a substitute for the C/QPP.

62 This is an important point. Economic analysis suggests that where payroll deductions of premiums (such as employment insurance or C/QPP) are perceived by workers as a form of taxation, they will reduce labour supply, driving up reservation wages and reducing employment. Alternatively, if premiums are seen as a contribution toward benefits of value to the employee, they will not have the same negative effect on labour supply.


64 The Turner commission chose the 3 to 4 percent employer match rate because, when 3 percent is added to the value of tax deductibility of the employee contribution (worth about 1 percent), it allows the government to say that employee contributions are effectively matched pound for pound.
Employers will remit the contributions to a single government-established body, the Personal Accounts Delivery Authority (PADA). This body will contract with private sector firms to provide investment and administrative services. It will provide account holders with a default investment option as well as alternatives. The government anticipates that the PADA should be able to achieve administration costs of no more than 0.3 percent of assets, as proposed by the Turner commission.

Recognizing the potential burden of the compulsory employer contributions, the government has provided that the scheme will begin operating in 2012 and that the default contribution rates will be phased in over the first three years of operation.

One question about the UK approach is whether small employers might try to limit their costs by encouraging employees to opt out of the scheme. Many employees at modest earning levels might invite such an employer response because of the strong disincentives to retirement saving created by the pension credit and other income-tested benefits (such as the housing benefit). The Pensions Act 2008 provides for penalties to be levied on employers who commit offences such as failing to enrol employees or seeking to screen prospective employees in order to choose those who would opt out. However, these provisions may be difficult to apply.

Another question is the extent to which such a plan may crowd out existing employer pension plans that promise greater benefits. This was an issue when Canada and Quebec introduced the C/QPP, but the main result appears to have been the integration of C/QPP and RPP benefits. However, if a broad-based automatic enrolment plan with compulsory employer contributions were established in Canada, it could well provide some employers with increased incentives to simply abandon their RPPs. The UK government has addressed this issue by including specific restrictions and deterrents in the Pensions Act 2008: there are provisions prohibiting transfers of funds to UK PAs from other pension plans, and penalties for employers who abandon more generous pension plans in favour of contributions to UK PAs. Again, these may be difficult to enforce.

Should Annuitization of Savings Be Required?

Under the OAS/GIS and the C/QPP, benefits are paid in the form of annuities. The same is true for retirement benefits under DB and most DC plans. Under an RRSP, on the other hand, funds generally may be withdrawn in lump sums, or are only subject to minimum payout requirements following conversion of the RRSP to a

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65 The introduction of the pension credit in 2003, with its 40 percent benefit reduction rate, was estimated to increase the proportion of seniors aged 65-74 who qualified for income-tested benefits from 47.4 percent to 55.2 percent. See Mike Brewer and Carl Emmerson, Two Cheers for the Pension Credit? IFS Briefing Note no. 39 (London: Institute for Fiscal Studies, 2003).

66 The income tax rules were amended some years ago to allow RRIF-type payout arrangements under DC RPPs. This change responded to pressure from RPP members, and recognized that they could achieve the same result (with the employer’s agreement) by quitting their RPP at retirement and transferring their pension assets to an RRSP.
registered retirement income fund (RRIF). If a new form of pension or savings plan were created, what should the rules be regarding the form of retirement benefits?

The UK Turner commission takes the position in its proposals that, since benefits from the proposed scheme would form part of participants’ basic pension income, they should be paid in the form of annuities (counter to a long tradition in the United Kingdom of payments in the form of lump sums at retirement).

Ambachtsheer goes further, suggesting that funds in DC plans should be annuitized progressively, starting some years before retirement. As well as ensuring that plan members do not outlive their savings, this procedure is designed to reduce the harmful effect of unfavourable market conditions for annuity purchase at the time of retirement.

While these recommendations seem quite sensible, particularly given projected increases in longevity, there is evidence that Canadians would resist the forced annuitization of funds contributed to individual accounts. The development of the RRIF rules in the 1980s responded to a widespread belief that annuities offered an unfair deal. Moreover, those choosing RRIFs over annuities appear to value the option that RRIFs provide of allowing individual holders to manage their own investments during retirement. Recent experience suggests that nearly all newly matured RRSPs are converted to RRIFs, rather than being used to purchase annuities.

These considerations suggest that, under any new government-sponsored pension or savings plan, strong consideration should be given to requiring annuitization of a good portion (say, 50 percent) of assets, but not all of them.

POLICY APPROACHES

A wide variety of policy responses could be considered that would strengthen Canada’s retirement income system, and make it better prepared to meet the challenges discussed above. This section provides brief comments on a number of possible responses, grouped under the following broad approaches:

- minor changes to the current system,
- enrichment of fiscal incentives for RPP or individual saving,
- creation of new pension institutions, and
- expansion of the C/QPP.

Minor Changes to the Current System

There are many minor changes that could be considered, as reflected, for example, in the detailed recommendations for changes to pension benefits legislation coming

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67 Where RPP assets are transferred to RRSPs, they are locked in to retirement age (generally age 55 for this purpose) and may only be paid out through an annuity or a RRIF (payments from which are subject to annual maximums as well as minimums).

68 See supra note 52.

69 This observation is based on an unpublished tabulation of data for 2000 from the T1 taxation data file created by the Canada Revenue Agency.
out of the three provincial pension reviews. Comments are provided on only a few possible measures.

**Financial Information**

In a retirement income system such as Canada’s, which gives a big role to employer-sponsored and individual saving, sound information regarding retirement choices and financial planning is important.\(^70\) The review of problems with individual saving suggests that this is an area in which there is great need for improvement. While improving the level of financial literacy presents enormous challenges, and is unlikely to remove the need for other measures, it is certainly an important task. On June 26, 2009, the federal minister of finance announced the creation of a task force on the issue.\(^71\)

**Encourage Multi-Employer Shared-Cost DB Plans**

Another idea is to promote the spread of DB plans by including features that make them less risky for employers and more suited to today’s pension environment. To limit the risk for employers and make them more sustainable, these plans would have benefit conditionality (sometimes called a target benefit structure) and fixed employer-employee cost sharing. Like other multi-employer plans, these plans can withstand solvency problems of individual employers. Also, their scale is generally sufficient to warrant the relatively high administrative costs of DB plans.

Various steps can be taken to encourage plans of this sort. The Régie des rentes in Quebec has modified its pension regulations to accommodate “member-funded pension plans.” The federal Income Tax Regulations\(^72\) (regulation 8510(9)) have also been amended to accommodate the plans. Although such plans involve negotiated employer contributions, the funding risk (all surpluses and deficits) belongs solely to the plan members.

The response to changes of this sort might well be modest. Most multi-employer DB plans have been introduced either as union-led plans (for example, plans for workers in the forestry, construction, steel, and food services industries) and/or in the public sector (plans for teachers, municipal employees, and health-care workers). While these plans have many desirable features, they also have high startup costs and demand strong interest and commitment from both employers and employees. From the employer’s perspective, a key issue is the loss of individual control over policy choices that affect contribution costs. Nevertheless, there may be some potential for governments to further encourage the spread of such plans.

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\(^70\) The experience in the United Kingdom in the 1980s provides an instructive example. There, many middle-income individuals were encouraged to opt out of the state pension plan in favour of personal pension plans, which, because of their riskiness and high administration costs, proved quite inappropriate to pensioners’ needs.


\(^72\) CRC 1978, c. 945, as amended.
Extending RPP Eligibility to the Self-Employed

Industry representatives have asked that self-employed individuals be permitted to be members of RPPs. Such a measure might be limited to plans with a specified minimum number of members.

The aim would be to encourage greater saving by allowing self-employed individuals to join RPPs where the benefits of scale and risk pooling are available. The measure would be targeted at certain groups—such as musicians and actors—with unions or associations that could run large-scale multi-employer plans. Higher-income groups, such as doctors, could also benefit from such arrangements.

The design of such a measure would need to avoid unintended revenue costs associated with “top-hat” or one-person plans. Where the plan sponsor is also the plan member, there can be a strong incentive to build up surplus as a means of avoiding tax. Since DB plans with only one or a few members offer no risk-pooling advantages, they are really DC plans in disguise, and the case for accommodating them is much weaker.

Extend the RRSP Contribution Deadline

Extending the annual RRSP contribution deadline from the end of February to April 30, the deadline for submitting personal income tax returns, might encourage more RRSP contributions; tax preparers, for example, could promote late contributions by demonstrating their potential effect on taxes owing or on the size of a tax refund. This approach is taken in the United States, where IRA contributions may be made up to the tax-filing deadline.

Tax on RRSP Withdrawals Before Retirement

A penalty tax could apply to RRSP withdrawals before a target age, such as 60. The aim would be to increase the effectiveness of tax-preferred saving in delivering retirement income and also to help discourage early retirement. The United States imposes a 10 percent penalty tax on IRA withdrawals before age $59\frac{1}{2}$.

There are problems with such a measure. Rules like those in the United States quickly become complex, since they must be refined to deal with special situations such as disability, financial hardship, and investments in education, housing, and small businesses. More generally, RRSP savings can now be used for precautionary purposes, and this is a valuable role. LeBlanc found that most of the money withdrawn from RRSPs before retirement was withdrawn by people who experienced significant income reductions. Restrictions on access to funds also diminish the incentive to accumulate retirement savings in RRSPs. Thus, restricting withdrawals could reduce, rather than increase, the pool of savings available to finance retirement.

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Enriched Incentives for RPP or RRSP Saving

Several measures have been suggested to encourage increased sponsorship of RPPs or increased saving in individual plans. Also, the Alberta/BC pension task force recommended that fiscal incentives be considered to encourage employer participation in the proposed new government-sponsored pension plan (the so-called ABC plan, discussed briefly below).\(^\text{74}\) Note, however, that such incentives would not address the concerns regarding the high cost of saving in small-employer RPPs or individual plans.

Support for RPP Startups

Assistance could be provided to employers who introduce RPPs. It could take the form of grants or tax credits to offset startup costs, or temporary (for example, three-year) relief on employment insurance premiums. The benefit could apply to all employers currently without RPPs, or it could be limited to small businesses in recognition of their inability to benefit from economies of scale in providing RPPs.

While a limited subsidy of this kind should have leverage, because of its focus on employers who actually introduce RPPs, it seems unlikely to pay great dividends. In the section on policy issues, it was argued that the saving disincentives of the GIS and the costs associated with locking in weaken employee demand for RPP coverage in the small business sector. This raises doubts about whether employer-based incentives would have a big effect on the provision of RPPs. Moreover, while RPP costs are relatively high for small businesses, the ongoing costs of RPP administration (investment, regulatory compliance, employee communications) are much more important than the one-time costs of plan startup. Thus, a measure focused on startup costs would probably have little effect, and employers would likely seek permanent rather than temporary support.

Finally, on equity grounds, similar assistance would likely have to be extended to employees who make contributions to DPSPs and/or group RRSPs.

Superdeduction for Employer Pension Contributions

Employer contributions could be made deductible at, say, 50 percent rather than the employer’s marginal tax rate. In principle, this superdeduction could be limited to, say, the first $3,000 of contributions per employee and to contributions in respect of employees below a certain salary level.\(^\text{75}\)

This measure is too unfair to warrant serious consideration. It would provide no benefit to non-taxable and tax-exempt employers, or to self-employed individuals who are restricted to RRSP saving. It could also encourage the substitution of

\(^{74}\) Alberta/BC report, supra note 1, at 187.

\(^{75}\) Assigning employer contributions to individual employees, in order to apply dollar caps or other eligibility conditions, would be simple under DC plans but would raise administrative and compliance issues under DB plans. An imperfect measure such as the pension adjustment would likely have to be used.
employer contributions for employee RPP contributions (which are not very high in the private sector) and employee RRSP contributions. Employees would be motivated to negotiate, at no cost to the employer and without necessarily adding to their existing savings, 401(k)-like swaps of current compensation for employer RPP contributions. This would raise the cost of the measure without materially increasing savings. Some of these disadvantages might be limited by extending eligibility only to small businesses where existing RPP coverage is low, but it is questionable whether such an eligibility restriction could be successfully defended.

**Matching Grant for RPP and RRSP Contributions**

In the manner of the CESG for RESP contributions, the government could make a matching contribution of some percentage of certain eligible annual contributions. For example, the amount could be 20 percent of the first $3,000 of contributions made in the year by or on behalf of those earning less than $40,000. A key question is whether such a measure should apply to pension (and DPSP) saving only or to contributions to an RRSP as well. There would be strong pressure, on fairness grounds, for broad application of the measure.

If applied to RRSPs, the subsidy would need to be limited to contributions made to locked-in accounts, or be subject to other rules to limit “churning” (short-term contributions designed to profit from the subsidy). One approach would be to restrict the grant to contributions to an RPP (or DPSP) or individual contributions to a new government-sponsored savings plan, under which contributions would be subject to lock-in provisions similar to those applicable to RPPs. As well as addressing the churning issue, this would ensure that the saving by individuals benefited from the low-cost administration and expert investment services available in a large-scale plan.

The measure would reduce the disincentive effect of the GIS on saving by lower-income earners. Thus, it could promote RPP coverage by making deferred compensation more attractive to modest earners. Unlike the superdeduction, the matching contribution mechanism would not favour employer versus employee contributions or employees of taxable versus non-taxable employers.

The measure would make most sense for DC plans, where the matching grant would add directly to retirement savings. However, it would be untenable to deny parallel treatment to members of DB plans. Apart from being unfair, exclusion would create a clear incentive for DB-DC conversions. On the other hand, DB plan members might well see such a grant as being directed to employers, since it would have no direct effect on their own promised benefits. They would likely prefer that the subsidy go to their RRSP contributions or to “additional voluntary contributions” made to RPPs on a DC basis.

Such a measure would be expensive. The cost of the measure applied to existing contributions alone could be over $600 million for RPP contributions and (if covered) over $900 million for RRSPs. Assuming that the measure generated a contribution increase of 20 percent in the eligible population, the total annual cost could be close to $2 billion. Whether the new saving generated by such a measure would be enough to justify the revenue cost is unclear.
Targeted Supercredit For RRSP Saving

A special tax credit could be provided for RRSP contributions, in addition to normal deductibility. For example, as in the case of a matching grant, the credit could be 20 percent of contributions up to a limit of $3,000 per year made by eligible taxpayers earning up to $40,000. The aim would be to encourage greater saving among modest earners, particularly those who do not belong to RPPs. The measure would help to counter the disincentive to saving created by the 50 percent tax-back rate under the GIS program.

The United States has introduced such a credit, and there is preliminary evidence that it is having some effect. However, the US retirement income system (social security plus the supplemental security income [SSI]) does not provide the same level of benefits to low-income seniors as the OAS/GIS does in Canada. Nor does the SSI tax-back rate create the kind of disincentive to saving that arises with the GIS.

In the context of the challenge of declining pension coverage, an additional RRSP credit seems ill advised. It would not address the issue of poor investment returns in individual savings plans. And it would encourage some RPP members to have their employers replace their RPP benefits with contributions to RRSPs.

Extend Working Income Tax Benefit Treatment to RPP and RRSP Income

Incentives to save in RPPs and RRSPs can be provided at the front or back end of the saving process. Thus, providing more favourable tax treatment of pension and RRSP income would be an alternative to grants or credits on contributions.

The working income tax benefit (WITB), announced in the 2007 federal budget for introduction in 2008, provides an income-tested benefit based on employment income. In its application to seniors, it helps to offset the work disincentive effects of the GIS. Extending it to apply to RPP and RRSP income would help to offset the disincentive effects of the GIS on saving. It would also help to counter a possible shift

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77 The SSI is reduced at 100 percent of other income, and is subject to an asset test as well; but because of the tight targeting, only a small proportion of the senior population is eligible for it.

78 See Canada, Department of Finance, 2007 Budget, Budget Plan, March 19, 2007, 375-79. For single individuals, the maximum annual WITB is $500. It is phased in at 20 percent of earnings over $3,000 and phased out at 15 percent of net income over $10,500. For single parents and couples, the maximum benefit is $1,000 and phase-out begins at family net income of $14,500. In early 2009, the government announced a doubling of the resources devoted to the WITB: see Canada, Department of Finance, 2009 Budget, Canada’s Economic Action Plan, January 27, 2009, 312.
away from RPP participation to TFSA saving by employees at modest income levels. (TFSA benefits are not treated as income in determining eligibility for the GIS.)

Creation of New Pension Institutions

Another approach to the extension of pension coverage is to offer employers and employees (especially in the small business sector) a low-cost pension administration facility that accepts on behalf of employers as much as possible of the risk and responsibility of pension management.

Most of the options for implementing this idea share certain characteristics. The plan is government-sponsored at the national or provincial level but operates at arm’s length from government, with no claim on government support in the event of adverse investment experience. Like the Canada Pension Plan Investment Board, the arm’s-length agency that administers the plan is charged with doing so solely in the best interests of plan members. In particular, it should aim to maximize investment returns without undue risk and taking into account the nature of the plan’s obligations.79 The plan would be afforded the same income tax treatment as an RPP.

Under this broad approach, important variations are possible. The plan structure could be a DB or a DC; it could be compulsory, voluntary, or an intermediate form, such as automatic enrolment with the right to opt out; and its contribution or benefit structure would need to be defined. However, not all variants would be practical.

A DB plan, for example, would likely have to be compulsory and national in scope to be successful. Because the cost of a given pension benefit varies with the contributor’s age and expected longevity (which varies with sex and income), a voluntary plan would be prey to adverse selection, with heavy enrolment by high-cost individuals driving up plan costs and making it a poor savings choice for others. In addition, a small-scale DB plan would have to deal with many partial and interrupted periods of service, which would make it costly and complicated to administer and to explain to plan members. Accordingly, the DB option is treated separately as a fourth approach.

As outlined in the policy issues section, the choice regarding compulsory participation is a critical one. A compulsory plan (with an exemption for employees already covered by RPPs) would have the greatest effect on pension coverage and would promise the lowest-cost administration. On the other hand, its inflexible contribution requirements would impose welfare costs on some plan members.

79 A smaller-scale variant of this general approach was recently proposed by the Ontario government in response to a recommendation of the Ontario Expert Commission on Pensions (Ontario report, supra note 1, at 186–87). Under the proposal, the Ontario Teachers’ Pension Plan would be given a mandate to provide investment and pension administration services to other plans. See Ontario, Ministry of Finance, 2009 Budget, Budget Papers, March 26, 2009, 131.
Recent proposals for government-sponsored pension plans such as the UK PAs, Ambachtsheer’s “Canada supplementary pension plan,” and the ABC plan have tried to balance these advantages and disadvantages by adopting an intermediate approach involving some form of automatic enrolment. The key issue with any variant of automatic enrolment is how effective it is likely to be in encouraging participation by employers and employees. Takeup rates will also be affected by choices made regarding default contribution rates, the investment options provided, rules regarding possible access to funds before retirement, and rules regarding access to benefits after retirement (annuitization). A point to consider is that compulsory contributions could be introduced at a later date if an automatic enrolment approach proved ineffective in encouraging satisfactory levels of retirement saving.

With regard to contribution structure, the main question is whether compulsory or default-level contributions should include nearly all earnings (for example, earnings over $3,500, as under the C/QPP) or whether a higher earnings threshold should apply. A higher threshold (say, $20,000) would avoid imposing welfare costs on low-wage workers whose earnings replacement needs are largely covered by existing public pension benefits.

Many other issues would have to be considered in designing a plan of this sort. For example, should members of existing RPPs be exempt from compulsory or automatic enrolment in the new plan? Should eligibility (or compulsory participation) extend to self-employed individuals? Should irregular voluntary contributions be allowed? Should transfers of assets into the plan from—or out of the plan to—RRSPs and/or RPPs be allowed?

With an automatic enrolment plan, or a compulsory one, the creation of a low-cost, government-sponsored alternative for retirement saving could lead to the termination of a considerable number of RPPs. Before proceeding with a plan of this sort, it would be important to assess the likely scale of such a response, since it would be critical in determining how effective the plan would be in generating a net increase in retirement saving.

**Expansion of the C/QPP**

Expansion of the existing public pension plans, especially the earnings-related C/QPP, is an obvious alternative to other measures aimed at increasing retirement income security. As argued below, this approach would need to include the creation of a second tier of C/QPP benefits that may differ in their characteristics from those under the existing plans. A parallel DB plan would be possible as well.

The key aspect of this approach, noted in the preceding section, is that it would deliver defined benefits under a compulsory plan that is national in scope.

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80 For the UK personal accounts, see supra notes 57 and 63; for the ABC plan, see the Alberta/BC report, supra note 1; for Ambachtsheer’s proposals, see supra note 52.
Certain conclusions flow from the principle that such a plan should operate at arm’s length from the government, and in a self-sustaining manner that does not expose the government to the risk of future financial obligations:

1. The plan should be fully funded rather than operating on a pay-as-you-go ("PAYGO") basis, under which future contributions are relied upon to cover the cost of future benefits. In an aging population, where little growth is expected in the size of the contributor base, PAYGO plans generally require higher contribution rates than fully funded plans.

2. Benefits would be based solely on years of service during which contributions to the expanded plan were made. This means that, as in the case of a newly created DC plan, the expansion of the C/QPP would have little effect on the retirement incomes of those now near retirement.

3. Because growth in future contributions will be slow in an aging population, adjustments to promised benefit levels as well as contribution rates would be needed to ensure that adequate funding levels are maintained in the face of fluctuations in investment returns.

As in the case of contributions under a DC plan, the structure of benefits is an important issue. Targeting the benefit increase strictly on earnings replacement needs would imply basing contributions and benefits on earnings above a higher threshold than the current $3,500 threshold under the C/QPP. Such a structure would also limit opposition to the plan from workers at low earnings levels who have relatively little need for additional earnings replacement and upon whom the burden of an inflexible contribution regime would be greatest. On the other hand, an expansion of the existing structure of C/QPP benefits could serve to offset the expected decline in the earnings replacement role of OAS benefits, which will occur to the extent that future wage increases exceed the rate of inflation (to which OAS benefits are indexed).

With a compulsory nationwide DB plan, exemption of members of existing RPPs is less appealing than the alternative of leaving it to RPP sponsors to adjust their benefit rate structures so as to integrate them with the new benefits. This raises the issue that some plan sponsors might find it unduly burdensome to continue administering a smaller plan. The possibility that some employees would experience a net reduction in pension benefits is a concern.

**SUMMARY OF MAIN POINTS**

As Canada’s retirement income system has developed and matured over the last several decades, it has grown substantially, and to date, it has performed well, both

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81 Even with this benefit conditionality, the level of pension benefits under such a DB plan should be less uncertain than that under a DC plan.
reducing the incidence of low income among seniors and enabling the great majority of retirees to maintain their living standards in retirement.

Several challenges, however, pose threats to the continuation of this good performance. Increasing longevity, combined with the uncertainty of actuarial projections, raises the costs of providing given levels of pension income and increases the riskiness of DB plans for plan sponsors. By increasing the dependence of pension benefits on plan assets and investment income relative to new contributions, an aging population also adds to the riskiness of DB plans. The expectation of lower rates of return on plan funds over the next few decades exacerbates these problems. Pension plan coverage has declined steadily over the past 25 years, and the trend appears to be continuing. Private sector coverage is now quite low. For some time, increased contributions by individuals to RRSPs offset the decline in employer-sponsored pension savings, but the RRSP saving rate has also declined significantly since the mid-1990s.

Further understanding of these trends and challenges helps in considering possible policy responses. Lack of pension coverage is concentrated among small businesses and not-for-profits. Employers in these sectors are not well placed to run pension plans (especially DB plans) because they do not benefit from economies of scale and cannot cope with pension risks. Moreover, a majority of their employees have relatively low earnings, and hence little incentive to participate in employer-sponsored pension plans. Modest earners are also more likely to prefer savings that can be accessed before retirement in case of need. All these considerations suggest that attempts to reverse the trend to lower pension coverage in traditional single-employer plans are unlikely to be successful, and may not even be beneficial for either small employers or their employees.

The prospect of very limited growth in the size of the contributor population over the next two or three decades has strong implications for the management of DB pension plans. By increasing the extent to which benefits must be funded out of investment income (or a drawdown of assets) rather than new contributions, these trends make DB plans increasingly vulnerable to investment swings. Making benefit levels as well as contribution rates conditional on the financial health of the plan is a response to this situation that is supported by analytical studies and is increasingly being adopted in practice. This response does mean, though, that the “benefit certainty” advantage of DB over DC plans is no longer as great as it once was.

Studies in recent years have cast doubt on the effectiveness of saving in individual plans. One problem is that many individuals do not appear able to make informed, timely, and disciplined decisions about retirement saving. A second is that administration fees in individual plans and costs incurred in shifting between investments eat up a substantial part of the gross return on saving. The result is rates of return on individual saving that are much lower than those obtained in large pension plans.

The studies of savings behaviour also show that individuals are quick to accept suggested choices or default options and less responsive to changes in financial incentives.

These findings suggest that we should definitely proceed with measures to improve the operation of the current system, including, for example, measures to reduce
the regulatory burden on RPPs, to allow greater flexibility in plan design, to encourage the creation of multi-employer plans or plans covering self-employed groups, and to improve the financial literacy of Canadians. At the same time, we may need to consider bolder approaches, such as the creation of new government-sponsored pension or savings plans to meet the identified challenges.

Proposals for plans of this sort share the key characteristic that the plan should be run by a government-created agency that operates at arm’s length from government and is charged with getting the best possible results for plan members.

Beyond this trait, there are key choices to be made in designing such a plan. A DB plan would work well only if it were compulsory and nationwide. It should be fully funded and have benefits that are conditional on the plan’s funding status to allow a fair sharing of the investment risks between beneficiaries and contributors.

A DC plan could operate at the provincial level provided that it was large enough to attain low administration costs. It would not provide the same degree of risk pooling and benefit certainty as a DB plan, but it would be cheaper to run, more transparent, and easier to explain to plan members. It could be compulsory or voluntary, or it could offer an intermediate option such as automatic enrolment of both employers and employees coupled with the right to opt out. Recent proposals have focused on variants of the automatic enrolment approach.

Targeting of contributions or benefits is another important choice. Basing them on earnings above a fairly high threshold, such as $20,000, would focus the plan strongly on the goal of maintaining earnings replacement rates, but there are arguments for broader coverage as well.