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The Canadian Retirement Income System

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Acronyms:

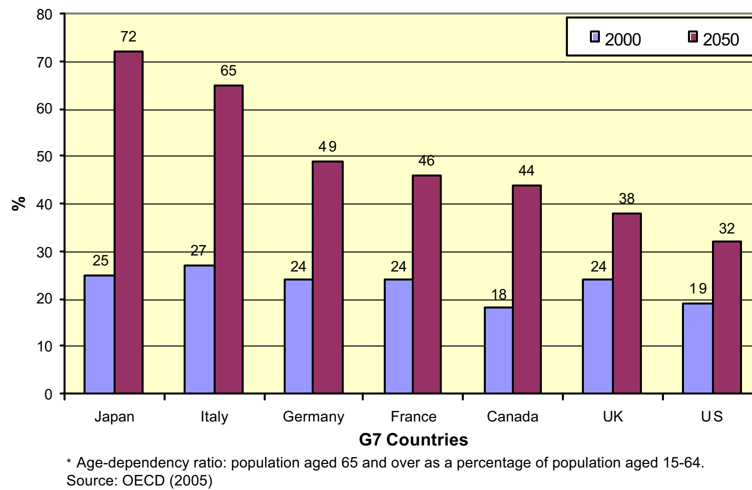
RIS:	Retirement Income System
OAS:	Old Age Security
GIS:	Guaranteed Income Supplement
SPA:	Spouse's Allowance
WSPA:	Widowed Spouse's Allowance
CPP:	Canada Pension Plan
QPP:	Quebec Pension Plan
RPP:	Registered Pension Plans

Introduction

The Canadian retirement income system (RIS) is generally considered a success story. Since 1971, senior citizens have experienced a significant improvement in their relative incomes, and an impressive number of seniors has moved out of poverty. The system provides most elderly Canadians at the low-to-middle income level with the means to largely preserve their living standards in retirement. At the same time, middle-to-high income households have an incentive to save for retirement because public pension benefits remain relatively modest. The reforms that have been implemented since the late 1990s have rendered the system viable in the long-run. They include a gradual increase in contributions (to a "steady-state" level) and in the amount of earnings subject to premium payments, changes in the administration and calculation of benefits, and the creation of an investment board to invest funds not immediately needed for benefits.

However, the retirement of the baby boom generation, starting at the end of this decade, raises new challenges. The old-age dependency ratio is expected to rise sharply (Chart 1), and the RIS will have to cope with these new demographic trends. Although the adjustments to the RIS and the economic recovery of the late 1990s restored the financial health of the RIS, there is still scope for additional reforms in preparation for the retirement of the baby boom generation.

CHART 1
OLD AGE DEPENDENCY RATIO



* Age-dependency ratio: population aged 65 and over as a percentage of population aged 15-64.
Source: OECD (2005)

This paper describes the RIS and discusses the state of the system today. In Part I, Canada's three-pillar pension system is described. Part II discusses the balance between fairness, efficiency and sustainability, pension incomes and retirement trends, and the scope for future changes. The last section offers some concluding remarks.

Part I: An Overview of the RIS[1]

The Canadian society experienced a large phase of industrialization between the end of the 19th century and beginning of the 20th. Industrialization significantly changed the Canadian way of life, as farm life and family support systems dissolved and migration from rural communities to cities and towns greatly affected the lives of the elderly. Life expectancy increased in this period, but most seniors lived in poverty as not many jobs were available to them (factories were more inclined to hire young workers). Industrialized countries started to provide benefits for their senior citizens at that time. In the case of Canada, the first social security program for seniors was implemented after World War I. The Canadian government established the *Old Age Pensions Act* in 1927 to help senior citizens out of poverty, providing poor seniors with a monthly pension of C$20.

It was during the fifties and the sixties, however, that the Canadian government consolidated its social security system. Pushed by political parties, unions, and social interests groups, and fueled by high economic growth, the government developed programs with the aim to protect all Canadian citizens from poverty. In 1952, following the adoption of the Unemployment Insurance and Family Allowances, the Canadian government established the *Old Age Security Act (OAS),* a federally funded pension plan providing every Canadian over the age of 70 who had lived in Canada for more than 20 years with a monthly taxable allowance. In 1965, the age for retirement was reduced to 65. In 1966, the *Canada Pension Plan (CPP)* came into force, a pay-as-you-go program providing Canadian workers and their families with a supplemental income for their retirement.[2] In 1967, the Canadian government introduced the *Guaranteed Income Supplement (GIS)* program, providing low-income senior citizens with a monthly allowance to place them above the poverty line.

Over the next two decades further changes to Canada's public pension system were introduced in order to help women, the disabled, low-income workers and other groups most vulnerable to poverty. For example, the *Spouse's Allowance (SPA)* was introduced in 1975 and the *Widowed Spouse's Allowan*ce (WSPA) in 1985.

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1 See Appendix for a detailed timeline of the evolution of the Canadian pension system.

2 The *Quebec Pension Plan* was created at the same time.

In the nineties, concern about the sustainability of the social security system due to demographic trends, economic performance and fiscal balance, led the government to make modifications to the system, which included changes to contributions and benefit calculations, as well as the creation of an investment fund.

The Canadian retirement income system has three pillars. The first pillar is used as a safety net and comprises the OAS, the GIS and the SPA. It seeks to protect senior citizens from poverty, providing them with an income floor. The second pillar, the CPP, is a mandatory contribution social insurance system covering all employed and self-employed Canadians, which provides them with a retirement income based on their previous earnings. The third pillar consists of private pensions and savings subject to favorable tax treatment, including rules and regulations to employer-sponsored and individual retirement savings plans, aimed at improving living standards after retirement (vis-à-vis the mandatory first two pillars). The first two pillars are not intended to meet all the financial needs for retirement. Rather, they provide a base upon which Canadian citizens can add private savings, which is the objective of the third pillar (Government of Canada, 2001).

The pillars of the RIS have different funding approaches. OAS, GIS and SPA are financed through the federal budget. CPP funding combines premia split between employers and employees (self-employed pay both parts) and investment earnings. The third pillar is fully funded with contributions from participants, which receive favorable tax treatment. This funding mix provides better flexibility and shortens the time required for adjustments to changing demographic and economic circumstances.

The first pillar: OAS, GIS and SPA

The OAS provides a monthly pension for Canadian citizens once they reach the age of 65. Benefits depend on the number of years one has lived in Canada after the 18th birthday (the applicant must be a resident of Canada for at least 10 years). The employment history of the applicant is not a factor in determining eligibility, nor does the applicant need to be retired (Government of Canada, 2004b).

To receive a full pension, retirees must have lived at least for 40 years in Canada. For each year under the 40 years limit, the amount seniors receive is abated by 1/40 of the full monthly pension. In addition, the OAS benefit is cut by 15% for every dollar of revenue received from other sources that is over a threshold, which is fully indexed to inflation. This threshold was C$59,790 in 2004. A full OAS pension per year was C$5,592.75 in 2004. The monthly amount received is adjusted for inflation four times a year (in January, April, July and October).

To complement the safety net, the Canadian government created the GIS, which gives an additional monthly benefit (C$560.69 by the end of 2004) for low-income OAS pensioners. Combining both the OAS and the GIS senior citizens may receive up to C$12,240 a year (based on benefit rates for 2004). However, to be eligible for the GIS, senior citizens must have no or little income other than the OAS pension. In addition, GIS amounts depend inversely on income from other sources. For each dollar an applicant receives from other sources, the GIS allocation is cut down (or "clawed back") by 50 cents. Unlike the OAS, the GIS is not subjected to income taxes. Both the OAS and GIS are funded from general tax revenues.[3]

[3] According to Sarney (2002), OAS benefits represent approximately 16% of the average wage, while GIS and OAS benefits together represent roughly 35%. About 37% of OAS beneficiaries also receive GIS benefits.

The SPA (for 60-64 year old spouses) is also part of the first pillar. The SPA benefit is tax-free like the GIS, and is reduced or “clawed back” by 75 cents for every dollar of other income.

The second pillar: CPP

The second level of the Canada’s retirement system was set up to help workers maintain their living standards after retiring. In Canada, two programs fulfill this mission: the CPP and the *Quebec Pension Plan (QPP)*. Both programs are similar, except for the way the funds are managed.[4] The CPP is a joint federal-provincial program, with changes requiring the agreement of two-thirds of the provinces carrying two-thirds of the population (IMF, 2004).

The CPP is a compulsory pension plan in which workers from all provinces (except Quebec) contribute. It provides a monthly retirement pension for senior citizens older than 65 who have paid into the system, as well as disability, survivor and death benefits. The CPP benefit varies according to the income of the retiree and the period of time he/she has contributed to the fund. In general, this pension replaces approximately 25% of the earnings on which people have made contributions. The maximum CPP benefit is roughly one quarter of the past five years’ average industrial wage.

The CPP benefit also depends on the age of retirement. When an individual retires before the age of 65, the amount of the retirement pension decreases by 0.5% for each month before the 65th birthday. If an individual retires later, the benefit increases by 0.5% for each month over the age of 65 (up to the age of 70). CPP benefits are indexed to the Consumer Price Index and adjusted every January, to keep up with increases in living costs, and are fully taxable. In addition, the CPP excludes 15% of the contributor’s lowest earnings when calculating the benefit[5], ensuring that the future pension is not reduced because of a few low-earning years (Government of Canada, 2001).

The CPP provides benefits not only for retirees but also for their survivors. The surviving spouse or common-law partner and dependent children also receive benefits:

- The death benefit: a one-time payment to, or on behalf of, the estate of a deceased contributor;
- The survivor's pension: a monthly pension paid to the surviving spouse or common-law partner of a deceased contributor;
- The children's benefit: a monthly benefit for dependent children of a deceased contributor.

As with most CPP benefits, the amount of the death benefit depends on how much and for how long the individual paid into the Canada Pension Plan. The Plan calculates how much the contributor's retirement pension is, or would have been, if the contributor had been 65 at the time of death. The death benefit is equal to six months worth of this "calculated" retirement pension, up to a maximum of C$2,500 (Government of Canada, 2004a). The amount a surviving spouse or common-law partner will receive depends on whether the spouse or common-law partner is also

[4] Two different programs exist because the province of Quebec opted out of the CPP in the 1960s due to the provincial government’s desire to use the resources generated by the plan according to its own priorities (Diekmeyer, 2004).

[5] Time spent away from work while raising children under the age of 7 can also be excluded.

receiving a CPP disability or retirement pension; how much, and for how long, the contributor has paid into the plan; and the spouse or common-law partner's age when the contributor dies.

Funding for the CPP has been substantially modified since its creation in 1966. In its inception, the CPP was a pay-as-you-go program with benefits being paid for by contributions from employers and employees. From 1966 to 1986, employees and employers contributed a total 3.6% (1.8% each) of pensionable earnings per year to the CPP. This share then increased by 0.2% per year until reaching 4.6% in 1991. Contributions after 1991 had originally been scheduled to rise 0.15% each year from 1992 to 2011, when the combined employee and employer contribution rate would equal 7.6%. However, the 1988 Canada Pension Plan Statutory Actuarial Report concluded that this schedule of increases would be inadequate to meet long-term costs, because by 2030, the system would need a contribution rate in excess of 14.2% to preserve its long-term actuarial balance.

To avoid a sharp increase in contribution rates and associated intergenerational inequities, a reform plan was introduced in 1998. The system moved from pay-as-you-go to fuller funding. Contributions gradually increased to reach a steady-state 9.9% contribution rate by 2003, and a new investment policy was introduced. The CPP is now financed through contributions from employees, employers and self-employed persons, as well as returns on the CPP investment fund. Consequently, contributions are used to both benefits and an investment fund that will be utilized in the future by the CPP to help paying benefits to working Canadians who will begin retiring in 2021 and later (CPP Investment Board, 2004b).

Contributions are based on earnings between a minimum and maximum amount. For example, these amounts were C$3,500 and C$38,300 in 2001. As part of the reform, and for the purpose of calculating pension contributions, the minimum amount, called the Yearly Basic Exemption (YBE), was frozen at C$3,500. However, with the Yearly Maximum Pensionable Earnings (YMPE) rising with average wages, the amount of earnings subject to premium payments has been gradually increasing. [6] CPP contributions are tax deductible and kept separate from general tax revenues. They are only used to pay off benefits, cover administrative costs and for investments (Government of Canada, 2001).

The third pillar: Private Pensions and Savings

In Canada, private pensions and savings are an important part of retirement income, especially for higher income workers who want to preserve their living standards after retirement. Two types of plans are used by workers to save for their retirement: employers' pension plans and personal pension plans. Employers' pension plans can be divided in two categories: Registered Pension Plans (RPP) and *group* Registered Retirement Savings Plans (RRSP). Individuals who do not contribute to either plan can divert money to a *personal* RRSP. Canadian households held an estimated C$604 billion (50% of GDP) worth of assets in RPPs and C$408 billion in individual retirement plans in 1999 (Statistics Canada, 2001).

Around 40% of workers in Canada were covered by employers' pension plans in 2001 (Government of Canada, 2001). Occupational pensions that are voluntarily provided by

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[6] An individual's pensionable earnings are defined as earnings up to YMPE, which is indexed to the average industrial wage, less the YBE. Prior to the 1998 reforms, the YBE was set at one tenth of the YMPE. Pensions are calculated as follows: 0.25 x (average YMPE over the previous 5 years) x (average ratio of pensionable earnings to YMPE over 85% of the individual's working life). The working life is calculated by subtracting 18 years from the age when the benefits are first drawn, with up to 7 years of "drop-outs" being provided for periods when the contributor is caring for a young child (IMF, 2004, p.56).

employers and some unions play a relatively important role in providing income for the elderly in Canada (Pozebbon, 2004). Contributions are tax-deductible and investment income is not taxed when earned. Taxes are paid when funds are withdrawn from these plans or received as pension income. The money invested in RPPs is locked in the plan until retirement.

RPPs are the most common type of employer-sponsored plan. In 2003, there were some 15,400 RPPs, covering about a third of the workforce (5.4 million workers), including employees of the federal, provincial, and municipal governments, which account for almost half of all workers covered by RPPs. Almost 90% of public sector employees are members of an RPP, compared to only 30% of workers from the private sector (IMF, 2004). Under Canadian Law RPPs are subject to minimum standards prescribed by both federal and provincial legislators. There are two categories of RPP: Defined Contribution (DC) and Defined Benefit (DB).[7] In the latter, employers are free to invest in any financial instruments, but since they ultimately bear the risk, they usually invest in safer ones. The importance of DC plans, which shift investment risks to employees, has increased in recent years (Table 1). DC plans are the preferred choice of small companies, partly because individual accounts are easily transferable to individual or group retirement accounts. Large companies generally sponsor DB plans, but employers have been increasingly offering members the option of accumulating future benefits on a DC basis, and in some cases, of converting accrued benefits to cash for transfer into a DC account. However, almost all public pension plans have remained on a DB basis, typically offering 2% of salary for each year of service up to a maximum of 35 years (IMF, 2004).

Table 1: Membership in Registered Pension Plans

(In percent of all employees)

	1989	1991	1993	1995	1997	1999	2001
Total	45.7	48.5	48.1	45.7	44.6	43.6	43.5
Defined Contributions	3.8	4.3	4.7	4.8	5.6	5.9	…
Defined Benefits	41.4	43.6	42.9	40.3	38.3	36.9	…
Mixed	0.4	0.7	0.6	0.7	0.7	0.8	…
Public Sector	83.5	89.4	87.4	84.6	83.9	82.2	…
Private Sector	33.6	34.1	33.6	32.1	31.4	31.1	…

Source: IMF (2004), Statistics Canada.

Group RRSPs are also popular. These are essentially “pooled” individual RRSPs to which employers typically facilitate access by underwriting administrative charges and deducting employee contributions directly from payroll. They are similar to RPPs, in that contributions made by workers and investment returns receive tax-deferred treatment. When compared to RPPs, *group* RRSPs typically offer a wider range of investment choices and are not subject to

[7] DC is a retirement plan wherein the amount contributed is fixed, but the benefit is not. However, a certain amount is set aside each year for the benefit of the employee. There are restrictions as to when and how you can withdraw these funds without penalties. There is no way to know how much the plan will ultimately provide the employee upon retirement.
DB is a retirement plan for which retirement benefits are based on a formula indicating the exact benefit that one can expect upon retirement. Investment risk and portfolio management are entirely under the control of the employer. There are restrictions on when and how you can withdraw these funds without penalties. This fund is different from many pension funds whose payout is somewhat dependent on the return of the invested funds. The payouts made to retiring employees participating in this defined benefit plan are determined by factors such as salary history and the duration of employment.
Source: Investopedia.com

pension legislation. Thus employers are not required to contribute to them and lump-sum withdrawals are permitted, unless the plan specifies otherwise (Pozebbon, 2004).

To safeguard employees' rights to benefits, RPPs must abide and be administered according to appropriate pension legislation.[8] Eleven different regulations of RPPs exist in Canada. A plan must be registered to enjoy the tax advantages provided by the Canada Customs and Revenue Agency. The jurisdiction in which a plan is registered depends on where the contributors are located. The province in which the majority of members are employed is responsible for maintaining the plan's registration. Certain industries, such as banks, transportation, telecommunications, are considered of national interest and fall under federal jurisdiction.[9] At the federal level, the Office of the Superintendent of Financial Institutions (OSFI) is responsible for protecting the rights of pension plan members and for administering a regulatory framework aiming at assuring the appropriate funding and sustainability of pension plans.

Individual RRSPs are the most popular method of personal savings for retirement. They were introduced in 1957 to provide non-participants in employers' pension plans, such as self-employed, with a tax-preferred channel for retirement savings. *Individual* RRSPs are thus voluntary retirement savings vehicles. Since 1991, Canada's income tax law allows tax advantages to RRSP contributions similar to those granted to RPPs. As a consequence, workers not covered by RPPs can save up to 18% of earnings in a tax-sheltered *individual* RRSP, which was capped at C$14,500 in 2003 (Pozzebon, 2004, p.10). The 2004 budget increased the annual cap to C$18,000 by 2006, and provided for the indexation pf the annual cap in line with average wage growth (IMF, 2004). RRSP funds can be invested in a range of financial products, such as Canada Saving and Premium Bonds, term deposits, guaranteed investment certificates and mutual funds (Government of Canada, 2001).

Contributions to RRSPs have declined in recent years. While participation in RRSPs (defined as a percentage of eligible tax filers making a contribution in a given year) steadily increased to 50% in the late 1990s and the amount of RRSP contributions reached 6.5% of total wages and salaries in 1998, since 1997 both participation levels and average contribution size have declined. In 2002, contributions to an RRSP were down 7% from the peak of C$29.3 billion in 2000 (to C$27 billion). Also, only one-third of all tax filers contributed to RRSPs in 2002, out of about 80% of filers that were eligible (IMF, 2004).

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[8] Three main reasons explain why Canadian governments decided to regulate Pension Plans (Pension Commission, 2003): to ensure the resulting pension benefit is used for retirement; to safeguard employees' rights to benefits promised under private pension plans; and to provide protection for the spouse or common-law partner of a member.

[9] There are some 1,200 plans of companies operating in federally regulated areas of employment. These plans cover about 550,000 employees and are registered with and supervised by the Office of the Superintendent of Financial Institutions (OSFI, 2003).

Part II: Fairness, Efficiency, and Sustainability in the RIS

The RIS accomplished a significant reduction in the poverty gap for senior citizens, but it is now at a critical juncture. The combined forces of the retirement of the baby boom generation, rising life expectancies, and falling birth rates will stretch the system over the next 30 years. As a consequence, future generations could face a significantly higher level of taxation to support the current level of benefits. To avoid placing such a burden in future generations, the Canadian government has introduced changes to the RIS with a view to achieving a more durable balance between fairness, efficiency and sustainability.

Equity

The RIS has performed remarkably well over the years in narrowing the income gap between affluent and poor seniors and in combating growing inequity in market incomes (Battle, 2001). The success in raising retirement incomes for poorer Canadians has been reflected in a reduction in domestic inequalities, with virtually all of the relative gains since the early eighties taking place at the lower end of the income distribution (IMF, 2004; Table 2). Although public expenditures on the RIS have remained moderate by international standards, low-income rates among the elderly in Canada are currently among the lowest in the OECD (Table 3). Looking at relative poverty, the RIS, thanks to its first pillar, succeeded in pulling most retirees out of poverty. In absolute terms, the poorest seniors are much better off than their counterpart in the United States and the United Kingdom. The poverty rate for Canadian senior citizens declined from 28.4% in 1973 to 5.4% in 1997, while the poverty gap was reduced from 26.2% in 1973 to 15.8% in 1997 (Table 4).

Table 2: The Distribution of the Elderly by Population Income Quintile, 1980-95 (%)

Quintile	1980	1990	1995	Change 1980-95
Bottom	39.7	25.2	17.5	-22.2
2nd	22.1	29.7	32.5	10.5
3rd	12.2	16.2	20.0	7.8
4th	13.3	14.9	16.0	2.7
Top	12.8	13.9	14.0	1.2

Source: Myles (2000).

Table 3: Old-Age Income and Labor Market Participation

	Low-income rate of elderly*	Partcipation rate, 2001 >65 (%)
Australia	16.1	6.0
Canada	**2.5**	**6.0**
France	10.7	1.2
Germany	10.4	3.0
Italy	15.3	3.4
Japan	..	21.8
Netherlands	1.9	3.1
Spain	11.3	1.6
Sweden	3.0	9.4
United Kingdom	11.6	4.8
United States	20.3	13.1

Source: OECD (2003). * Percentage of the elderly with income less than 50% of median disposable income.

Table 4: Poverty intensity and its components, Canada, 1973-1997

	All			Head of Family < 65			Head of Family >= 65		
	Poverty Intensity	Poverty Rate (%)	Poverty Gap (%)	Poverty Intensity	Poverty Rate (%)	Poverty Gap (%)	Poverty Intensity	Poverty Rate (%)	Poverty Gap (%)
Money Income before Taxes and Transfers									
1973	22.1	21.1	56.1	15.6	16.8	49.1	67.0	59.0	73.7
1979	23.3	21.3	58.8	16.3	16.3	52.6	68.2	61.8	72.6
1989	24.5	22.8	58.3	17.8	17.8	53.1	61.7	56.6	69.3
1994	30.3	26.3	63.3	23.7	21.1	60.5	65.3	60.8	69.8
1997	29.7	26.2	62.3	23.1	21.0	59.2	64.3	59.8	69.2
Money Income after Taxes and Transfers									
1973	8.4	13.6	32.1	7.8	12.0	33.7	13.6	28.4	26.2
1979	8.6	13.9	32.2	8.1	12.0	34.8	12.6	29.6	23.4
1989	6.1	11.0	28.4	6.5	11.0	30.5	3.2	11.4	14.7
1994	6.4	11.8	28.3	7.2	12.8	29.0	1.5	5.0	15.0
1997	7.6	12.5	31.8	8.6	13.6	32.7	1.7	5.4	15.8

Notes: -The Sen-Shorrocks-Thon (SST) index of poverty intensity is calculated as 1=(rate)*(gap)*(1+G(x)) where "rate" is the percentage of the population with incomes below the poverty line (sometimes called the head count ratio), "gap" is the average percentage gap between the incomes of the poor and the poverty line and G(x) is the Gini index of inequality of the poverty gap among all people. Since the term (1+G(x)) is nearly constant, it is not presented explicitly.

-The poverty line used is one-half the median equivalent income where the equivalent scale is the square root of the total number of people in the famil

-Author's calculations using the Survey of Consumer Finance, Economic Families.

Source: Osberg, Lars (2001) "Poverty among Senior Citizens -- a Canadian Success Story".

This reduction in poverty among seniors has come from a significant increase in pensions since the early 1980s. The combined share of retirement income provided by OAS benefits and the CPP rose from about 34% in 1980 to 43% in 1999. While the largest part of this increase was due to the CPP, the relatively constant share of OAS benefits indicates that a substantial increase in basic pension benefits has allowed poorer retirees to keep up with overall income growth in the economy. A decline in labor income, however, has partially offset the gains in retirement income. The share of employment income was only 10% in 1999, a result of the trend toward early retirement and falling participation rates among the elderly.[10] The share of income from private assets remained essentially stable over the period, but there was a major shift of privately invested funds into retirement savings schemes (IMF, 2004; Table 5).

Table 5: Sources of Pre-Tax Income for the Elderly

(Shares of total, %)

	1980	1985	1990	1995	1999
Employment income	26.4	20.1	17.3	16.7	10.0
Investment income	23.4	22.6	21.2	14.9	13.1
Retirement income	11.6	13.0	16.2	21.0	28.5
C/QPP benefits	7.7	10.9	14.3	17.3	19.0
OAS/GIS/SPA	25.9	28.0	25.1	23.6	24.0
Other	4.9	5.5	6.0	6.4	5.3

Source: Statistics Canada, *Income Trends in Canada, 1980-1999.*

BOX 1
EQUITY AMONG MALE AND FEMALE SENIORS

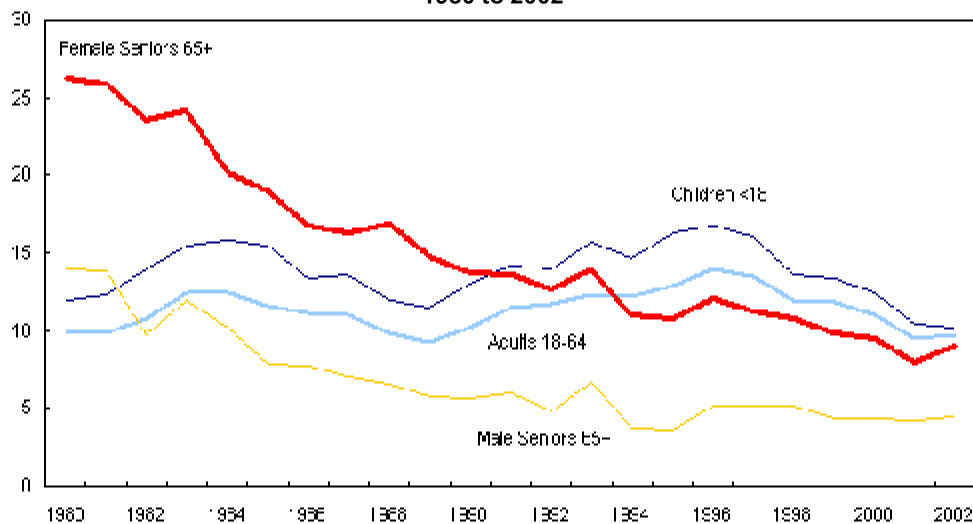
The RIS has also promoted equity among male and female seniors. Historically, low-income rates for senior women have been more than double those for senior men. However, the situation for women over 65 improved remarkably in the last 20 years. While the number of senior men living on low income decreased from 14% in 1980 to 4% in 2002, the number of senior women living on low income decreased from 26% in 1980 to 9% in 2002.

Together with the OAS and the GIS programs that provide a monthly minimum income for seniors, especially women, two other factors explain the improvement in the economic situation of elderly women. First, the CPP, with its spouse benefits, provides senior widows with a retirement income they would not have otherwise. Second, changes made in the legislation governing workplace pension plans have made surviving spouse benefits mandatory, unless both spouses agree to waive this right (Towson, 2000).

However, critics argue that the RIS has created a class of privileged citizens, with over-65 Canadians better off financially than many younger working Canadians, as the system provides relatively high after-tax income when compared with other income security programs at the disposal of younger Canadian citizens (Association of Canadian Pension Management, 2000). According to Statistics Canada (2002), the rate of seniors living on low income is lower than among adults between 18 and 24 and children below 18 (Chart 2).

[10] On average, Canadians retire earlier (and stay in retirement longer) than workers in the United States or Japan, but later than in many countries in continental Europe (IMF, 2004). The trend toward early retirement is due to a number of disincentives to work beyond the early retirement age (see discussion on the *Efficiency* of the system).

Chart 2: Low-income rates of children, adults of working age, and seniors 1980 to 2002



Source: Statistics Canada (2002).

Although the RIS allows for poor and low-income workers to maintain or even improve the standard of living after retirement, this is not the case for middle and high income workers. The standard of living of higher income Canadians is not maintained through the first and second pillars of the system. They must rely on the third pillar of the system, i.e., private pension and savings. However, even the third pillar may not be sufficient to maintain pre-retirement living standards. Given the limits on tax deferral on contributions, for Canadians earning more than twice the average income there are currently no retirement savings opportunities to maintain pre-retirement living standards (Association of Canadian Pension Management, 2000).

In addition, there is growing awareness about the vulnerability of employees with DC plans. They may not accumulate enough retirement savings, especially if plans allow them control over participation, contribution, and investment decisions. Moreover, according to Fretz and all (2002), pension caps allow higher pensions to be paid through DB RPPs than is generally possible through RRSPs or money-purchase RPPs; on equality grounds, a C$15,500 annual limit for these plans (instead of C$13,500) would be required (Fretz and all, 2002, p.18).

Finally, given that the bulk of the RIS is supported by the working population, the intergenerational equity of the system should be considered. It is important to evaluate whether the youth, when retiring, will have the chance to receive the same benefits as currently perceived by seniors, and whether they have to bear an unfair financial burden to support the system. To improve intergenerational fairness, the Government reformed the CPP, which was transformed into a partially funded system in 1998. If the government had not acted, the contributions would have put a significant burden on the young generation, which would have had to pay a contribution rate of 14.4% in 2030, compared with 5.85% in 1997 (International Reform Monitor, 2004).

Efficiency

There are intrinsic sources of inefficiency to be addressed in each of the pillars of the RIS. For example, there is no incentive for low income workers to divert money into the system because they cannot take full advantage of the various governmental tools to save money for retirement. They get little or no effective tax assistance for that effort, and savings are often offset by taxes and loss of benefits. To contribute to RRSPs during working years when incomes are low makes little sense given that the GIS clawback rate invalidates the advantages of RRSPs.[11] Moreover, about half of GIS recipients pay income tax, so they face an effective marginal tax rate on their RRSP that is at least 75% (the 50% from the GIS reduction rate plus 25% from the income tax) (Shillington, 2003, p.2).[12]

There are also a number of inherent disincentives to work beyond the early retirement age. The sharp clawback rate of GIS and SPA benefits and the progressive nature of the old-age income tax credit imply relatively large marginal disincentives to work (IMF, 2004). Under a range of factors, Gruber (1999) illustrates the choice facing Canadian men between continuing to work and taking up retirement. He shows that the marginal incentives to work drop sharply beginning at age 55, particularly after age 60, although the results are sensitive to the amount of non-pension income received by a retiree. The steepest disincentives are for workers with little spouse and other income, owing to the sharp clawback of GIS benefits. He also shows that the adjusted amount of CPP benefits for workers retiring after the statutory retirement age of 65 is not enough to create an incentive to work beyond that age.

How well the CPP is managed is an important factor in determining the effectiveness of the system's second pillar. Administrative costs of the CPP are low due to its non-profit nature and economies of scale. Under the CPP, administrative expenses for the 1999-2000 fiscal year were 336 million, or 1.8% of total benefit payments (Battle, 2003, p.30). The CPP investment fund (put aside to meet future commitments) is also considered efficiently managed. However, there are important differences between the CPP and the QPP, as the latter's actuarial position is currently less favorable, which has motivated the Quebec government to consider significant changes to improve the system's efficacy (Box 2).

[11] At the lower end of the earnings scale, a senior citizen collecting C$6,000 from the CPP and C$5,000 from the OAS will find that more than 70% of the first C$80,000 of her/his pension savings will be lost to taxes and GIS clawbacks (Association of Canadian Pension Management, 2000, p.15).

[12] The Association of Canadian Pension Management suggest that low and middle income senior citizens should not be subjected to combined tax/clawback rates in excess of 50% on retirement income. They also suggest that the tax-deferred contribution room available to build up the voluntary third pillar pension arrangements should be doubled (ACPM, 2000).

BOX 2
MANAGEMENT DIFFERENCES BETWEEN THE CPP AND THE QPP

For the CPP, the return on investments is the primary indicator used in determining if the investment fund has been well managed. In the case of the QPP, however, the fund has the dual mission of obtaining high returns on its investments while also promoting Quebec's development. Thus, it is harder to judge the efficacy of the fund managers.

Another major difference is the independence of the fund managers from government interference. The governance model of the CPP is internationally recognized for its transparency and independence from political influences[1]. One of the important features of the CPP is the check and balance that comes from the involvement of both federal and provincial governments, ensuring that the fund is not biased toward fulfilling the goals of any particular level of government (MacNaughton, 2004). This is not the case for the QPP fund, the Caisse. Since its creation in 1966, there have been close ties between the Government of Quebec and the Caisse. For instance, the Caisse CEO has been usually connected with the governing party (Weaver, 2003). The lack of independence of the Caisse has led to sharp criticisms, especially because of poor decision-making that negatively affected the returns of its investments.

All these facts explain why the QPP has moved recently toward a model that is somewhat similar to that of the CPP. In fact, the Government of Quebec has decided to reform the Caisse in order to guarantee more independence from the government. Consequently, the presidency of the Board and the CEO position will not be accumulated by the same person. The CEO will be nominated by the Board, with the agreement of the government. Moreover, two thirds of Board members will have to be independent from the government and its public corporations (Sansfacon, 2004). Finally, to lessen the risk of political intervention and to facilitate its evaluation, the Caisse will focus more on its performance. Gaining an optimal return on its investments will now be its first mission, while the mandate to contribute to the development of the province will be relegated to the second plan (Dutrisac, 2004).

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[1] The World Bank has cited the CPP as a best practice model (Impavido, 2002).

In the case of the third pillar of the RIS, regulations enacted by the different levels of government aim at improving the system's efficiency and ensuring that retirees will receive retirement income after having invested in RPPs. The 10% limit on investments by a single company's pension plan has probably protected pensioners from the recent deflating of the stock market bubble. Nevertheless, the multiplication of regulations, which are scattered over eleven different laws (federal and provincial), constitutes a disincentive for companies to create RPPs. A complicating factor, for example, is that each province has its own definition of spouse or domestic partner. Moreover, there are sharp differences among provincial regulations about minimum benefits that must be paid out when the contributor dies prior to retirement, as well as about who is entitled to pension plan surpluses and who oversees the plan (the company or a committee, including employees) (Rubin, 2004).

Sustainability

With life expectancy on the rise and the number of workers contributing to RIS on a downward trend, uncertainty about the sustainability of the system was an important issue in the 1990s. There were fears that the downward trend in the number of workers, combined with an increasing number of elderly citizens, would jeopardize the system's capacity to collect enough funds for the provision of future benefits (Table 6).

Table 6: Population of Canada less Québec

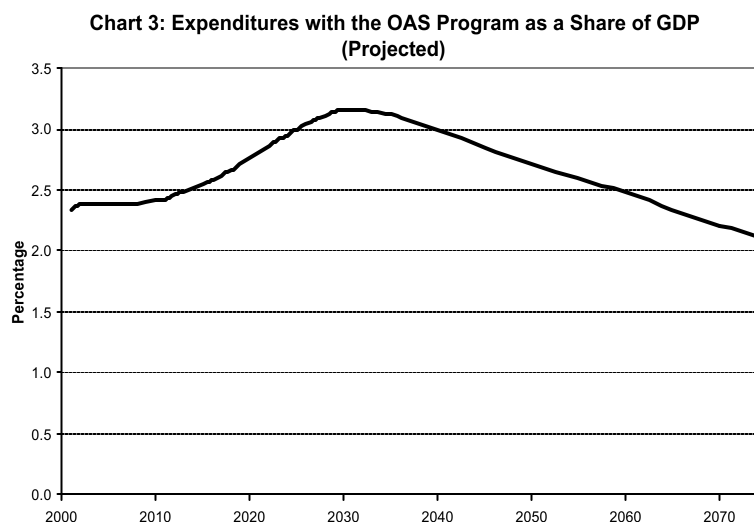
Year	Total	Age 0-19	Age 20-64	Age 65 and over	Ratio 20-64 to 65 and
2004	24 366	6 120	15 131	3 116	4.9
2007	25 037	6 015	15 711	3 311	4.7
2010	25 714	5 939	16 210	3 566	4.5
2020	28 104	6 028	17 071	5 004	3.4
2030	30 315	6 439	17 103	6 774	2.5
2050	33 190	6 692	18 381	8 117	2.3
2075	36 228	7 279	19 863	9 085	2.2

Source: Office of the Superintendent of Financial Institution (2003).

The rapid growth of the number of recipients will exert pressure on the governments' fiscal capacity to fund OAS-GIS programs. This will be even more pronounced with the upcoming retirement of baby boomers accelerating OAS-GIS claims and raising the cost of the programs. The number of recipients is projected to more than double, from 3.8 million in 2001 to 8.4 million in 2030, and the liability of the federal government is estimated to increase from C$25 billion in 2001 to C$109 billion in 2030.

However, according to the Actuarial Report published by the Canadian Office of the Superintendent of Financial Institutions (OSFI), the cost of these programs are expected to slow down after 2030, despite the expected increase in the number of recipients. Expenditures with OAS-GIS programs are projected to reach a maximum of 3.2% of GDP in 2030 due to the massive number of retirees and to slowly decrease to 2.1% of GDP in 2075 (Chart 3). [13]

[13] The cost of the OAS-GIS programs is expected to slowly decrease because the OSFI assumes that each new cohort of retirees will be wealthier than the preceding one, and that recipient rates for benefits will decrease over the projection period. Over the longer term, the effect of indexing benefit rates to the rate of inflation, which is assumed to be lower than the growth rate for both the GDP and the income of new retirees, would predominate.

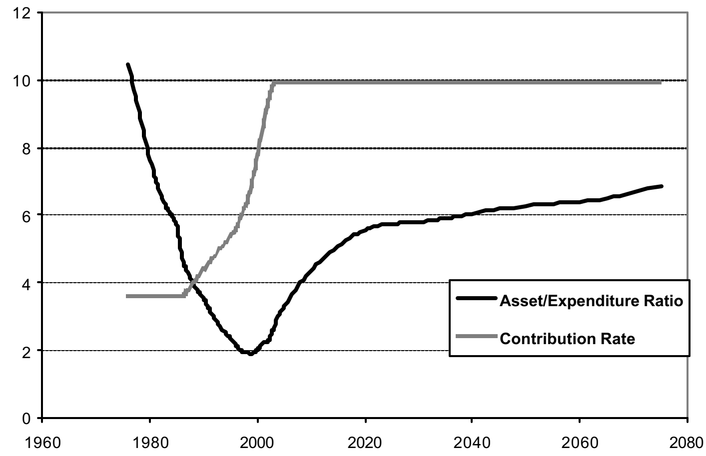


The successful implementation of the 1998 reform plan has made the CPP viable through 2075. The actuarial report prepared by the Office of the Superintendent of Financial Institutions (2003) projects that there will be more cash inflows over the entire projection period as a result of the reforms.

Although contributions increased substantially over a period of 7 years (from 1997 to 2003), they have leveled off after achieving the steady-state rate of 9.9% of contributory earnings, with no further increases thereafter. Contributions will exceed expenditures and build up a fund. The steady-state contribution rate is designed to accumulate a fund equal to about 5 years worth of benefits over the next 20 years. The CPP surplus is being invested in a diversified portfolio of assets, following the practice of large employers' pension funds in Canada and other countries.

The steady-state contribution rate is sufficient for future expenditures and to accumulate assets worth C$147 billion (i.e., 4.4 times annual expenditures) by the end of 2010. The ratio of assets to following year's expenditures, an important measure of the funding situation, is expected to grow from 3.1 in 2004 to 5.6 in 2021. It will rise slowly thereafter, to a value of 6.3 in 2050 (Chart 4). The pool of assets generated over the projection period makes it possible for the CPP to absorb foreseen economic or demographic fluctuations, which otherwise would have to be reflected in higher contribution rates (Battle, 2003).

Chart 4: Projected CPP Contribution Rates and Asset/Expenditure Ratio



Source: OSFI (2003).

Conclusion

People are living longer, fertility has declined, and the number of elderly people will rise significantly relatively to the number of working age people. To cope with these trends, the RIS has been adjusted, making the system sustainable in the long term. However, some challenges remain. Although the adjustments to the RIS and the economic recovery of the late 1990s restored the financial health of the RIS, there is still scope for further reforms in preparation for the retirement of the baby boom generation. The Canadian personal saving rate has fallen steadily from its peak of just over 21% of disposable income in 1982 to a historic low of 1.25% in the third quarter of 2003, standing now below the U.S. personal savings rate. This decline raises questions about the prospects of household spending, as well as whether households are adequately provisioned for retirement.

Basic pension benefits are projected to decline in real terms in future decades. The average benefit could decline from around 20% of average incomes in 2001 to 14% by 2030, with lower incomes facing a larger decline, assuming that benefits would continue to be indexed to prices (OECD, 2003). However, despite the decline in benefits, public pension expenditure is expected to increase by 2% of GDP through 2050, a higher increase than in some G7 countries (Table 7). Expenditures would be pushed much higher if benefit provisions were more generous. A shift to wage indexation, for example, could result in an increase of 5% of GDP, comparable to some of the large continental European countries (IMF, 2004).

Table 7: Change in public pension expenditure, 2000-50
(% of GDP)

Country	% of GDP
Australia	1.6
Canada	**2.0**
France	3.9
Germany	5.0
Italy	-0.3
Japan	0.6
Netherlands	4.8
Sweden	1.6
United Kingdom	-0.7
United States	1.8

Source: OECD (2003).

It is thus important to explore options that not only would simplify the existing system but would also target benefits more directly to the poorest seniors. Also, adequate basic public pension benefits should be maintained by simplifying the RIS and perhaps unifying benefits that are currently provided trough different programs. Testing benefits for family income instead of personal income could contribute to increase intergenerational equity and make the benefit structure more transparent.

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Appendix

Pensions System Timeline

Canada's public pensions have evolved significantly over the last 75 years. Below is a timeline of how they have evolved and when the key changes were made:

1927	The *Old Age Pensions Act* was enacted, permitting the federal government to give assistance to provinces that provided a pension to British subjects 70 and older.
1952	The *Old Age Security Act* came into force, establishing a federally funded pension. It replaced the 1927 legislation that required the federal government to share the cost of provincially run, means-tested old age benefits.
1965	Amendments to the *Old Age Security Act* lowered the eligible age for its pension to 65, one year at a time, starting in 1966 at the age of 69.
1966	The *Canada Pension Plan* and *Quebec Pension Plan* came into force on January 1, 1966.
1967	The *Guaranteed Income Supplement* was established under the Old Age Security program.
1972	Full annual cost-of-living indexation was introduced for the Old Age Security program.
1973	Quarterly indexation was introduced for the Old Age Security program.
1974	Full annual cost-of-living indexation was introduced for the Canada Pension Plan.
1975	The Spouse's Allowance was established as part of the Old Age Security program.
1975	The same Canada Pension Plan benefits became available to male and female contributors, as well as to their surviving spouses or common-law partners and

	dependent children.
1975	The retirement and employment earnings test for Canada Pension Plan retirement pensions at the age of 65 was eliminated (a contributor can, upon application, receive his or her retirement pension the month following his or her 65th birthday, but can no longer contribute to the CPP).
1977	The payment of partial Old Age Security pensions was permitted, based on years of residence in Canada.
1978	Periods of zero or low earnings while caring for the contributor's child under the age of seven were excluded from the calculation of Canada Pension Plan benefits.
1978	Canada Pension Plan pension credits could be split between spouses in the event of a marriage breakdown (CPP credit splitting).
1985	Under OAS, the Spouse's Allowance was extended to all low-income widows and widowers aged 60 to 64.
1987	Several new CPP provisions came into effect, including: · flexible retirement benefits payable as early as the age of 60; · increased disability benefits; · continuation of survivor benefits if the survivor remarries; · sharing of retirement pensions between spouses or common-law partners; · expansion of credit splitting to cover the separation of married or common-law partners.
1989	The repayment of OAS benefits or "claw back" was introduced.
1991	Legislation was passed to assist those people who were denied a CPP credit split as a result of provisions contained in a spousal agreement entered into prior to June 4, 1986.
1992	Three major amendments to the CPP came into effect: · a new 25-year schedule for employer-employee contribution rates was established; · children's benefits were increased; · a provision was made for individuals who were denied disability benefits because of late application.
1995	· The period of retroactivity for OAS benefits changed from five years to one year. · Individuals were permitted to request that their OAS benefits be cancelled.
1998	· The CPP moved from pay-as-you-go financing to fuller funding. · Contribution rates were increased. · A new investment policy was introduced.
2000	All OAS and CPP benefits and obligations were extended to same-sex, common-law couples.