V

Recent Amendments to Canada's Retirement Income Security System

5.1 Introduction

In less than a year the government (including the provincial governments in the case of amendments to the Canada Pension Plan [CPP]) announced two proposed changes in the existing system of government-sponsored retirement income security. In March 1996 the federal government announced that, effective in 2001, the Old Age Security (OAS) and Guaranteed Income Supplement (GIS) would cease to exist and would be replaced by the new Seniors Benefit.

Then, in February 1997, the federal government (with the agreement of eight provinces) announced significant changes to the CPP, which were mirrored by amendments to the Quebec Pension Plan [QPP]. The Seniors Benefit proposal failed and was not implemented. Changes to the Canada/Quebec Pension Plans (C/QPP) have been implemented.

This chapter analyzes these amendments, discusses reasons for the failure of the Seniors Benefit proposal, and projects the potential impact of the changes to the C/QPP on the overall economic security that Canadians can hope to realize.

5.2 The Seniors Benefit

In its budget speech of March 6, 1996, the government announced the most fundamental amendments to social security in Canada since the introduction of the C/QPP in 1966. It was proposed that, in 2001, OAS and the GIS would effectively disappear, to be replaced by the new Seniors Benefit.

In his budget speech, Finance Minister Paul Martin stated that the new Seniors Benefit would guarantee that the support provided to seniors through the OAS and GIS would be sustainable and would be there in the future (Canada 1996b, p. 3): "[the government] is proposing a new Seniors Benefit to take effect in 2001 as part of its commitment to Canadians to ensure they have a secure and sustainable pension system now and in the future" (ibid., p. 5).

5.2.1 Seniors Benefit Plan Design

Under the proposed Seniors Benefit, those elderly receiving GIS today would have gotten $120 a year more. Seventy-five percent of single seniors and couples would have received the same or higher benefits. Another 16% would have received lower benefits. The remaining 9%—seniors with the highest incomes—would have received no benefits at all (National Council of Welfare 1996b, p. 17).

The Seniors Benefit would have effectively combined the present OAS and GIS. The new benefit was to be nontaxable income and fully indexed to inflation (including the clawback thresholds). The clawback was based on the combined income of spouses, as is the case for the GIS today (however, for the OAS clawback, individual income is used today).

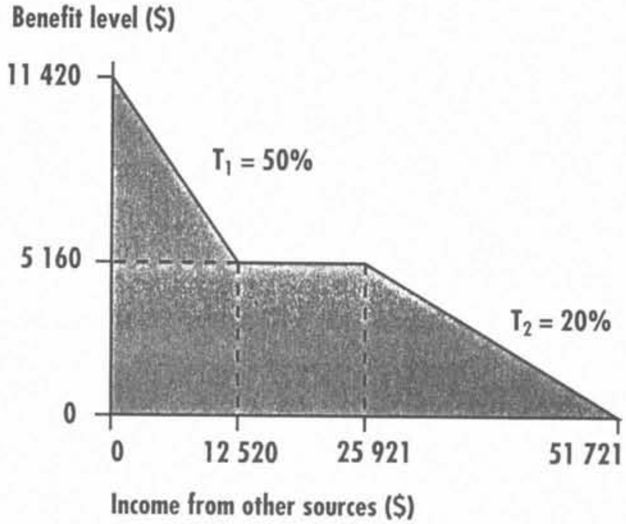
Seniors with incomes above $45,000 would have received lower benefits than under the present system. Single seniors with incomes above $51,721 and couples with incomes above $77,521 would have received no benefits at all. Table 5.1 illustrates the projected level of the proposed Seniors Benefit in 2001.

TABLE 5.1
PROJECTED LEVEL OF THE SENIORS BENEFIT BY INCOME LEVEL, 2001

Income from Other Sources	Tax-Free Benefit	
	Single Seniors	Elderly Couples
$0	$11,420	$18,440
5,000	8,920	15,940
10,000	6,420	13,440
15,000	5,160	10,940
20,000	5,160	10,320
25,000	5,160	10,320
30,000	4,350	9,510
35,000	3,350	8,510
40,000	2,350	7,510
45,000	1,350	6,510
50,000	350	5,510
60,000	0	3,510
70,000	0	1,510
80,000	0	0

Source: Canada 1996b, p. 30.

FIGURE 5.1
LEVEL OF THE SENIORS BENEFIT FOR SINGLE SENIORS ACCORDING TO INCOME



Source: Quebec 1996, p. 38.

The maximum benefit was $11,420 ($18,440 for a couple), $120 more than the projected maximum value of OAS and GIS in 2001. The benefit dropped by 50 cents for each dollar of income until it reached $5,160 per senior, which is equal to the level of current OAS payments adjusted for projected inflation to the year 2001. Beginning at an income level of $25,921, the benefit dropped by 20 cents for each dollar of additional income. This is illustrated in Figure 5.1 (Quebec 1996, p. 38). The level of benefit was to be automatically recalculated each year, based on the previous year's tax return. In the case of couples, the monthly payment would have been split and sent separately to each spouse.

Under the new system, the federal government expected to see projected savings of $0.2 billion in 2001, $2.1 billion in 2011, and $8.2 billion in 2030 (which is 10.7% of the program cost) (Canada 1996b, p. 34). Future savings depended on how much faster wages rose than the cost of living (the government assumed that wages would grow 1% per annum faster than benefits), because the Seniors Benefit was indexed to inflation, not wages. Thus, if wages rise faster than the cost of living (the historic norm), more and more Canadians would have more and more of their Seniors Benefit clawed back.

It would appear that the new Seniors Benefit was designed as a fairly straightforward combination of the present OAS and GIS systems, with a larger clawback than now in effect for the OAS. This plan was not without problems and issues, however, which ultimately led to the failure of the proposal (announced July 1998).

5.2.2 Issues with Respect to the Seniors Benefit

The Seniors Benefit was to be clawed back in two tiers: 50% on a portion of annual family income up to approximately $16,000, and 20% for each dollar of additional income above $25,921. (This compares to the present OAS clawback threshold of $53,215 for a single person, or $106,430 for a couple.) There was to be no clawback between $16,000 and $25,921. The benefit was entirely clawed back for a single person earning $51,721 a year or for a family with income of $77,521 (versus $84,484 for a single and $168,968 for a couple for the OAS). Strictly speaking, the proposed reduction under the new Seniors Benefit would not be a clawback, it would simply not be paid out in the first place.

Analysts of the proposed system criticized the high marginal tax rates that resulted. If the marginal clawback rate for the Seniors Benefit and the marginal tax rate were added, senior citizens would have lost between 47% and 78% of every dollar of income after age 65 from all sources other than the Seniors Benefit, with a small exception for income between $16,000 and

$25,921 (Mercer 1996a). This is shown in more detail in Table 5.2. The effect is close to a 50% flat tax for senior citizens, higher than the marginal tax rates faced by many corporate executives. It was argued that once the general public understood these rates, the rates would create a significant disincentive to save for retirement. Most Canadians, finding their marginal tax rates are higher after age 65, would avoid taxes by cutting back on savings or by taking savings out of RRSPs before age 65.

TABLE 5.2
PROJECTED TOTAL MARGINAL CLAWBACK AND TAX RATES (SINGLE SENIORS)

Other Income	Clawback Rate	Tax Rate	Total Marginal Rate
\$0–6,500	50%	0%	50%
6,500–12,500	50	27%	77
12,500–26,000	0	27%	27
26,000–36,000	20	27%	47
36,000–51,750	20	40%	60
51,750–54,000	0	40%	40
54,000+	0	50%	50

Source: Author's calculation.

Table 3.12 showed that RPPs now hold $485 billion and RRSPs hold $200 billion. Further, contributions in 1995 totaled $20 billion to RPPs and $23 billion to RRSPs (Statistics Canada 1997c). It was argued that the proposed Seniors Benefit would have endangered these important systems.

The other flaw in the Seniors Benefit that led to it being abandoned was the feature whereby the clawback was based on family income and not individual income (as under OAS). Thus, older women who never participated in the paid labor force would no longer have any retirement income in their own right. They would therefore lose that aspect of economic autonomy in their spousal relationship and in their community of women who have not been employed. This was a very important factor in the death of the Seniors Benefit proposal, and a flaw that the government appeared to have underestimated.

5.3 Amendments to the Canada Pension Plan

On February 14, 1997, the Minister of Finance, Paul Martin, announced that agreement had been reached between the federal government and eight provinces to amend the CPP (agreement is required among two-thirds of the ten provinces, representing two-thirds of the population). Similar amendments were made to the QPP. A detailed description of the amendments to the CPP are found in *Securing the Canada Pension Plan* (Canada 1997).

It is noteworthy that while the C/QPP are financed entirely by worker and employer contributions, workers and employers have little, if any, direct say in how the plan is run. The decision to amend the plans was made by the federal and provincial governments behind closed doors and announced as a fait accompli. Further, amendments to the C/QPP were presented as if these plans were stand-alone schemes that could be changed without significant implications for the rest of the system (for example, potential impact on private pension plans). The government claims in *Securing the Canada Pension Plan* that "The changes will ensure that the CPP is affordable to future generations and can be sustained in the face of an aging population, increasing longevity, and the retirement of the baby boom generation" (Canada 1997, p. 6).

This section explores the claim that the reforms will guarantee affordability of the C/QPP to future generations. It should be noted first that *Securing the Canada Pension Plan* begins by telling Canadians that many important aspects of the plan will not be changed (Canada 1997, p. 6). In particular:

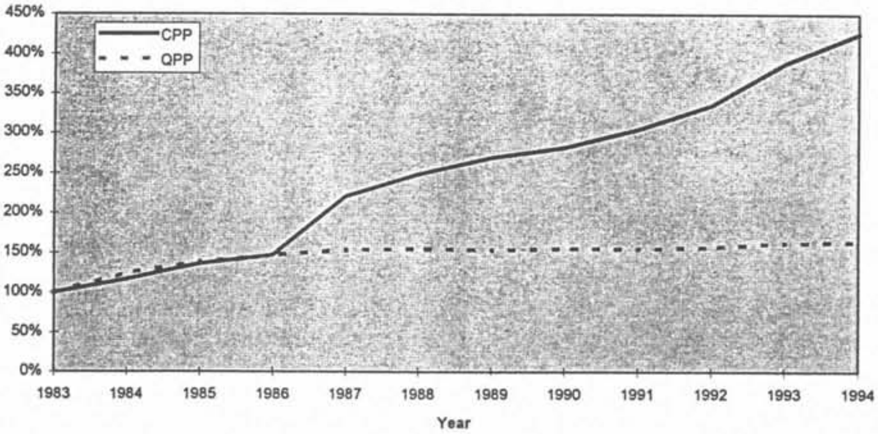
- All retired CPP pensioners or anyone over 65 as of December 31, 1997, are not affected by the proposed changes. Anyone currently receiving CPP disability benefits, survivor benefits, or combined benefits is also not affected.
- All benefits under the CPP will remain fully indexed to inflation.
- The ages of retirement—early, normal, or late—remain unchanged.

However, several amendments were announced that will both decrease the benefits paid in the future by the CPP and increase its level of funding.

5.3.1 Issues with Respect to Disability Income Benefits

As can be seen in Figure 5.2, disability income benefits within the CPP rose sharply after 1986 (Canadian Institute of Actuaries 1996c, p. 12). In fact, it was this increase in disability benefits, projected forward, that caused the CPP Actuary to suggest that the CPP contingency fund would be exhausted by 2016 (see OSFI 1995). There was no parallel increase in disability

FIGURE 5.2
GROWTH IN C/QPP DISABILITY BENEFITS, 1983–94
(1983 = 100%)



Source: Canadian Institute of Actuaries 1996c, p. 12.

benefits in the QPP, which has led to many questions and concerns.

In 1985 disability benefits represented 13% of all CPP expenditures. By 1995 these benefits had grown to 19.7% of overall costs or $3.3 billion (OSFI 1995, p. 8). This increase, by itself, adds 1.5 percentage points to the long-term costs of the CPP (Canada 1996a, p. 24).

Not all of the increase was a surprise. Prior to 1987 contributors were required to have worked and made CPP contributions for at least five of the last ten years before they could claim disability benefits. In 1987 the rules were changed to allow workers who had paid into the CPP for two out of the past three years to qualify for disability benefits (not two full years, but any part of two of the past three years). Also in 1987, the time limit for filing a retroactive claim was extended from 12 to 15 months, and the CPP disability benefit was increased to make it equivalent to the QPP benefit. However, the QPP rules and qualifying periods were not changed.

Another government bill in 1992 lifted the time limit on late applications. This change opened the program to many workers who previously had been denied benefits. There was also a campaign to make workers and employers more aware of these changes and the CPP disability benefits in general.

Another reason for the growing difference between the CPP and QPP in this benefit category was a change in the adjudication of disability within the CPP. The CPP introduced some nonmedical factors in the establishment of disability. For example, the ability to find work became a factor in getting disability benefits within the CPP, but not within the QPP. In 1988 the former director of the Disability Operations Division of CPP issued a memo stating that if applicants for CPP disability were over the age of 55 and unable to do their job, they should be considered as being unable to do any job (Ford 1996, pp. 85–86). For a while, the CPP became a de facto Unemployment Insurance program (Torjman 1996, p. 107). The use of socioeconomic factors in determining disability was rescinded in September 1995 (Ford 1996, p. 86). As a result, new applications for CPP disability benefits are down (Torjman 1996, p. 108).

The CPP also recognized several "new" causes of disability not recognized by the QPP such as stress, chronic fatigue, and environmental hypersensitivities. The QPP continues to use a more physical-cause base for disability (Wills 1996, p. 74).

Once a worker qualifies for a CPP disability benefit, there is little follow-up to reassess claims for continued disability. This was not a serious problem historically when workers had to have profound physical disabilities to qualify for the CPP benefit, but today there are indications that some workers continue to collect CPP disability benefits even after they are able to return to work. The Auditor General estimates that the lack of systematic reassessment, even in some cases in which the individual has reported his/her return to work, has led to overpayments of up to $65 million a year (Ford 1996, p. 88).

In response, the CPP administration started a program of reassessment. The project, started in May 1993, had conducted 18,585 reassessments by August 1996 and ceased payments to 6,762 beneficiaries (Torjman 1996, p. 5). Under the new directives, it is hoped that up to 20,000 files per year can be reassessed out of the 350,000 recipients. However, at this time, there are not enough personnel to achieve this goal.

The CPP is also the first payor of benefits when two sources are available. For example, if a worker is eligible for disability benefits under both the CPP and a provincial Workers' Compensation plan, the CPP pays its full benefit, and the Workers' Compensation plan need only top up benefits to the extent necessary (in some provinces the disabled worker gets the total of both benefits, a significant disincentive to return to work). In Quebec, people on Workers' Compensation cannot apply for QPP disability benefits. If there is another source of disability income (for example, a claim against an automobile insurance policy) the QPP is second payor. This helps to keep QPP disability income costs down.

A wide variety of potential changes to CPP disability income benefits were proposed. These included the following:

- Make the contribution period for eligibility longer. Instead of requiring contributions in two of the last three years, it would be moved to four of the last six years.
- Separate the CPP disability benefits from the rest of the plan. In this way, the other CPP benefits would be immune from the apparent volatility of the disability benefits. At the same time, however, contribution rates for the now-separate disability benefits would assume that volatility.
- Make the CPP disability benefit second payor to other disability benefits including workers' compensation, employment insurance, and private disability income insurance. This would put the CPP on a more equal footing to the QPP in this regard and should also do more to provide rehabilitation for the disabled worker.
- Completely reform the coverage of disability in Canada so that there is one logical integrated system for all, versus the patchwork approach today (Torjman 1996, pp. 109–20).

The only one of these reforms adopted was the first, extension of the contribution period required for eligibility. There will also be a nonretroactive change in the way disability pensions are converted to retirement pensions at age 65. The conversion will be based on the C/QPPs' Year's Maximum Pensionable Earnings (YMPE) at the time of disablement with subsequent full *price* indexing, rather than on the YMPE at the time the recipient turns age 65 (which means, in short, indexation to prices, not wages). This is consistent with how other CPP benefits are calculated (Canada 1997, p. 15).

In conclusion, one can see a hardening attitude toward disability income claims under the CPP. This could mean that workers who are too young for early retirement benefits under the C/QPP, and who might have previously qualified for disability income benefits, will now more likely be dependent on provincial welfare. We will return to this in the discussion of public policy implications of raising the age-of-entitlement for retirement income security in Chapter 7.

5.3.2 Changes to Benefits and Their Administration

A number of changes to benefits and their administration have been announced. The government projects that these changes will reduce total CPP costs by 9.3%, compared to the present plan, by the year 2030.

New retirement pensions, and the earnings-related portions of the disability and survivor benefits, will now be based on a contributor's average career earnings updated to the average of the YMPE in the last *five* years, instead of the last *three* years, prior to the commencement of benefits. This change will be phased in over two years. This saves the C/QPP money (and lowers the ultimate contribution rate) and makes the C/QPP more like private pension plans since many more private plans use the five-year final average approach than the three-year final average formula (see Statistics Canada 1994c).

The government estimates that if this measure had been in place in 1997, the maximum CPP retirement pension would be $724 a month instead of $736, or $12 a month less. However, this calculation was done in a period of very low wage increases. Consulting actuaries from Watson Wyatt (1997, p. 7) have shown that if average wage increases were 4% per annum, benefits for those with earnings below the YMPE would be reduced by about 3.75%, or $25 a month versus the $12 claimed by the government.

This is a straight reduction of benefits. Private pension plans that are integrated with the C/QPP will pick up the difference between these reduced benefits and the benefits promised by the employer-sponsored plan (where benefits are based on earnings, 87.9% of workers are in plans in which benefits are integrated with the C/QPP (Statistics Canada 1996b, p. 64). For the government, decreases in C/QPP benefits will be offset to a certain extent by increased costs for GIS benefits for those who qualify. The National Council of Welfare (1996c, p. 27) has estimated that a 10% cut in C/QPP benefits would increase GIS costs by $270 million. Hence, a total 9.3% cut should be expected to increase the cost of the GIS system by about $250 million. The government did not disclose any estimate for this. Thus, while costs to the C/QPP may be reduced by 3.75% by these amendments, total costs of retirement income security in Canada will be reduced by much less.

Among other benefit changes that were made, individuals who receive retirement pensions or disability benefits from the CPP are entitled to further survivor benefits if their spouse dies and contributed to the CPP. New rules (which are largely the same as pre-1987 rules, when the rules were relaxed) will limit the extent to which these benefits can be combined.

Finally, it has been proposed that the CPP death benefit continue to be equal to six months of retirement benefits, but that the maximum be limited to $2,500. Previously, the maximum was equal to 10% of the YMPE or $3,580. Although the option of eliminating the death benefit was discussed in the dialogue leading up to reform, that option was rejected.

Again, these reforms are simply ways to cut C/QPP benefits. While they result in lower ultimate contribution rates, they also result in equally smaller benefits.

5.3.3 Freezing of the Year's Basic Exemption

Prior to reform, the C/QPP Year's Basic Exemption (YBE) and the YMPE both grew with average wages (the YBE was set equal to 10% of the YMPE rounded down to the nearest $100). The government has announced that the YBE will be frozen at its current level of $3,500 for the foreseeable future. While this reform seems small and is subtle, the philosophical importance of this change will be discussed in detail in Chapter 6.

5.3.4 Fuller Funding of the CPP

Whereas the CPP (and QPP) are now designed to carry a reserve fund equal to two years of benefit payments (about $40 billion for the CPP), contributions will be raised substantially to 9.9% by 2003, which is expected to increase the reserve fund to about five years of benefits (or about $110 billion for the CPP) over the next two decades. Whereas these funds are now lent to the provinces, who pay the federal long-term bond rate of interest on the borrowed funds (they were not lent to the provinces free as some reports purport, and the provinces have repaid loans when needed), the new reserve fund that will build up is to be invested by an independent CPP investment board in a diversified portfolio of securities at arm's length from governments, with the objective of achieving higher rates of return (estimated to be 3.8% per annum, real). These hoped-for higher rates of return will allow the ultimate CPP contribution rate to stabilize at its projected 9.9%. The board will be subject to broadly the same investment rules as other pension funds in the private sector. For example, the 20% foreign investment limit will apply.

If the provinces wish to borrow from the CPP, they will pay the same rate of interest as they do on their own market borrowings. However, as a transitional measure, provinces will have the option of rolling over existing CPP borrowings at maturity for another 20-year term, which could dampen the overall rate of return of the fund for some time to come. In addition, for the first three years, provinces will have access to 50% of the new CPP funds that the board chooses to invest in bonds.

There are a myriad of public policy issues surrounding the proposal to create a larger level of prefunding for the CPP. These matters are of considerable importance and are thus discussed separately in Chapter 6.

5.3.5 Issues Left for Future Review

A number of important issues are left to be addressed over the next few years, so long as the steady state contribution rate of 9.9% is not affected. These include the following:

- The possibility of providing partial pensions during phased retirement, while participants continue to work and earn further pension credits
- Possible amendments to the provision of survivor benefits, given that 68% of working-age women are in the workforce earning credits in their own right
- The possibility of requiring mandatory credit splitting during marriages
- A possible extension of covered earnings beyond the YMPE, as proposed by British Columbia
- A study of the integration of OAS/CPP benefits with those under the Employment Insurance program
- A possible further reduction in the YBE, as proposed by Quebec.

5.4 Conclusion

This chapter has reviewed some of the reforms proposed for the Canadian social security system, including the new Seniors Benefit. The problems surrounding the proposed Seniors Benefit, as outlined, were severe enough that in July 1998 the government abandoned the proposal.

Although the proposal failed, it is important to study the attempted reform for several reasons. Designing an optimal social security system is far from easy. Several criteria need to be satisfied. An optimal social security system should be expected to have all of the following properties:

- The total cost must be affordable
- Poor Canadians should be supported to at least the poverty level
- The system should be progressive in that more benefits should be provided to the poor than to the wealthy per dollar of contribution or tax
- The system should not create any perverse incentives (for example, marginal tax rates that create disincentives to saving for retirement).

The Seniors Benefit passed on three of the four criteria. It would have been cheaper in total than the current OAS plus GIS. It gave more support to the poorest Canadians than the OAS and GIS. It was highly progressive, which resulted in clawback rates as high as 50%. But when these high clawbacks were added to one's marginal tax rates, disincentives were created that could have had serious implications to the desire of Canadians to save for retirement and provide their own retirement income security. Thus, as much can be learned about social security from the failure of the Seniors Benefit as might have been learned had it succeeded.

The next two chapters look at three particular aspects of the C/QPP amendments that are worthy of fuller public policy discussion than has been received to date. Chapter 6 looks at the proposal to freeze the YBE and the implications of such an amendment; it also discusses the issues surrounding the plan to implement fuller funding of the CPP, in an attempt to determine if such a move will add to the real security of social security. Finally, Chapter 7 offers a potential demographic alternative previously rejected in the potential reforms to the CPP, namely, the use of the age of eligibility for retirement benefits as a means to stabilize the future financing of Canada's social security systems.