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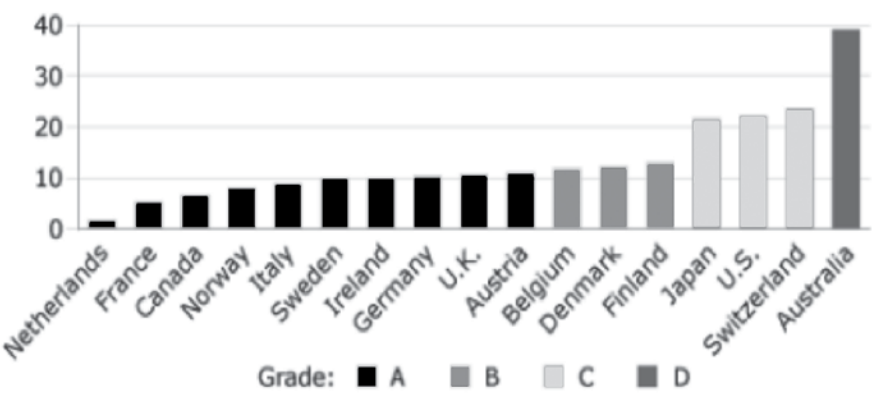
A COMMITMENT TO SUSTAINABILITY

Why I am optimistic about having access to the retirement security enjoyed by today's Canadian retirees.

By Joe De Dominicis

Growing up I was regularly reminded to respect my elders. Clearly many other Canadians received the same message, putting Canada in elite company as one of the best countries in the world to be a retiree. According to a recent report by the Conference Board of Canada, poverty among the elderly in Canada is at a low 6.7 percent. In fact we rank third amongst our Organization for Economic Co-Operation and Development (OECD) peers in this area as shown in the chart below from the Conference Board of Canada report.[i]

ELDERY PROVERTY RATE, LATE 2000S
(PER CENT)



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The relatively low elderly poverty rate is a direct result of Canada's Social Security System, consisting of means tested floor benefits [OAS (Old Age Security)/GIS (Guaranteed Income Supplement) plus some provincial programs], plus an earnings related component [C/QPP (Canada/Quebec Pension Plan)]. Like social security systems around the world, the sustainability of the Canadian system has been strained in recent years by a confluence of factors including, the financial crisis, low fertility rates, aging baby boomers, longer life spans, and a decline in retirement coverage for many citizens, primarily due to lower coverage from private sector pension plans. In the face of these factors, and in comparison to the systems of peer nations, the Canadian system has proven rather resilient. While we are not immune to the risks now facing social security systems around the world, some prudent decisions have helped mitigate those risks, helping to ensure that the Canadian Social Security System will be available for future generations; these include:

1. Better Funding: Moving the CPP from a pay-as-you-go system to a partially funded system,
2. Better Governance: An increased focus on oversight, transparency and intergenerational equity, and
3. Plan Changes: Recent benefit changes providing incentives for Canadians to retire later.

BACKGROUND

The foundation, or floor, of Canada's Social Security System is the Old Age Security (OAS) program. The main components of the OAS program are the Old Age Security Pension and, for Canada's lowest income seniors, the additional Guaranteed Income Supplement (GIS) and Allowances. The OAS program is financed from general tax revenues of the Federal Government and provides a flat monthly benefit to most Canadian citizens, on or after age 65, based on their residency in Canada after age 18 and is provided regardless of their employment history. Both the OAS and GIS are means-tested. Higher income seniors have a portion of their OAS benefits "clawed back" after reaching a threshold annual retirement income and GIS benefits are not paid to pensioners above a certain low income threshold.

The second, income related, component to Canada's government administered retirement system, the Canada Pension Plan (CPP),[1] was established in 1966. CPP benefits are financed solely by contributions from working Canadians and their employers. The Quebec Pension Plan (QPP) is a sister program for residents in the province of Quebec. The CPP and QPP are almost identical.

For a Canadian who works a full career, the CPP and OAS are designed to replace roughly 40 percent of income, up to the national average wage ($51,100 in 2013).[ii] As of March 31, 2013, the maximum basic benefit a retiring Canadian could receive from CPP and OAS, combined, is $18,702.84. Many Canadians aspire to have retirement income in excess of that amount. However, CPP and OAS are only meant to provide a foundation on which working Canadians can build. At the same time they ensure that, at a minimum, most Canadian seniors retire above the poverty level.

Since the Canadian Social Security System was established, the programs have been amended on many occasions to reflect changing needs and to help preserve the sustainability of a system so many Canadians cherish. The Canadian system is certainly not immune to the risks now facing social security systems around the world, but some prudent plan changes and decisions have helped mitigate those risks and have made the Canadian system one of the most resilient.

THE SHIFT FROM PAY-AS-YOU-GO TO PARTIALLY FUNDED

The 1996/1997 review of the CPP revealed that, in its pay-as-you-go form, the plan was no lon-

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> ... the financing of the CPP was changed from a pay-as-you-go basis to a partially funded basis. ...

ger sustainable. For example, in 1996 the contributions collected were $11 billion, but $17 billion in benefits were paid out.[iii] It was clear that, given a rapidly aging population, the ratio of the number of workers contributing to the number of retirees drawing benefits would continue to decline, making the plan increasingly unmanageable—the chief actuary concluded that the plan's reserves would be completely exhausted by 2015.[iv]

In response to this imminent problem, federal and provincial finance ministers recommended and made a number of reforms to help ensure the long-term sustainability of the CPP. In addition to various benefit changes, the total level of contributions was increased gradually from the 1997 rate of 6 percent to 9.9 percent by 2003. And, most importantly, the financing of the CPP was changed from a pay-as-you-go basis to a partially funded basis called steady-state funding, where an asset reserve is accumulated with the goal of maintaining a stable asset/expenditure ratio.

The higher contributions were used to create the asset reserve to partially fund the CPP. In addition, the CPP Investment Board (CPPIB) was created to manage and invest the assets at arm's length from the government, for the sole purpose of maintaining the sustainability of the plan. As of Dec. 31, 2012, the CPPIB had $172.6 billion under management. The 25th Actuarial Report on the Canada Pension Plan as of Dec. 31, 2009, prepared by the Office of the Chief Actuary concluded that, under best estimate assumptions, the CPP is "expected to be able to meet its obligations throughout the projection period and remain financially stable over the long term." [v, 2, 3]

INCREASED FOCUS ON OVERSIGHT, TRANSPARENCY AND INTERGENERATIONAL EQUITY

In addition to moving from pay-as-you-go financing to a partially funded CPP, the 1997 reforms also increased the frequency for reviewing the CPP from once every five years to once every three years. In the event that a review reveals that legislated contribution rates are no longer sufficient to maintain the stability of the CPP, "self-sustaining" provisions have been implemented to allow certain benefits to be decreased if legislated contribution rates are not increased.

A full funding provision was also included to ensure that any future increases to CPP benefits are fully funded with contributions that are in addition to the regular, steady-state required contributions. This provision ensures that the costs of benefit improvements are not passed on to future generations.

The 1997 reforms were instrumental in helping to ensure the sustainability of programs. More recent changes continue to demonstrate a commitment to maintaining these programs.

RECENT CHANGES TO MITIGATE THE IMPACTS OF INCREASING LONGEVITY

Like most citizens in the developed world, Canadians are living longer and therefore drawing retirement benefits longer than in the past, and longer than was anticipated when our social security system was first designed.

In his speech to the World Economic Forum in January 2012, Canadian Prime Minister Stephen Harper verbalized his concerns about the coming demographic threat, "Our demographics also constitute a threat to the social programs and services that Canadians cherish. For this reason, we will be taking measures in the coming months … to secure the sustainability of our social programs … over the next generation."[vi] As part of the 2012 federal budget released later that year, the "Plan to Place OAS on a Sustainable Path" was announced and included reforms to increase the full eligibility age for OAS benefits from age 65 to 67, with the change to be phased in over the period from 2023 to 2029.

As the demographic crisis continues to unfold, additional changes may be required, but at the very least the current changes are a step in the right direction and demonstrate the flexibility of the Canadian system to adapt to challenges as they arise.

CONCLUSIONS

Social security systems around the world face immediate and significant challenges to their sustainability from the global headwinds of the economic crisis and rapidly shifting demographics. Certainly Canada is no exception. In comparison with other social security systems, recent and historical reforms have helped to improve the odds that the Canadian Social Security System will remain viable in some form, for future generations. There are no guarantees in life, and there will, no doubt, be future challenges in the short-, medium- and long-term that will continue to threaten the sustainability of our system. However, past decisions demonstrate, at the very least, the willingness of the stewards of our Canadian system to take action when needed to protect the retirement stability now enjoyed by most Canadian seniors. All of which increase the chances that future generations will have access to some form of government administered retirement income, even if it may not provide the level of retirement security now enjoyed by my parents and their peers.

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8. Alexander Laurin, Kevin Milligan and Tammy Schirle. *Comparing Nest Eggs: How CPP Reforms Affect Retirement Choices*. Commentary #352. CD Howe Institute (May 2012). Online.

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10. Office of the Chief Actuary. *25th Actuarial Report of the Canada Pension Plan as at December 31, 2009*. OSFI (Nov. 3, 2010). Online.

FOOTNOTES

[1] The federal government, nine provinces and two territories participate in the CPP. The province of Quebec opted out of the CPP and instead instituted the Quebec Pension Plan (QPP). The history, benefits and contributions of the QPP are very similar to the CPP.

[2] By no means is the plan fully funded. Most of the annual benefit payments are made directly from contributions on a pay-as-you-go. However, the asset reserves held by the CPPIB are sufficient to cover benefit payments in excess of contributions for the foreseeable future assuming actual experience is in line with best estimate assumptions. The report also reviews the sensitivity of the long-term projected financial position of the plan to other sets of assumptions and provides an indication of the required increase (or decrease) in contributions under those scenarios.

[3] *The Actuarial Valuation of the CPP Report as of Dec. 31, 2012*, will be released later this year.

END NOTES

[i] Conference Board of Canada. "How Canada Performs, Details and Analysis, Society, Elderly Poverty." Canada CBoC, 2013. Online (Accessed April 9, 2013).

[ii] Morrneau Sobeco. *Morneau Sobeco Handbook of Canadian Pension and Benefit Plans 14th edition*. Canada: CCH Canada Limited, 2008. Print. Page 55.

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