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How the Politicians Saved One Country's Social Security Pension System

By Alan Cooke

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This country's economic situation resembled the condition of any one of a number of countries after the 2008 financial crisis. Unemployment stood at more than 11 percent, the federal deficit was at record levels, government bonds had been downgraded by several rating agencies and there were rumours of impending bailouts from international institutions. In addition, the country's social security pension plan was viewed as being bankrupt as the fund supporting it was expected to be exhausted in about 20 years. No, this was not Greece or Ireland in 2012 but rather Canada in 1993. However, through the political courage of the country's federal Minister of Finance, not only did Canada's economy get put back on a solid footing over the next four years but its pay-as-you-go social security system was converted to a "steady state" financing system that stabilized its funding for the subsequent 75 years. We will start this unlikely political story with a little background on the Canadian social security system.

CANADIAN SOCIAL SECURITY SYSTEM

Canada has three sources of social security pensions:

1. the "GIS" is payable to Canadian residents over age 65 and provides a guaranteed minimum income to low income retirees,
2. the **"OAS"** is payable to over-65s but is taxed back entirely for high income retirees (those earning roughly twice the average industrial wage),
3. **"CPP"** is an employment- and earnings-related plan providing retirement benefits as early as age 60 as well as death and disability benefits. (The Province of Quebec has a similar program to the CPP, the QPP, but that program is outside the scope of this article.)

GIS and OAS are funded out of general tax revenue whereas CPP is funded from employer and employee payroll deductions. For those of you familiar with the U.S. Social Security system, CPP resembles OASDI. There is a popular perception that Canada is a "big spender" on social welfare programs. However payments from the three above-mentioned programs only represent 4.1 percent of Canadian GDP whereas the comparable figure for the United States is 6.0 percent.

The focus of this article will be on CPP but there will be some mention at the end of the article to possible reforms of the OAS and GIS systems that were announced in 2012.

DEC. 31, 1993 CPP ACTUARIAL VALUATION

Canada's government actuary (the "Chief Actuary") prepares statutory actuarial valuations for the CPP at least once every three years. The Dec. 31, 1993 CPP actuarial valuation revealed a deteriorating financial situation as a result of lower than expected contributions due to high unemployment and higher disability pension claims. In this report, the CPP pay as you go rate was projected to rise from 7.36 percent of covered payroll in 1994 to 14.2 percent in 2030 reflecting the aging of Canada's population. In contrast, the actual level of

total contributions being paid by employers and employees was only 5 percent of covered payroll: the shortfall relative to actual benefit expenditures was being covered by interest income and capital from a small CPP fund invested notionally in provincial bonds. This CPP fund was forecast to be exhausted by 2015 under the current schedule of contributions. The Federal Finance Department feared that the ultimate CPP cost of 14.2 percent of covered payroll would be unacceptable to future generations of CPP members if premiums at this level were ever actually assessed. Thus reform was critical.

REVIEW OF CPP PROGRAM

In an act of rare political courage the Canadian Federal Minister of Finance (comparable to the United States Secretary of the Treasury for those familiar with that system) conducted a total review of CPP benefits, funding and investment policy. Simultaneously this same Minister was addressing the greater problems of the country's federal deficit and deteriorating international credit standing. This must be kept in mind as significant federal program cost-cutting was occurring at the same time as difficult reforms being undertaken for the CPP.

The Federal Minister of Finance solicited public input on CPP options from many bodies including the Canadian Institute of Actuaries (CIA). The CIA's input was largely incorporated into the ultimate CPP reforms so the actuarial profession was quite happy with its contribution to the process.

RESULTING CHANGES IN CPP BENEFITS, FUNDING AND INVESTING

A combination of benefit reductions and dramatic changes to its funding and investment policy resulted from the government's review of CPP and were reflected in the Chief Actuary`s Dec. 31, 1996 actuarial report.

1. **Benefit Reductions:** Changes in death, disability and pension provisions produced a long-term reduction in CPP costs of 1.1 percent of payroll. It should be noted that none of the benefit changes involved raising the age of entitlement despite the prevalence of this practice in other countries.

2. **Funding**: The federal politicians decided that future generations would never accept a total rate of CPP contributions as high as 10 percent of covered payroll since this was much higher than the perceived (and actual) value of the accruing benefits. Thus a new pattern of future contribution increases was calculated that would quickly create a large fund whose investment earnings would be sufficient to keep the long-term contribution rate below the psychologically-significant rate of 10 percent of pay. It was determined that this fund would ultimately stabilize at a size equal to 4.3 times annual CPP benefit payouts. To get to this large a fund, the total CPP contribution rate increased from 5.0 percent of covered payroll in 1994 to 9.9 percent in 2003. This did not produce a fully-funded pension plan in the manner of a funded corporate pension plan but rather created a steady-state funded status that stabilized contributions for the subsequent 75 years. It is important to note that several provisions were subsequently added to the CPP's regulations to preserve its steady-state funding. Firstly, if a subsequent actuarial valuation disclosed a long-term funding rate above 9.9 percent of pay, benefit reductions would be immediately implemented to bring the system back into balance. Secondly, any future improvements to CPP benefits could only be adopted if they were subsequently

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fully funded in accordance with private pension plan practices.

3. **Investment Policy**: Many Canadians felt that the former CPP fund containing notional provincial government debt did not constitute "real" assets backing up the CPP promises. More significantly the federal government concluded that the yields on this type of investment were much lower than could be achieved if the fund was invested more aggressively, i.e., in a manner more similar to a large private pension plan. The government also appreciated that such a large pension fund would need to be free of political interference so an independent investment board was established to oversee all CPP fund investment activities. The resulting structure was similar to that of other large trusteed pension plans. The Chief Actuary revised his long-term real (i.e., net of inflation) rate of investment return from 2.5 percent to 3.8 percent to reflect this change of investment policy. This change reduced the estimated long-term funding requirement by 1.5 percent of payroll.

ACTUARIAL CONTROVERSY

This entire process was not without some related controversy. A CPP actuarial valuation was prepared one year after the Dec. 31, 1996 valuation. Before it was finalized the Chief Actuary allegedly refused his boss' instruction to change a figure in this Dec. 31, 1997 report that would have showed that a contribution rate higher than the politically-sensitive 9.9 percent of payroll was required. The Government actuary was subsequently fired, purportedly for "management differences." The CIA formally expressed its strong concern over the independence of the Chief Actuary in this situation. As a result, the government invited the CIA to solicit its membership for a team to independently review the draft Dec. 31, 1997 CPP actuarial report. This independent actuarial review confirmed that a long-term contribution rate under 10 percent was still valid. However this controversy resulted in a new process under which all statutory CPP reports are peer reviewed by an independent actuarial committee made up of CIA volunteers.

Update on CPP and Other Reforms

The Chief Actuary produced a special statement to Parliament in 2010 reconfirming the stability of the long-term funding rate despite the decline in the CPP fund`s assets after the financial crisis. In a separate development, the current federal government has proposed in a March 2012 budget statement that it intends to raise the age of entitlement under the unfunded OAS and GIS programs from 65 to 67 over a period of years. This change will be phased-in starting in 2023.

Applicability of CPP Reforms to Other Countries?

The most radical aspect of the CPP reforms was to build up a very large fund and set up an independent board to actively manage its investments. This is an approach that has not been implemented in many other countries because it is feared that such a large fund would be subject to political interference. I would encourage the reader to go to the website (*www.cppib.ca*) of the independent board that manages CPP investments to see how they are structured to avoid political interference. They appear to have been successful in this regard and their investment portfolio includes a sophisticated range of domestic and foreign assets. Another obstacle to the CPP approach is that most governments see social security funds as captive buyers of their debt so do not want to

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diminish this market for their bonds. However I would argue that the CPP fund's mandate "to maximize returns without undue risk of loss" better serves the public than exclusively holding government debt.

In conclusion, the CPP reforms of the mid-1990s restored the public's faith in the security of the program and helped to stabilize costs between generations. Remarkably, it was undertaken during one of the darkest economic periods in Canada's history, thus refuting the argument that reforms can only occur in "good times." Unfortunately there is a bigger social security issue that Canada still has not addressed: reforming our health care system to make it sustainable over the long run. Hopefully another brave politician will emerge with the courage to address this issue. □

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