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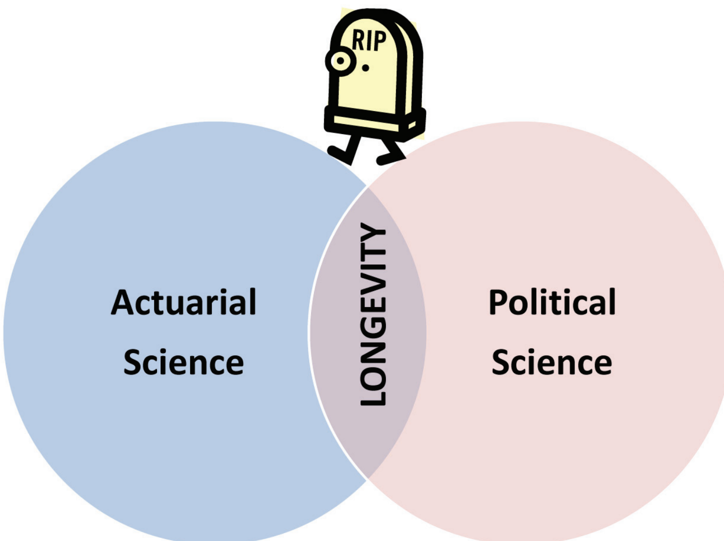
Canadian Old Age (In) Security

By Geoffrey Melbourne



In the winter of 2012, the Canadian Prime Minister, Stephen Harper, attended the World Economic Forum in Davos, Switzerland. Among the things of which he spoke[1] were:

- Telling developed countries they have to start making hard choices and stop taking their wealth for granted,
- Promising to make economic and labour force needs the central goal of Canada's immigration efforts in the future, and
- Promising changes to Canada's retirement system that are necessary to ensure it's available now and for the next generation, which is the subject of this article.

After enjoying the reputation as "Canada's natural governing party," the Liberal Party of Canada suffered successive defeats to the Harper Conservatives in 2006 and 2008, and then were relegated to third place in the 2011 elections in which the Conservatives earned a strong mandate as the first majority government in four elections (the New Democratic Party, with democratic socialist principles, forms the official opposition). Political responses to the retirement system changes from the opposition parties lamented the impact on low-income seniors, and protested the silence on the proposed changes during the 2011 election campaign (when they presume that the government would have known about them).

So just what do these changes entail in Canada, where the economic climate seems sunnier than in many other parts of the developed world, though the meteorological climate will often leave you with a chill?

The main pillars in Canada's social security system are Old Age Security (OAS), which is residence-based; Guaranteed Income Supplement (GIS), which is means-tested; and Canada Pension Plan[2] (CPP), which is based on employment earnings. According to the prime minister:

- We have already taken steps to limit the growth of our health care spending and must do the same for our retirement income system.
- CPP, the centerpiece of the retirement income system, is fully funded, actuarially sound and does not need to be changed.
- For those elements of the system that are not funded, we will make the changes necessary to ensure sustainability for the next generation while not affecting current recipients.
- Canada's demographics also constitute a threat to the social programs and services that Canadians cherish.

> Today there are four working-age Canadians for every senior; by 2030, there will be only two.

OAS is the single largest federal program. It is financed from general government revenue and provides benefits to most Canadians 65 years of age and over. It is designed to replace approximately 15 percent of income up to the average industrial wage (approximately $50,000 in 2012)—the maximum pension payable in 2012 is approximately $545 per month. GIS is payable to OAS recipients with income below certain thresholds. OAS pensions are also gradually clawed back once income exceeds a threshold of approximately $70,000 in 2012, with full claw-backs after income exceeds approximately $113,000 in 2012. Pension payments are indexed quarterly in line with the consumer price index (CPI).

The proposal would see the eligibility age for OAS and GIS gradually increasing from age 65 to age 67 over six years starting in 2023. In addition, there would be voluntary deferral of OAS pensions for up to five years, subject to an enhancement of 0.6 percent for each month of deferral. On the administrative side, there would be a proactive enrollment process that would remove the need for many seniors to apply for the OAS pension and the GIS.

The justification for the changes further adds that:[3]

- The number of Canadians aged 65 and over will rise sharply over the next two decades, due to the aging of the baby boomers and longer life expectancy. By 2030, seniors will represent close to 25 percent of the population, compared with about 14 percent in 2010. In that same time period, the working-age population will barely grow at all.

- OAS annual expenditures are projected to increase from approximately $38 billion in 2011 to $108 billion by 2030. Today, 13 cents of every federal tax dollar is spent on OAS benefits. If no changes are made, by 2030—2031, this spending is projected to increase to 21 cents of every federal tax dollar.

- Today, there are four working-age Canadians for every senior; by 2030, there will only be two.

Canada's labour force growth will slow due to the increase in the number of retirements. This may also slow Canada's economic growth.

On the reverse page though, Parliamentary Budget Officer Kevin Page reports that the restrictions in health care spending alluded to by the prime minister allow enough room in the federal fiscal structure to absorb OAS cost pressures without raising the eligibility age by two years. Page suggests that there may be other policy rationales for the changes, which the cynic might interpret as being purely ideological—the pragmatic might see them as being more focused on economic growth.

Notwithstanding its prominence in the federal budget, with a target replacement ratio of only 15 percent of national average income, most Canadians would obviously be reliant on other sources of income for their financial security in retirement. CPP, the other main social security pillar, has a 25 percent target replacement ratio and has been assessed to be actuarially sound. The maximum pension payable at age 65 in 2012 is approximately $987 per month, and benefits are indexed annually in line with CPI. In their pursuit of financial sustainability, CPP and other major Canadian pension funds received what some may consider as un-Canadian coverage by *The Economist*,[4] being given the haughty label of "Maple revolutionaries." Depending on what one sees as the ideal overall

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replacement ratio, there still exists considerable room for retirement savings at either or both of the personal or workplace levels.

There is significant underutilization of the tax-preferred savings options afforded to Canadians at the personal level. At the same time, like employers in many other countries, changes have been made and are being considered to workplace pensions in areas such as:

- Conversions from defined benefit (DB) to defined contribution (DC)
- Plan terminations
- Various forms and degrees of plan de-risking.

The federal government's main solution to the problem of declining pension coverage rests with the concept of pooled registered pension plans (PRPPs). These would operate on a DC basis, with features such as auto-enrollment (with an opt-out provision), voluntary employer contributions and (hopefully) low management fees. They have been welcomed by some stake-holders, not least of whom are the insurance companies who will have additional asset pools to manage (and who dominate the DC landscape for workplace pensions), and some employers who welcome the absence of any mandatory contributions on their part. Ontario, Canada's most populous province, continues to express reservation about PRPPs, favouring instead an expansion in the tried-and-tested CPP.

So what does all this mean for the retirement system? For those already retired, the OAS changes will have no effect. Given the phase-in, the ultimate eligibility age of 67 will only apply to those born in 1962 or later. Against the background of trends to increased longevity, and the recent release of mortality improvement scale BB, there is some justification for the higher eligibility age, though accompanied by the fear in some quarters about the erosion of the social safety net. The CEO of another of the "Maple revolutionaries," the Ontario Teachers' Pension Plan, which is facing acute challenges of a very mature membership profile, says "The changes are necessary. As long as the saving period is long enough, it's fair."[5] Although CPP is funded by employers and employees, some may find the optics of the eligibility age of 65 which prevails thereunder to be curious.

More generally, it is widely viewed that Canadians are not saving enough for retirement, over and above the benefits provided by the social security system, and it seems unlikely that employer sentiment toward workplace pensions will improve in a hurry. With increased longevity and low interest rates raising the bar, hopefully better use will be made of the savings vehicles already available to future retirees, and new ones such as PRPPs when they do come.
Meanwhile, politically, pensions have often been thought to be one of the hot coals. The lessons from Canada seem to be that those in and close to retirement would best be left untouched, and timing is everything—the tail-winds of a resounding mandate from the electorate might provide a great opportunity to prescribe an antidote to the "fountain of youth." □

END NOTES

1 http://www.cbc.ca/news/politics/story/2012/01/26/davos-harper-thurs.html

2 Quebec Pension Plan (QPP) for residents of Quebec.

3 http://www.servicecanada.gc.ca/eng/isp/oas/changes/index.shtml.

4 http://www.economist.com/node/21548970.

5 http://www.thespec.com/news/business/article/707046--five-questions-with-jim-leech.