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OPINION

The Canadian social security solution: pre-funding the baby boom with bonds

by Robert L. Brown

Canada faces a more severe revolution in the cost of social security than virtually any country in the world.

The first reason is that the Canadian social security system is very young. The Canada/Quebec Pension Plans were introduced in 1966, with the first full benefits in 1976. Since then, the plans have been significantly enhanced, making them younger in reality.

The second reason for Canada facing a more dramatic transition is it had the biggest demographic wave, known as the baby-boom/baby-bust tidal wave, of any of the western industrialized nations. Today, Canada faces the most dramatic cost shifts in the world among countries with large social security promises. Today's Canada/Quebec Pension Plan contribution rates of 5.6 % (2.8% from the worker and 2.8% from the employer) will rise to a projected 14.4% by 2031 for the present system.

Possible solutions

A variety of funding options has been presented, ranging from just biting the bullet and paying 14.4% to replacing the C/QPP with a Chilean-like individual defined-contribution scheme.

The government might advise a sharp and early rise in contribution rates for the C/QPP to create a large C/QPP fund to be invested in provincial government bonds and used to pay the baby-boom benefits. In my opinion, this is the worst of all possible solutions.

Why pre-funding is not the answer

First, pre-funding social security does not get around the demographic problems facing it. Social security is not a large private pension plan. Social security is a means to divide Gross National Product (GNP) between workers and retirees. However, GNP must be produced just before it's to be divided and consumed. Therefore, pre-funding of social security has no real meaning.

For individuals, the economic function of a pension scheme is to transfer consumption over time, from one's working years to one's retirement years. However, in the aggregate, the economic function of social security is to divide today's total production between workers and retirees. This cannot be pre-funded.

The baby boom buildup and demand

The existence of a huge baby-boom fund will create the illusion of demographic immunity where none exists.

Let's look at it in more detail. We build a huge fund over the next 20 years and invest the money in government bonds. This means that social security contributors pay more than necessary under a pure Pay-As-You-Go (PAYGO) funding basis and therefore forego some of their potential consumption. However, by investing the money in government bonds, the fund allows the provinces cheap financing and a means of distributing wealth that would otherwise not be possible. In that way, today's taxpayers can pay lower taxes than would otherwise be possible, allowing them to consume more. However, social security participants and taxpayers are the same people. Thus, in the aggregate, nothing has changed.

Twenty years from now, as the baby boom retires and demands its pension benefits, the reverse scene unfolds. The supposed baby-boom fund helps pay for some benefits, keeping social security rates lower than they would be on a pure PAYGO basis. This allows social security contributors lower contributions and more money to spend on consumption. However, the government calls the bonds used to pre-fund the baby boom, and taxpayers are left to pay the IOU. This raises their taxes and lowers their consumption. Again, since social security participants and taxpayers are the same people, nothing has changed.

The funding dilemma

Actually, by creating the large social security fund, some things have changed for the worse. We have created the illusion of enhanced security when none exists. We have also created an easy source of deficit financing for the government that lessens its resolve to be fiscally responsible. And, with the large accumulation of supposed assets, we create pressure to enhance the existing social security benefits.

How do we get the baby boom to pay a more equitable share of its benefits if we stick to pure PAYGO funding? How do we overcome the problems of the rapid demographic shift we face over the next 50 years? How do we redesign the social security system in Canada to continue to produce a stable mix of production and consumption? Easy. We raise the age of entitlement for social security in Canada in a way that results in a constant ratio of wealth production and wealth transfer. Space does not permit me to go into the details of this solution, but anyone wanting them can contact me at my *Directory* address.

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