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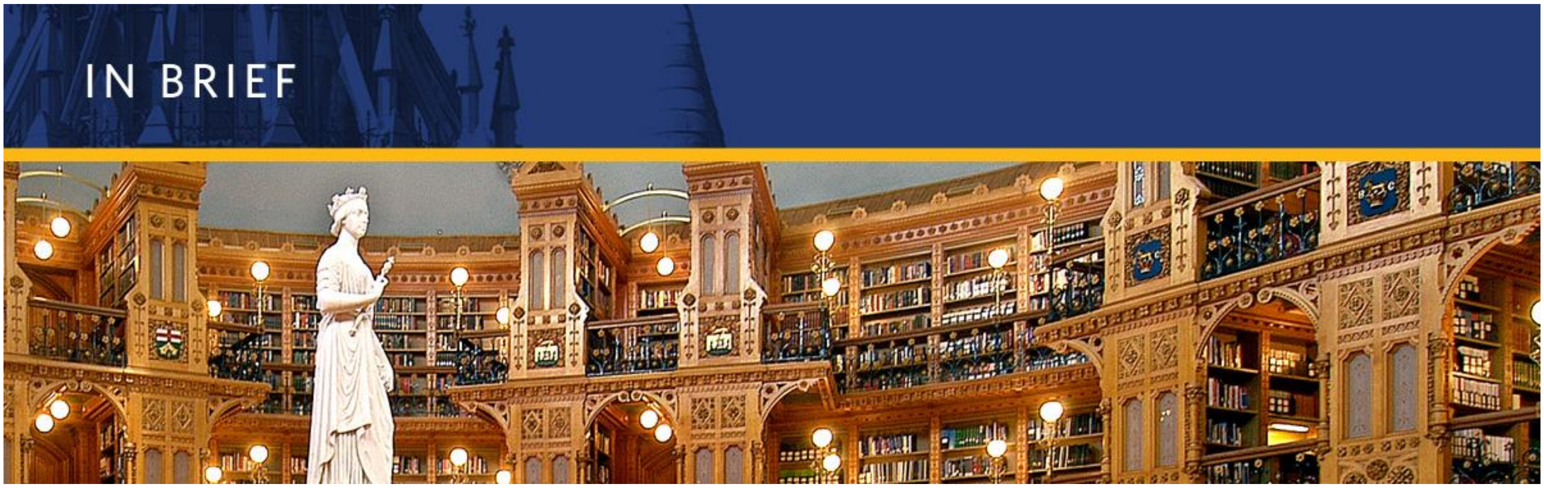

Canada's Aging Population and Public Policy: 4. The Effects on Public Pensions

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Canada's Aging Population and Public Policy: 4. The Effects on Public Pensions

(In Brief)

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CANADA'S AGING POPULATION AND PUBLIC POLICY: 4. THE EFFECTS ON PUBLIC PENSIONS*

1 INTRODUCTION

The members of the baby-boom generation, the demographic bulge born between 1946 and 1965, will reach 65 years of age between 2011 and 2030. While many in this generation seem financially ready to retire, this is not the case for all. To ensure that baby boomers and future generations have a better financial foundation for retirement, some analysts advocate changing public pension plans, such as the Canada Pension Plan (CPP) or Old Age Security (OAS), or modifying other savings vehicles, such as registered retirement savings plans (RRSPs) or tax-free savings accounts (TFSA). Some of the proposed changes would result in additional costs, but even without the changes, the aging population will cause an increase in the cost of these programs in the coming decades. What is important is whether the programs have long-term financial viability and thus the ability to provide a sufficient basic income for retired baby boomers and succeeding generations.

This paper provides an overview of how the aging population will affect retirement planning and public pension plans. The first section examines to what extent Canadians are financially prepared to retire. The second section explores some of the changes made to public pension plans and tax incentives, as well as proposals for further changes. The last section analyses the increased costs of the CPP, OAS and federal public service retirement plans.

2 ARE CANADIANS FINANCIALLY PREPARED FOR RETIREMENT?

The replacement rate, a basic concept in retirement planning, is the ratio between people's income after retirement and the income they earned at the end of their career, a time when employment earnings are usually at their highest.

A 70% replacement rate is considered a reasonable goal, although some analysts recommend higher or lower targets.[1] The appropriate replacement rate varies from one person to the next based on such factors as the number of dependants, one's health, and housing costs, but in general, there are two main reasons why this rate may be sufficient to guarantee that people maintain a standard of living in their retirement that resembles their pre-retirement living standard.

The first reason is that a 30% drop in pre-tax income does not necessarily mean an equivalent decrease in after-tax income, since a lower pre-tax income is taxed at a lower rate. A variety of tax credits, such as those for persons aged 65 and older and for pension income, as well as pension income splitting, contribute to this situation.

The second reason is that certain expenditures decrease or are no longer necessary after retirement. These include such work-related expenditures as transportation and clothing; some family-related expenditures, such as caring for children or parents;

and expenditures on durable goods, such as the house and furniture, which are often completed before retirement. They also include expenditures on some services, such as meal preparation and housework, which may also become unnecessary, as retirees, with their additional free time, take on the tasks themselves.

It is important to determine whether Canadians are saving enough to attain an acceptable replacement rate and so to maintain their quality of life following retirement.[2] In 2009, the federal, provincial and territorial ministers of Finance asked a group of experts to study this issue. In its report, the group concluded that "Canadians are, by and large, doing relatively well in ensuring that they have adequate savings for their retirement."[3]

However, this is not necessarily the case for everyone. People with the highest incomes are more likely to experience a lower replacement rate. A recent study has shown that 34% of those in the highest income quintile experienced a replacement rate of 60% or less, while 22% in the middle income group and 1% in the lowest income quintile experienced this rate.[4] Low-income individuals, such as social assistance recipients, sometimes have a higher post-retirement income thanks to public pensions. Their replacement rate can be greater than 100%. While high replacement rates among people with low incomes may seem to indicate a desirable situation, it should be remembered that, in 2009, 5% of seniors had incomes below Statistics Canada's after-tax low-income cut-off. This figure reached 14% for seniors living alone.[5]

Simulations conducted as part of a study by the C.D. Howe Institute indicate that replacement rates for retirees will decline in the coming years for two main reasons.[6] The first is that the income replacement rate offered by OAS benefits will shrink over time if earnings outpace inflation, because OAS benefits are indexed to inflation but not to increases in earnings. If earnings outpace inflation, the income replacement rate offered by OAS benefits will shrink over time. This is not the case for the CPP, because, in addition to indexation of benefits to inflation, the CPP maximum yearly insurable earnings are indexed to the average increase in earnings. This means that the initial CPP benefit, before indexation to inflation, takes into account increases in earnings up to a certain point.

The second is that fewer and fewer employers, particularly those in the private sector, are offering registered pension plans (RPPs) with defined benefits. This trend is expected to continue.

As a result, the percentage of people aged 66 with a replacement rate of less than 75% is expected to increase from 16% between 2006 and 2010 to approximately 45% between 2046 and 2050.

3 MEASURES PROPOSED OR TAKEN TO ENCOURAGE RETIREMENT PLANNING

Several analysts have suggested changes to public pension plans and savings incentives to address the anticipated decline in replacement rates.

Some modifications have already been made. The maximum allowable contribution to RRSPs, which held steady at $13,500 from 1996 to 2002, has been increased by about $1,000 a year to reach $22,970 in 2012. The TFSA, introduced in 2009 by the federal government, has a contribution limit of $5,000 annually, is indexed to inflation and features tax-free investment income. In addition, spouses have been able to split pension income since 2007.

The federal government also announced the creation of pooled registered pension plans, which should allow workers whose employers do not offer a registered pension plan access to a pooled plan with defined contributions.[7]

The main proposal for enhancing retirement income for all workers involves either a mandatory or a voluntary increase in the CPP replacement rate (currently 25%), financed through larger contributions, or an increase in the level of maximum insurable earnings.[8]

Inadequate preparation for retirement can also result from a lack of knowledge about financial planning. In June 2009, the government established a task force on financial literacy. In December 2010, it released its report. It contained 30 recommendations, including one which recommended that employers offer automatic savings tools to encourage employees to set money aside for retirement.[9]

4 THE VIABILITY OF PUBLIC PENSION PLANS

Given that the country's population is aging, there is reason to wonder how much more the public pension plans will cost and how much more the federal government will pay as an employer contributing to employee pension funds. To reduce the cost of public pension plans, several proposals, such as increasing the age of eligibility, have been made.[10]

4.1 CANADA PENSION PLAN/QUEBEC PENSION PLAN

An aging population means that annual CPP expenditures will likely increase by $63.1 billion, from $34 billion to $97.1 billion in current dollars between 2011 and 2031, or to $62.7 billion in 2011 constant dollars, which corresponds to an annual rate of increase of 3.1% in real terms (taking inflation into account).[11] After 2031, the annual increase should stabilize at a real rate of about 1.9%.

In contrast, during the 1990s, contribution rates increased in anticipation of an aging population. The CPP has posted a surplus since 2000, as contributions have exceeded expenditures. This trend is expected to continue until about 2020, at which time it should be possible to partially fund benefits through investment earnings on the surplus.

The CPP has recently undergone changes – such as an increase in the actuarial adjustment (the penalty or advantage related to benefit uptake, which can happen between ages 60 and 70) – that may improve the plan's situation to a small degree.[12]

According to the latest CPP actuarial report, the current contribution rate of 9.9% is enough to ensure the plan's long-term viability.

Previous increases in contribution rates and recent changes to the CPP, introduced primarily in response to an aging population, seem to be enough to ensure the long-term viability of the CPP. As a result, the increase in the CPP benefits paid out should not affect federal expenditures, particularly since the CPP is funded by employee and employer contributions. The CPP's revenues and expenditures are completely separate from Canada's national accounts, and the federal government has no responsibility for funding the CPP.[13]

The Quebec government administers the Quebec Pension Plan (QPP). The financial position of the QPP is less secure than that of the CPP. If the QPP system is not changed, the entire QPP reserve (its capital) could be depleted by 2039. That is why the Quebec government announced in its March 2011 budget that it would increase contribution rates and implement various changes that have already been made to the CPP but not to the QPP.[14]

4.2 Old Age Security

The OAS program, composed of the basic pension, the Guaranteed Income Supplement (GIS) and the Allowance, is financed directly from the Government of Canada's general tax revenues. For this reason, increases in OAS costs are more worrisome than increases in CPP costs – there is no revenue-generating fund to defray the increases.

According to the last actuarial report on the OAS, the program's annual expenditures should increase by $73.7 billion, from $38.8 billion to $112.5 billion in current dollars (or to $72.7 billion in 2011 constant dollars) between 2011 and 2031,[15] which would correspond to an average annual increase of 3.2% in real terms. In relation to the gross domestic product, these expenditures should increase from 2.36% in 2011, to reach 3.14% in 2031 and return to the current rate by about 2060. These estimates do not include the cost of enhancements to the GIS, which came into effect in July 2011 and are expected to be in the order of $307 million in fiscal year 2012–2013.[16] The estimates do, however, include the cost implications for GIS benefits resulting from the creation of the TFSA. The TFSA will enable more low-income Canadians to be eligible for the GIS.[17] These costs are estimated at $4.2 billion in current dollars in 2050, or $1.8 billion in 2011 constant dollars.

4.3 Registered Pension Plans Financed by the Federal Government as an Employer

The federal government must also contribute to the retirement plans of the public service, the Canadian Forces and the Royal Canadian Mounted Police. From 2007 to 2013, the contribution rate for federal employees will increase from 4.6% to 6.4% for earnings below the maximum covered by CPP/QPP, and from 8.1% to 8.4% for earnings above this maximum. Consequently, employees' share of the plan's costs will eventually reach 40%.[18]

It is estimated that between 2011 and 2023, the government's annual contribution to the public service pension plan will increase by $1.7 billion, from $2.4 billion to $4.1 billion in current dollars (or to $3.1 billion in 2011 constant dollars, an increase of $700 million in real terms). Increases for other plans sponsored by the federal government will be lower.

5 CONCLUSION

Over the next 20 years, the baby boomers will become senior citizens. Many of them are financially prepared for retirement (some have already retired). However, it is currently difficult for people with middle and high incomes to achieve an acceptable replacement rate at retirement. Proposals have been put forward to enhance public pension plans or provide other incentives for people in these income groups.

An aging population will lead to large increases in the cost of the CPP/QPP and the OAS program. In the case of the CPP/QPP, these increases have been expected for some time, and adjustments have already been made. The QPP is in a weaker financial position than the CPP, but changes were announced in March 2011.

In the case of the OAS, cost increases are more problematic, because they are financed directly from the federal government's annual revenues. The government has other obligations as an employer, but the increase in the cost of federal public service pension plans will be small compared with the increase in the cost of the OAS.

NOTES

* This paper is one of seven in the Library of Parliament series, "Canada's Aging Population and Public Policy." The other publications are:

André Léonard, *1. Statistical Overview*, Publication no. 2011-63-E, revised 28 February 2012.

Édison Roy-César, *2. The Effects on Economic Growth and Government Finances*, Publication no. 2011-121-E, 5 December 2011.

Raphaëlle Deraspe, *3. The Effects on Health Care*, Publication no. 2011-121-E, 21 October 2011.

Sandra Elgersma et al., *5. The Effects on Employers and Employees*, Publication no. 2012-07-E, 20 February 2012.

Julie Cool, *6. The Effects on Home Care*, Publication no. 2012-03-E, 23 January 2012.

Havi Echenberg, *7. The Effects on Community Planning*, Publication no. 2012-02-E, 23 January 2012.

1. For an examination of replacement rates, see Michael C. Wolfson, "Projecting the Adequacy of Canadians' Retirement Incomes: Current Prospects and Possible Reform Options," *IRPP* [Institute for Research on Public Policy] *Study*, No. 17, April 2011.

2. For an example of the savings needed to attain various replacement rates, see David A. Dodge, Alexandre Laurin and Colin Busby, "The Piggy Bank Index: Matching Canadians' Savings Rates to Their Retirement Dreams," *E-brief*, C.D. Howe Institute, 18 March 2010.

3. Jack M. Mintz, *Summary Report on Retirement Income Adequacy Research*, Prepared for the Research Working Group on Retirement Income Adequacy of Federal–Provincial–Territorial Ministers of Finance, 18 December 2009, p. 26.

4. Sébastien LaRochelle-Côté, John Myles and Garnett Picot, *Replacing Family Income During the Retirement Years: How Are Canadians Doing?* Analytical Studies Branch Research Paper Series, No. 328, Statistics Canada, Cat. no. 11F0019M, July 2010.

5. Statistics Canada, *Income in Canada 2009*, Cat. no. 75-202-XWE, June 2011.

6. Kevin D. Moore, William B. P. Robson and Alexandre Laurin, "Canada's Looming Retirement Challenge: Will Future Retirees Be Able to Maintain Their Living Standards Upon Retirement?," *C.D. Howe Institute Commentary*, No. 317, December 2010.

7. Department of Finance Canada, *Framework for Pooled Registered Pension Plans*, December 2010.

8. For a summary of proposals for improving the CPP, see Monica Townson, "Options for Pension Reform: Expanding the Canada Pension Plan," *Policy Brief*, Canadian Centre for Policy Alternatives, April 2010.

9. Task Force on Financial Literacy, *Canadians and Their Money: Building a brighter financial future*, December 2010.

10. For example, see Frank T. Denton and Byron G. Spencer, *Age of Pension Eligibility, Gains in Life Expectancy, and Social Policy*, Research Paper No. 276, Program for Research on Social and Economic Dimensions of an Aging Population, October 2010.

11. Office of the Superintendent of Financial Institutions Canada, Office of the Chief Actuary, *25^{th} Actuarial Report on the Canada Pension Plan as at 31 December 2009*, November 2010.

12. For a description of changes to the CPP, see André Léonard, *Changes to the Canada Pension Plan Retirement Pension*, Publication no. 2011-54-E, Parliamentary Information and Research Service, Library of Parliament, Ottawa, 20 May 2011.

13. Canada Pension Plan Investment Board, *Annual Report 2011*, p. 19.

14. For information on changes to the QPP, see *Changes to the Québec Pension Plan*, Régie des rentes du Québec.

15. Office of the Superintendent of Financial Institutions Canada, Office of the Chief Actuary, *9^{th} Actuarial Report on the Old Age Security Program as at 31 December 2009*, June 2011.

16. Department of Finance Canada, *The Budget Plan*, 6 June 2011.

17. Public pension plans and their various savings incentives and work incentives are explained further in another paper in this series. See Édison Roy-César, *Canada's Aging Population and Public Policy: 2. The Effects on Economic Growth and Government Finances*, Publication no. 2011-121-E, Parliamentary Information and Research Service, Library of Parliament, Ottawa, 5 December 2011.

18. Office of the Superintendent of Financial Institutions Canada, Office of the Chief Actuary, *Actuarial Report on the Pension Plan for the Public Service of Canada as at 31 March 2008*, September 2009.