Public Pensions in a Development Context

The Case of Canada

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Acronyms

CAD	Canadian dollar
CDPQ	Caisse de dépôt et placement du Québec (*Quebec Deposit and Investment Fund*)
GDP	gross domestic product
ISSA	International Social Security Association
LICO	low-income cut-off
RRIF	registered retirement income fund
RRSP	registered retirement savings plan

Summary/Résumé/Resumen

Summary

In Canada, as in other countries around the world, the pension system must adapt to the realities of an ageing society. Until now, the Canadian system has been effective in fulfilling its two primary objectives: ensuring a minimum income for the elderly and assisting seniors to maintain pre-retirement living standards after retirement. Whether the Canadian pension system will be able to continue to meet these objectives in the coming decades will depend largely on how well it responds to the economic and social challenges of population ageing.

This paper starts by describing the Canadian pension system, which consists of a mix of public and private elements. It then focuses on the reforms made to the public parts of the system in recent years. In particular, the paper examines the ground-breaking changes to the financing of the Canada Pension Plan, a publicly administered, mandatory social insurance programme. The paper concludes with some of the lessons learned from Canada's experience that are relevant for both developing and developed countries seeking to adapt their pension systems to the challenges posed by population ageing.

Canada has a "three-pillar" pension system. Using the terminology of the World Bank's 2005 report, *Old-Age Income Support in the Twenty-First Century: An International Perspective on Pension Systems and Reform*, these are: a "zero" pillar consisting of a non-contributory, residence-based scheme that ensures a minimum income for all of Canada's elderly; a "first pillar" made up of the mandatory, contributory Canada Pension Plan and its sibling-scheme, the Quebec Pension Plan; and a "third pillar" composed of voluntary, tax-assisted mechanisms for retirement savings, including occupational (employer-sponsored) pension plans and individual retirement savings accounts. Unlike the World Bank model, Canada does not have a "second pillar" consisting of *mandatory* individual retirement savings accounts.

In the mid-1990s, public policy attention in Canada turned to the financing of the Canada Pension Plan. This plan, which began in 1966, was originally designed as a pay-as-you-go, defined-benefit scheme with a small reserve fund equal to two-years' costs (benefits and administrative charges). By 1995 it had become apparent that the plan, unless reformed, would become very costly for future cohorts of workers—more costly, in fact, than what the future workers would otherwise have to pay for comparable pensions. The reasons for the increase in the costs of the plan were complex and included economic, political, demographic and administrative factors.

After an extensive consultation process, a proposal emerged for the reform of the Canada Pension Plan. The proposal consisted of a package of measures centring on the financing of the plan, but also including some small reductions to benefits. The financing reforms were made up of four parts:

- rapidly increasing the plan's contribution rate over a period of seven years, in order to achieve a "steady-state" rate (one that, according to actuarial evaluations, can be maintained without change for the indefinite future);
- as a result of increasing the contribution rate, building up a substantial fund (projected to equal more than five times annual costs) that can be invested and used to finance part of the pensions of the baby-boom generation;
- adopting a new investment policy that allows the plan's fund to be invested in a wide range of asset classes, including equities, whose long-term real rates of return should exceed those of the bonds in which the plan's fund was previously invested; and
- establishing an independent agency, the Canada Pension Plan Investment Board, charged with implementing the new investment policy.

The paper concludes that drastic changes to benefits—for example, severe reductions in retirement pensions or increases in the retirement age—or the wholesale replacement of public defined-benefit programmes by privately administered defined-contribution schemes are not necessarily the only alternatives for preparing pension systems for population ageing. Through reforms that are carefully thought out and planned, existing programmes can be made sustainable at a reasonable cost.

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Résumé

Au Canada, comme dans d'autres pays à travers le monde, le système des retraites doit s'adapter aux réalités d'une société vieillissante. Jusqu'à présent, le système canadien a réussi à satisfaire à ses deux exigences essentielles: assurer un revenu minimum aux personnes âgées et aider les seniors à conserver après la retraite leur niveau de vie antérieur. La capacité du système de retraite canadien à continuer de remplir ces conditions dans les décennies à venir dépendra dans une large mesure de son aptitude à répondre aux défis économiques et sociaux du vieillissement de la population.

Les auteurs commencent par décrire le système de retraite canadien, qui combine éléments publics et éléments privés. Ils s'intéressent ensuite aux réformes apportées ces dernières années aux composantes publiques du système, en particulier aux changements exemplaires introduits dans le financement du Régime de pensions du Canada, régime d'assurance sociale obligatoire à gestion publique. Ils concluent leur étude en tirant de l'expérience du Canada quelques leçons susceptibles de profiter aux pays, développés et en développement, qui cherchent à adapter leur système de retraite aux défis posés par le vieillissement de la population.

Le Canada a un système de retraite à "trois piliers". Pour reprendre la terminologie du rapport de la Banque mondiale de 2005, *Les régimes de retraite au vingt et unième siècle: Perspective internationale sur les systèmes de retraite et leurs réformes*, ces piliers sont les suivants: un pilier "zéro" consistant en un régime qui n'est pas constitué par cotisations et assure un revenu minimum à toutes les personnes âgées établies au Canada; un "premier pilier" composé du Régime de pensions du Canada, obligatoire et constitué par cotisations, et de son équivalent québécois, le Régime de rentes du Québec; et un "troisième pilier", composé de mécanismes volontaires d'épargne, assortis d'avantages sur le plan fiscal, en vue de la retraite et parmi lesquels se rangent les régimes de retraite professionnels (soutenus par l'employeur) et les comptes d'épargne-retraite individuels. A la différence du modèle de la Banque mondiale, le Canada n'a pas de "deuxième pilier" composé de comptes d'épargne-retraite individuels *obligatoires*.

Vers le milieu des années 1990, le financement du Régime de pensions du Canada a commencé à retenir l'attention des politiques. Ce régime, qui date de 1966, était originellement conçu comme un régime par répartition, à prestations déterminées, et disposait d'un actif de réserve modeste, égal aux coûts de deux ans (prestations et frais d'administration). En 1995, il était devenu évident que le régime, s'il n'était pas réformé, aller coûter très cher aux cohortes futures de travailleurs—plus cher, en fait, que ce qu'ils auraient à payer ailleurs pour des rentes comparables. La hausse des coûts du régime était due à des raisons complexes dans lesquelles entraient des facteurs économiques, politiques, démographiques et administratifs.

Après de larges consultations, une proposition s'est dégagée pour la réforme du Régime de pensions du Canada. La proposition réunissait diverses mesures axées sur le financement du régime mais prévoyait aussi de modestes réductions des rentes. La réforme du financement portait sur quatre points:

- une augmentation rapide, étalée pendant une période de sept ans, du taux de contribution au régime pour parvenir à un taux "d'état d'équilibre" (qui, selon les évaluations actuarielles, puisse être maintenu sans changement pendant un avenir indéterminé);
- du fait de l'augmentation du taux de contribution, la constitution d'un actif important qui, selon les projections, devait être égal à plus de cinq fois les coûts annuels et puisse être placé et utilisé pour financer une partie des retraites de la génération du baby-boom;
- l'adoption d'une nouvelle politique de placement qui permette d'investir les fonds du régime dans un large éventail de catégories de biens, y compris des actions, dont les taux de rendement réels à long terme seraient supérieurs à ceux des obligations dans lesquelles l'actif du régime était antérieurement investi; et
- la création d'une institution indépendante, l'Office d'investissement du Régime de pensions du Canada, chargé d'appliquer la nouvelle politique de placement.

Les auteurs concluent que des changements radicaux des prestations—par exemple, une forte réduction des pensions de retraite ou un relèvement marqué de l'âge de la retraite—ou le remplacement intégral des régimes publics à prestations déterminées par des régimes à gestion privée et à contributions déterminées ne sont pas nécessairement les seules solutions qui permettent de préparer les régimes de retraite au vieillissement de la population. Par des réformes mûrement réfléchies et planifiées, il est possible de faire en sorte que les régimes actuels résistent au temps sans entraîner un coût déraisonnable.

Ken Battle est président de l'Institut Caledon des politiques sociales (Caledon Institute of Social Policy), groupe d'analystes établi à Ottawa, Canada. Il est aussi l'un des plus éminents experts du Canada en politique sociale. En 2000, il a été décoré de l'Ordre du Canada, catégorie sciences sociales, pour ses travaux sur l'allocation nationale à l'enfance et sa contribution à la réforme de la politique sociale canadienne. Edward Tamagno est expert associé en politiques à l'Institut Caledon des politiques sociales. Auparavant, il travaillait pour le gouvernement fédéral canadien; il était affecté à l'administration des régimes publics de pensions du Canada, et responsable de la négociation et de l'administration des accords de sécurité sociale qui coordonnent le régime public de pensions canadien avec ceux d'autres pays à travers le monde.

Resumen

En Canadá, como en otros países del mundo, el sistema de pensiones debe adaptarse a las realidades del envejecimiento demográfico. Hasta la fecha, el sistema canadiense ha resultado eficaz en el cumplimiento de sus dos objetivos primordiales: garantizar un ingreso mínimo para las personas de edad y ayudarles a mantener tras su jubilación el nivel de vida que disfrutaban antes de retirarse de la actividad laboral. La posibilidad de que el sistema de pensiones de Canadá continúe satisfaciendo estos objetivos en las próximas décadas dependerá en gran medida de su capacidad para responder a los desafíos económicos y sociales que trae consigo el envejecimiento de la población.

En la primera parte de este documento se describe el sistema de pensiones canadiense, que es una mezcla de elementos públicos y privados. Seguidamente se analizan las reformas que se han realizado en los últimos años al componente público del sistema. El documento analiza especialmente los innovadores cambios al financiamiento del Plan de Pensiones de Canadá, un programa de previsión social obligatorio de cuya administración se encarga el gobierno. El documento concluye con algunas lecciones aprendidas de la experiencia canadiense que

resultan pertinentes tanto para los países en desarrollo como para las naciones desarrolladas que buscan adaptar sus sistemas de pensiones a los desafíos que plantea el envejecimiento de la población.

El sistema de pensiones de Canadá se sustenta sobre tres "pilares". Siguiendo la terminología utilizada en el informe del Banco Mundial titulado *Soporte del ingreso en la vejez: Una perspectiva internacional de los sistemas de soporte y de sus reformas* (2005), estos pilares son los siguientes: un pilar "cero", o sistema no contributivo basado en la residencia que provee un nivel mínimo de ingreso para todos los canadienses de edad avanzada, un "primer" pilar, en el cual figuran el sistema contributivo obligatorio del Plan de Pensiones de Canadá y su pariente, el Plan de Pensiones de Québec, y, finalmente un "tercer" pilar, conformado por mecanismos voluntarios de ahorro para la jubilación, que gozan de ciertos beneficios fiscales, entre ellos los esquemas pensionales ocupacionales (patrocinados por el empleador) y las cuentas de ahorros individuales para la jubilación. A diferencia del modelo del Banco Mundial, el sistema del Canadá no cuenta con un "segundo" pilar, que son las cuentas individuales *obligatorias* de ahorros para la jubilación.

A mediados de los años 90, la atención de la política pública canadiense se centró en el financiamiento del Plan de Pensiones de Canadá. Iniciado en 1966, este plan se concibió originalmente como un plan de beneficio definido sin financiamiento anticipado; únicamente contaba con una reserva cuyo importe era suficiente para cubrir los dos primeros años de prestaciones (beneficios y costos administrativos). Para 1995 resultaba evidente que, de no reformarse, el plan sería demasiado oneroso para las generaciones futuras de trabajadores; de hecho, resultaría más costoso que lo que los futuros trabajadores tendrían que pagar por pensiones similares. Las razones del incremento de los costos del plan eran complejas y respondían a factores económicos, políticos, demográficos y administrativos.

Tras un amplio proceso de consulta, surgió una propuesta para reformar el Plan de Pensiones de Canadá. La propuesta contenía un conjunto de medidas que se ocupaban principalmente del financiamiento del plan, pero que también contemplaban ciertas reducciones menores de los beneficios. La reforma del financiamiento constaba de cuatro partes:

- el aumento acelerado de la cotización al plan durante un período de siete años hasta alcanzar una tasa "estable" que, de acuerdo con las evaluaciones actuariales, pueda mantenerse inalterada por tiempo indefinido;
- como resultado del incremento de la cotización, constitución de un fondo sustancial (calculado en una cuantía equivalente a cinco veces los costos anuales) que pueda invertirse y utilizarse para financiar parte de las pensiones de los jubilados pertenecientes a la generación del baby-boom;
- adopción de una nueva política de inversión que permita invertir el fondo del plan en una amplia gama de categorías de activos, incluidas las acciones, cuyas tasas reales de rendimiento a largo plazo sean superiores a las de los bonos en los cuales se habían invertido estos recursos anteriormente; y
- el establecimiento de una entidad independiente, el Consejo de Inversiones del Plan de Pensiones de Canadá (Canada Pension Plan Investment Board), con la tarea de poner en práctica la nueva política de inversión.

El documento concluye que los profundos cambios en materia de prestaciones—por ejemplo, una marcada reducción de la cuantía de las jubilaciones o el aumento de la edad de jubilación—o la sustitución generalizada de los programas públicos de beneficio definido por sistemas privados de contribución definida no son necesariamente las únicas alternativas para preparar los sistemas de pensiones de cara al envejecimiento demográfico. Mediante la implementación de reformas cuidadosamente concebidas y planificadas, puede alcanzarse la sostenibilidad de los programas existentes a un costo razonable.

Ken Battle es presidente del Instituto Caledon de Política Social, un centro de estudios ubicado en Ottawa, Canadá, y es uno de los principales expertos canadienses en política social. En 2000 recibió la Orden de Canadá en la categoría de las ciencias sociales, por su labor en la creación de la iniciativa *Prestación Nacional para los Hijos* (National Child Benefit) y su contribución a la reforma de la política social canadiense. Edward Tamagno se desempeña como asociado de políticas en el Instituto Caledon de Política Social. Antes de unirse al instituto, trabajó para el Gobierno Federal de Canadá como encargado de administrar los programas públicos de pensiones del país, y fue responsable de la negociación y administración de los convenios de previsión social que coordinan el sistema público de pensiones de Canadá con los de otros países alrededor del mundo.

Introduction

Over the past 80 years, Canada has developed a multipillar pension system, consisting of public and private elements, designed to provide income security to the elderly.[1] As in other countries, the Canadian pension system has two fundamental objectives: ensuring a minimum income for the elderly (often referred to as poverty alleviation) and assisting seniors to maintain pre-retirement living standards after retirement (usually designated as income replacement).

The Canadian system, overall, has been effective in meeting its core objectives. In terms of poverty alleviation, between 1980 and 2002, poverty[2] among Canada's elderly fell from 21.3 per cent to 6.8 per cent (Statistics Canada 2005a). Canada has one of the lowest rates of elderly poverty among industrialized countries, ranking third lowest behind only Finland and Sweden[3] (Jesuit and Smeeding 2002; Beaujot and Liu 2002). In terms of income replacement, the average income after tax of elderly families[4] is about 69 per cent of that of non-elderly families, while for elderly individuals living alone the figure is almost 87 per cent (Statistics Canada 2005b). This compares favourably with the usual measure of adequate income replacement, which is a post-retirement income in the range of 60 per cent to 70 per cent of pre-retirement income.

Ensuring that the Canadian pension system will remain financially sustainable and will continue to meet its objectives in the face of a rapidly ageing population and a changing economy has been one of the important policy challenges that governments[5] in Canada have had to address in recent years. A few numbers demonstrate the magnitude of the challenge. In 2001, 12.7 per cent of Canada's population was aged 65 or more. By 2026, those aged 65 or more will make up 21.4 per cent of the population (Statistics Canada 2005c). The ratio of persons of working age (those aged 20–64) to the elderly, which now stands at 4.9:1, is projected to decline to 2.3:1 in 2050 (Office of the Chief Actuary 2004).

This paper describes the different parts of the Canadian pension system and how each has evolved over time. It focuses on the public components of that system, and the reforms that governments have introduced in the past decade to ensure the sustainability of those components. Particular attention is given to financing issues, especially as they relate to reforms made in 1997, which shifted the financial system underlying the Canada Pension Plan, a mandatory contributory programme, from its historic pay-as-you-go foundation to a significantly funded one. From these descriptions and analyses, the paper seeks to draw policy conclusions from Canada's experience that are of relevance to other countries, irrespective of their state of economic development.

In order to place the Canadian pension system in a context that is readily understandable to an international audience, this paper employs terminology based on a multipillar pension model consisting of five elements (Holzmann et al. 2005:9–10):[6]

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1 The terms "elderly" and "seniors" are used in this paper to refer to persons aged 65 or more.

2 The most commonly used measures of poverty in Canada are the "low-income cut-offs" (LICOs) developed by Statistics Canada, the statistical agency of the federal government. LICOs are a blend of absolute and relative measures based on the percentage of income spent by an average family for essentials (housing, food and clothing). The low-income lines are set at the income levels at which a family spends 20 percentage points more of its income for these essentials than an average family. LICOs take into account family size as well as urban and rural differences. The low-income estimates cited in this paper are calculated by Statistics Canada using its after-tax LICOs; the agency also publishes before-tax LICOs that yield somewhat higher estimates of the incidence of low income. For a discussion of LICOs and other measures of low income, see Paquet (2001).

3 The studies on which this statement is based define poverty as income less than half of the national median. Using this measure, the poverty rate among seniors in Canada is 5.3 per cent, while in Finland and Sweden the rates are 5.2 per cent and 2.7 per cent, respectively.

4 An economic family is defined by Statistics Canada as a group of individuals sharing a common dwelling unit who are related by blood, marriage (including common law partnerships) or adoption. An elderly family is an economic family in which the major income earner is aged 65 or more.

5 The use of the plural ("governments") is important because of Canada's constitutional structure as a federal state consisting of a national government (always referred to as the federal government) and 10 provincial and three territorial governments. Under the Canadian Constitution, pensions are a shared responsibility of the federal and provincial/territorial governments. Each is sovereign in regard to those areas of responsibility assigned to it under the Constitution.

6 For information on the comprehensive policy framework for pension reform, see Holzmann et al. (2005).

- a non-contributory or "zero pillar" (in the form of a demogrant or social pension) that provides a minimal level of protection;
- a "first pillar" contributory system that is linked to varying degrees to earnings and seeks to replace some portion of income;
- a mandatory "second pillar" that is essentially an individual savings account but can be constructed in a variety of ways;
- voluntary "third pillar" arrangements that can take many forms (individual, employer sponsored, defined benefit, defined contribution) but are essentially flexible and discretionary in nature; and
- informal intrafamily or intergenerational sources of financial support to the elderly, including access to health care and housing.

As this paper shows, the Canadian pension system is very close to this model. It has a zero pillar, known as the Old Age Security programme, and a first pillar, consisting of the Canada and Quebec Pension Plans. The goals that the multipillar framework seeks to achieve through its second and third pillars are, in Canada, realized through voluntary tax-assisted mechanisms for retirement savings (occupational pension plans and individual retirement savings accounts), making the mandatory individual accounts of the second pillar of the multipillar model unnecessary. Finally, Canada has an extensive set of other programmes—especially a universal publicly financed health insurance system covering all medically required services provided by doctors and hospitals—that are essential for the well-being of the elderly.[7]

The Zero Pillar: Old Age Security

Origins and evolution

The zero pillar of Canada's pension system is the Old Age Security programme, whose historical roots[8] date back to 1927, when the federal Parliament enacted legislation under which the federal government paid part of the costs of provincial means-tested benefits for the elderly. The resulting benefits were modest in amount and directed only to the poorest among the elderly. The means test on which entitlement was based was widely seen to be stigmatizing. Nonetheless, it was one of the starting points of the Canadian welfare state.

The landmark 1942 report of the Beveridge Commission in the United Kingdom had a profound effect on the theory and practice of social policy in Canada, most notably in the pioneering 1943 *Report on Social Security for Canada* commissioned by the federal government and written by "Canada's Beveridge", Leonard Marsh of McGill University. In the field of pensions, the tangible consequence was the enactment of the federal Old Age Security Act, which took effect on 1 January 1952, and which made provision for pensions to all persons in Canada who met the requirements of age (at the time, 70) and residence (at the time, at least 20 years in Canada after reaching age 18),[9] without regard either to their previous attachment to the paid labour force or to their other income or the value of their assets. The pensions were financed entirely from the general tax revenues of the federal government[10] and were in a flat-rate amount (that is, a demogrant).

[7] Even a cursory description of these programmes is outside the scope of this paper.

[8] For a history of pensions in Canada, see Canadian Museum of Civilization (2002).

[9] The residence requirement has been altered several times since 1952. Since 1976, a minimum of 10 years of residence in Canada after reaching age 18 is required in order for a person residing in Canada to be entitled to a pension. For a person residing outside Canada, a minimum of 20 years of residence after age 18 is required. Persons who have lived or worked in countries with which Canada has concluded a social security agreement may meet these residence requirements by totalizing (adding together) their periods in Canada and the other country. Canada currently has 47 social security agreements. For a full description of the eligibility conditions for Old Age Security benefits, see Social Development Canada (2004).

[10] An "earmarked" tax, the Old Age Security Tax, was originally introduced to finance the Old Age Security programme. The tax was calculated as a percentage of taxable income (at first 2 per cent, later increased to 4 per cent) and collected along with income tax. The revenues from the tax were recorded in a special account, the Old Age Security Fund, which was, for all intents and purposes,

It would be academic to debate whether the original objective of the Old Age Security pension was primarily poverty alleviation or income replacement. In the early 1950s, the economic situation of most elderly Canadians was such that the two goals could not have been significantly distinguished from one another. It would be reasonable to say that the Old Age Security programme, at its inception, responded equally to both objectives.

The first major development regarding the Old Age Security programme occurred in 1965, when the age of eligibility for a pension was lowered in stages from 70 to 65. This was done at the same time as legislation was enacted to establish the Canada and Quebec Pension Plans, mandatory contributory social insurance programmes whose most important benefit, retirement pensions, start at age 65. In effect, Canada had decided on 65 as the "normal" retirement age.

The next key development occurred in 1967 with the introduction of a second benefit to the Old Age Security programme: the Guaranteed Income Supplement, payable to pensioners on an income-tested[11] basis in addition to the basic Old Age Security pension. Canadian residents entitled to the basic pension are also entitled to a Guaranteed Income Supplement if their income is sufficiently low. In the case of a single pensioner, for every Canadian dollar (CAD) 2.00[12] of monthly income (other than the basic Old Age Security pension), the maximum monthly supplement is reduced by CAD 1.00. In the case of a pensioner couple, for every CAD 4.00 of the monthly income of the couple combined (again, excepting their basic pensions), each pensioner's supplement is reduced by CAD 1.00. To simplify administration, income for purposes of the supplement is defined in the same way as income for purposes of income tax, with a few exceptions (the most significant being the exemption of the basic pension).

In 1975, an additional income-tested benefit, the Spouse's Allowance (since renamed simply the Allowance), was introduced into the Old Age Security programme. The Allowance responds to the needs of couples[13] in which one spouse or partner is a pensioner and the other is aged between 60 and 64. It ensures such couples a minimum income equal to that to which they would be entitled if they were both pensioners. In 1985, the federal government created a variant of the Allowance, known as the Allowance for the Survivor,[14] available on an income-tested basis to widows and widowers aged 60 to 64 who have not remarried or entered into a common law relationship since the death of their spouse or partner. In spite of many calls to extend the Allowance for the Survivor to all other single persons aged 60 to 64 (that is, those who are divorced or have never married), the government has not done so because of cost. For these persons, social assistance[15] remains the programme of last resort if their incomes are very low.

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part of the Consolidated Revenue Fund of the federal government. The Old Age Security Tax was formally brought into the income tax system in 1972, and the Old Age Security Fund was merged into the Consolidated Revenue Fund in 1974.

[11] In Canada, the term "income-tested" refers to a benefit whose amount takes into account a person's or household's income, while the term "means-tested" refers to a benefit whose amount takes into account both income and the value of assets. This differs from the usage often found in the international literature in which means-tested means, for example, "a benefit that is paid only if the recipient's income falls below a certain level" (Holzmann et al. 2005:244).

[12] In 2005, CAD 1.00 averaged $.82.

[13] The term "couple" refers both to persons who are legally married (spouses) and to those who are in a common law relationship (partners), the latter being defined as two persons cohabiting in a conjugal relationship for at least one year. As a result of the Modernization of Benefits and Obligations Act that entered into force in July 2000, partners can be persons of the opposite or of the same sex.

[14] In its original conception, the Allowance was available only to a spouse aged 60–64 of a pensioner. When the younger spouse reached age 65, the Allowance ceased and was replaced by a basic Old Age Security pension and a Guaranteed Income Supplement. However, if the pensioner died before the surviving spouse reached age 65, the Allowance also ceased, leaving the surviving spouse with no benefit (other than, possibly, social assistance) until reaching age 65. Such situations occurred sufficiently often to lead to calls to continue payment of the Allowance until the surviving spouse reached age 65. In response to these calls, the federal government created the Allowance for the Survivor.

[15] Social assistance—usually referred to in Canada as welfare—consists of "needs-tested" benefits administered by the provincial and territorial governments. Entitlement is based on a detailed assessment of a household's needs, including family size and composition, income, the value of assets, housing costs and other basic needs. Because benefits under the Old Age Security programme are higher in almost all cases than those under social assistance, few of Canada's elderly receive social assistance.

The final significant development regarding the Old Age Security programme occurred in 1989, when the federal government introduced an explicit mechanism for reducing the amount of the basic pension paid to the high-income elderly.

Prior to 1989, the basic Old Age Security pension was a demogrant, paid in the same flat-rate amount to everyone who met the requirements of age and residence. Because the Old Age Security pension was (and remains) income for purposes of income tax, pensioners with sufficient income to put them over the tax-paying threshold had to repay part of their benefits in the form of federal and provincial/territorial income taxes. To this extent, therefore, net (after tax) benefits were roughly progressive because the flat-rate pension was (and still is) taxed at progressively higher marginal tax rates as overall income increases. However, all pensioners, no matter how wealthy, were still left with part of the basic pension.

This ended in 1989 with the introduction of a provision into the federal income tax system known officially as the "repayment tax" or the "recovery tax", and colloquially as the "clawback". Under this provision, the basic Old Age Security pension paid to those whose individual net[16] annual income is above a prescribed threshold is reduced, and no benefit at all is paid to the highest-income elderly.[17] The reduction equals 15 per cent of a pensioner's net annual income above the threshold, to a maximum equal to the full pension. For 2005, the repayment began when a pensioner's net annual income reached CAD 60,806, and the entire pension had to be repaid when net income reached CAD 98,660. About 5 per cent of all pensioners in Canada are affected by the clawback, and about 2 per cent of all pensioners must repay the entire benefit.

The combined effect of the Guaranteed Income Supplement, the Allowance and the clawback to the basic pension has been to make poverty alleviation the primary objective of the Old Age Security programme, although for modest and middle-income pensioners it also still plays a significant income-replacement role.[18]

In 2005, the monthly amount of the basic Old Age Security pension was CAD 476.97.[19] The maximum amounts of Guaranteed Income Supplement payable to a single pensioner and to each member of a pensioner couple were, respectively, CAD 566.87 and CAD 369.24. As a result, the minimum monthly income guaranteed to a single pensioner was CAD 1,043.84. For a pensioner couple, the guaranteed minimum monthly income was CAD 1,692.42.[20]

The Old Age Security programme is a powerful tool for poverty alleviation among the elderly in Canada, almost 96 per cent of whom received the basic Old Age Security pension in 2005.[21] Among all of Canada's elderly, about 26 per cent of their aggregate income came from the Old Age Security programme. Among elderly women, who are particularly dependent on the Guaranteed Income Supplement, 34 per cent of their income came from the programme (Statistics Canada 2003). More than one out of three of Canada's elderly (36 per cent) received the Guaranteed Income Supplement, and for almost 170,000 of Canada's elderly (about 4 per cent of the total population aged 65 or more), the Old Age Security programme was their *only* source of income (Social Development Canada 2005a).

[16] The basic Old Age Security pension is not included in income for purposes of the clawback.

[17] For the first several years of the clawback, all pensioners continued to receive the full monthly basic pension, and the amount to be repaid by a high-income pensioner was only determined at year end when the pensioner filed an income tax statement for the year. Since 1996, however, the clawback takes the form of reduced (or zero) monthly benefits during the course of the year, with the amount of the reduction based on a pensioner's income in the previous year. Adjustments (refunds or additional repayments) are made, if required, when the pensioner files an income tax statement for the year.

[18] For a person earning the average industrial wage—about CAD 41,100 in 2005—the basic pension, on an annual basis, replaces about 14 per cent of earnings.

[19] All benefits under the Old Age Security programme are indexed every three months in line with increases in the Consumer Price Index. The amounts given are those applicable for July to September 2005.

[20] Most provincial and territorial governments provide income-tested benefits of their own—often referred to as "top-ups"—in addition to the federal Guaranteed Income Supplement. In most cases, the top-ups are sharply targeted to the lowest-income pensioners.

[21] Those not in receipt of the basic pension are primarily recent immigrants to Canada who have not yet met the 10-year residence requirement and persons with incomes sufficiently high that their pensions are reduced to zero because of the clawback.

With the ageing of Canada's population, the cost of the Old Age Security programme will grow substantially from its annual level of CAD 27.9 billion in 2005 (Treasury Board of Canada Secretariat 2004) to CAD 109.8 billion in 2030 (Office of the Chief Actuary 2005)[22] when all of the baby boom generation will have reached pensionable age. However, the Canadian economy is also projected to grow significantly over the next 25 years. In addition, the overall income of the elderly is projected to increase because of the maturation of the other pillars of the Canadian pension system (discussed later in this paper) and the revolutionary rise in women's labour force participation, thus reducing the amount of income-tested benefits payable. As a result of these two factors, the ratio of expenditures of the Old Age Security programme to gross domestic product (GDP), which stood at 2.3 per cent in 2004, is expected to reach a high of 3.2 per cent of GDP in 2030 and then decline to 2.0 per cent by 2075 (Office of the Chief Actuary 2005). This indicates that the programme should remain affordable over the long term.

The primary reason for the relatively small growth of expenditures in relation to GDP is that benefits under the Old Age Security programme are indexed to prices, which generally increase at a lower rate than GDP and wages. While this is positive from the perspective of government financing, it does mean that, since benefits are not increased in line with increases in wages, the standard of living of beneficiaries of the programme, especially those who are dependent on it as their principal source of retirement income, will deteriorate in relation to that of Canadians of working age to the extent that increases in wages outpace increases in prices. The mechanism for responding to this problem is discussed in the next section of this paper.

The administrative costs of the Old Age Security programme are low—about 0.9 per cent of the annual benefits paid (Treasury Board of Canada Secretariat 2004). To keep administrative costs small and to minimize the burden on beneficiaries of the income-tested elements, annual reapplication for the Guaranteed Income Supplement, the Allowance and the Allowance for the Survivor is done automatically using income data obtained from the income tax system. Those who do not file an income tax statement must complete a simple annual application to renew their supplement or Allowance.[23]

Reforms

In 1996, the federal government proposed a major parametric reform of the Old Age Security programme. Under the proposed reform, the basic Old Age Security pension, the Guaranteed Income Supplement and two non-refundable tax credits in the income tax system directed to the elderly (the age credit and the pension income credit) would have been combined into a new Seniors Benefit (Government of Canada 1996a).

The architecture of the proposed Seniors Benefit would have resembled that of the existing basic Old Age Security pension and Guaranteed Income Supplement. However, the portion of the proposed Seniors Benefit corresponding to the existing basic pension would have been more targeted to low- and modest-income seniors. Moreover, for couples, the income test for this portion would have been based on the combined income of the spouses or partners (which has always been the case for the Guaranteed Income Supplement) rather than the individual income of each member (which is the case with the existing clawback applicable to the basic Old Age Security pension). In addition, the Guaranteed Income Supplement would have been increased by CAD 120.00 annually. Finally, the Seniors Benefit would have been exempt from income tax (as opposed to the existing programme, under which the basic Old Age Security pension is subject to income tax while the Guaranteed Income Supplement is not), and the age and pension income credits of the income tax system would have been eliminated.

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[22] The Chief Actuary of the federal Office of the Superintendent of Financial Institutions is required by law to produce an actuarial report on the Old Age Security programme every three years. These reports are tabled in Parliament by the minister of social development.

[23] Residents of Canada with income above the tax-paying threshold are required by law to file an annual income tax statement. Because of income-tested refundable tax credits paid through the income tax system (for example, the Canada Child Tax Benefit and the refundable credit paid in compensation for part of the Canadian federal value-added tax, known as the Goods and Services Tax), most Canadians with incomes below the tax-paying threshold also file a tax statement.

Under the government's proposal, the new Seniors Benefit would have replaced the Old Age Security programme in 2001 (except for the Allowance and the Allowance for the Survivor, which would have continued). Anyone aged 60 or more on 31 December 1995 would have had the option of remaining with the existing Old Age Security programme or the new Seniors Benefit, whichever would have been more advantageous.

When the Seniors Benefit was proposed, the federal government was running large annual deficits. Although the Seniors Benefit would not have had any short-term effect on the federal government's financial position (the provision allowing those aged 60 or more to choose between the old or the new system meant that there would be no significant cost savings for several years), the long-term effects would have been substantial, freeing resources that could be directed to other priorities of an ageing society. Three out of four of Canada's elderly households would have seen either higher benefits or the same amount from the Seniors Benefit in comparison to the existing system. Nine in 10 single aged women would have come out ahead (Battle 2003).

In spite of the improvements that the Seniors Benefit would have brought to many of Canada's elderly—especially those with low or modest incomes—and in spite of the long-term cost savings, the proposal failed to gain support. Most of those who would have benefited from it were silent, perhaps not fully understanding the drawbacks of the current complex system and the equally complex changes that were being proposed and, perhaps, because the increase in their benefits (as noted, CAD 120 a year) would have been modest. Meanwhile, a formidable coalition that included many women's groups, organized labour, some seniors and social advocacy groups and the pension industry expressed their opposition, for a variety of different reasons.[24]

The federal government never did an effective job of explaining the short- and long-term advantages of the proposed Seniors Benefit. With opposition from many quarters continuing, the final blow to the proposal came in 1998 when it became clear that the federal government would balance its budget much sooner than almost anyone had anticipated when the Seniors Benefit was first proposed in 1996. Without the spectre of the deficit to support the need for reform of the Old Age Security programme, short-term political expediency won out, and the government quietly withdrew its proposal in mid-1998—arguing that ongoing reforms to the Canada Pension Plan (discussed below) would solve most of the long-term cost pressures on the public pension system.

With the demise of the Seniors Benefit, no further changes were proposed to the Old Age Security programme until 2004, when a report commissioned by the prime minister recommended a variety of measures to respond to the evolving needs of Canada's seniors (Ianno 2004).

The report noted that the last *real* increase in benefits under the Old Age Security programme (that is, an increase above adjusting for inflation) took effect in December 1984. Since that time, the real wages of working Canadians had increased considerably, but the minimum income guaranteed by the Old Age Security programme had stayed the same in real (inflation-adjusted) terms. This meant that the standard of living of low-income pensioners had fallen behind that of other Canadians. In response to this situation, the report recommended that the Guaranteed Income Supplement should be increased so that the combined income provided by the basic Old Age Security pension and the supplement would have the same relation to average wages as was the case at the time of the last real increase in 1984. This would require an increase of CAD 36 a month in the Guaranteed Income Supplement for single pensioners, and CAD 58 a month in the supplement for pensioner couples.

[24] See Battle (2003) for a detailed analysis of the factors that led to the failure of the proposed Seniors Benefit.

The recommended increase to the Guaranteed Income Supplement became part of the governing party's platform in the general elections held in June 2004. The federal Parliament has since enacted legislation that will bring the increase into effect in two stages, half in January 2006 and the second half in January 2007. The projected cost of the increase is CAD 2.7 billion over the next five years (Department of Finance Canada 2005).

From a policy perspective, the increase to the Guaranteed Income Supplement is important for three reasons. First, it acknowledges the need to periodically review and adjust the income level guaranteed by the Old Age Security programme so that the elderly who rely on that programme as their principal source of income will not fall further behind other Canadians in relative terms. Second, by putting the entire increase into the income-tested Guaranteed Income Supplement,[25] the additional expenditure is sharply targeted to the poorest among the elderly, reinforcing the poverty alleviation objective of the Old Age Security programme. Third, because the inflation adjustment of the Old Age Security programme is maintained (thus protecting the purchasing power of the benefits), governments in the future will continue to have the latitude to decide when economic conditions will permit subsequent ad hoc adjustments to the Guaranteed Income Supplement above rises to the cost of living. This capacity is essential to ensure the long-term financial sustainability of the programme.

The First Pillar: The Canada and Quebec Pension Plans

Origins and evolution

Using the terminology of the multipillar model described in the introduction to this paper, the first pillar of the Canadian pension system consists of the Canada Pension Plan and its counterpart in the province of Quebec, the Quebec Pension Plan.[26] These two programmes, which started operation on 1 January 1966, are mandatory contributory social insurance schemes providing benefits in the event of the retirement, disability or death of a contributor. Virtually all employed and self-employed persons in Canada, including civil servants of the federal and provincial governments, are covered by the plans.[27]

The Canada and Quebec Pension Plans have always had the same contribution rate and pay the same types of benefits. There are some relatively small differences in the eligibility requirements for certain benefits and in the way in which some benefits are calculated. Agreements between the federal and Quebec governments coordinate the operation of the plans for individuals who have contributed to both.[28]

To simplify discussion, the remainder of this section will deal primarily with the Canada Pension Plan. However, significant differences regarding the investment of the reserve funds of the Canada and the Quebec Pension Plans are examined.

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25 The Allowance and the Allowance for the Survivor will also be increased by the same amounts since the rationale for increasing the supplement applies equally to these benefits.

26 Under the Canadian Constitution, primary responsibility for pension programmes rests with the provinces. The federal government may legislate in this field only if a province has not established its own programme. In the federal-provincial negotiations of the 1960s leading to the establishment of the Canada and Quebec Pension Plans, the Government of Quebec, which had been the first to propose a contributory public pension plan, indicated that it wished to establish its own programme. The other provinces indicated that they preferred to participate in a programme administered by the federal government. In recognition of the provincial role in establishing the Canada Pension Plan, its legislation requires that any significant change to the plan must be approved by the federal Parliament as well as by the governments of at least two-thirds of the provinces with at least two-thirds of the population of Canada.

27 Employed persons working in Quebec, and self-employed persons residing in Quebec, must contribute to the Quebec Pension Plan. Employed persons working in the other provinces and territories of Canada, and self-employed persons residing in those provinces and territories, must contribute to the Canada Pension Plan.

28 When such persons or their survivors apply for a benefit, they do so with the programme applicable in the place in which they reside. That programme determines eligibility and calculates the amount of benefit, taking into account contributions to both programmes. The two programmes subsequently share the costs of the resulting benefit. Thus, from the perspective of contributors to both the Canada and the Quebec Pension Plans, the two programmes operate as one.

The Canada Pension Plan is a defined-benefit programme. Contributions must be paid on all earnings from employment and self-employment up to an annual maximum known as the Year's Maximum Pensionable Earnings, which is approximately equal to the average industrial wage. For 2005, it was CAD 41,100. No contributions are paid on a first band of annual income, known as the Year's Basic Exemption. Prior to 1997, this band was equal to approximately 10 per cent of the Year's Maximum Pensionable Earnings. Since 1997, it has been frozen at CAD 3,500.

In 2005, the contribution rate for the Canada Pension Plan was 9.9 per cent of the earnings subject to contributions. For employed persons, half of the contribution (4.95 per cent) was paid by the employer and the other half by the employee. Self-employed persons were required to pay the entire contribution of 9.9 per cent. The collection of contributions is the responsibility of the Canada Revenue Agency, which is responsible for the administration of the federal income tax system.

All of the costs of the Canada Pension Plan—benefits and administrative expenses—must be financed from the contributions of employers, employees and self-employed persons and from the investment earnings of the plan's reserves. No government subsidies are allowed. In their capacity as employers, governments contribute to the plan in the same way as employers in the private sector.

The most important benefit under the Canada Pension Plan is the retirement pension, which is usually payable at age 65 but which can be paid on a reduced basis as early as age 60.[29] One valid contribution to the plan is sufficient to establish eligibility for a retirement pension.

A retirement pension is equal to 25 per cent of a person's average lifetime contributory earnings (that is, the earnings subject to contributions).[30] In calculating this average, earnings from previous years are indexed to reflect wage levels at the time the pension starts to be paid. Some periods of low earnings are excluded from the calculation.[31]

In addition to retirement pensions, the Canada Pension Plan pays pensions to eligible contributors with disabilities and to surviving spouses or partners of deceased contributors.[32] These pensions are calculated as a percentage of the real or imputed retirement pension of the contributor, plus, in the case of disability pensions and pensions to surviving spouses aged less than 65, a flat-rate portion (that is, a fixed amount that is the same for everyone). Children's benefits are also paid for the dependent children of disabled and deceased contributors, and a lump-sum death benefit is paid on the death of a contributor.

The modest percentage of average lifetime earnings replaced by the Canada Pension Plan, and the relatively low level of earnings subject to contributions, were the result of political compromises when the plan was established in 1966. They reflect a consensus at that time—and

[29] For each month by which a contributor's age when starting to receive the retirement pension is less than 65, the pension is reduced by 0.5 per cent of what it would be at age 65. The reduction is permanent. A contributor must cease working in order to qualify for a retirement pension prior to age 65, although work can be resumed after the pension starts to be paid. After reaching age 65, a person can receive a retirement pension even if still working. A person can postpone receipt of a pension until after age 65, in which case the pension is increased by 0.5 per cent for each month by which the contributor's age when starting to receive the pension is more than 65 (but not once the contributor has turned 70).

[30] The term "contributory earnings" refers to the amount of annual earnings on which contributions have been paid *plus* the Year's Basic Exemption. If a person's earnings in a year do not reach the Year's Basic Exemption, the person has no contributory earnings in that year.

[31] For all contributors, the excluded periods are the 15 per cent of the contributory period (the period over which average lifetime earnings are calculated) with the lowest earnings. Also, a parent (usually the mother) can exclude periods while caring for a child aged less than seven and in which earnings were below the contributor's lifetime average. A person's contributory period starts when reaching age 18 or 1 January 1966, whichever is later. It ends when the person reaches age 70, starts to receive a retirement pension, becomes disabled or dies, whichever is first. Periods of receipt of a disability pension from the Canada or Quebec Pension Plans are not considered part of a person's contributory period.

[32] Minimum contributory requirements and other conditions apply when determining eligibility for pensions and benefits other than the retirement pension. The Canada Pension Plan disability benefit is intended for contributors who are unable to work because of a serious long-term disability. For a description of these requirements and conditions, see Social Development Canada (2004).

never since effectively challenged, in spite of considerable debate on these subjects in the early 1980s—that the public programme should leave ample room for employer-sponsored (occupational) pension plans and individual savings for retirement, especially for persons with earnings above the average.

The maximum monthly retirement pension at age 65 in 2005 was CAD 828.75.[33] The average monthly pension was about CAD 460 (Social Development Canada 2005b). The Canada Pension Plan's retirement pension is paid in addition to the basic Old Age Security pension (except to those whose income is so high as to disqualify them from the basic Old Age Security pension). Pensions from the Canada Pension Plan are considered income for purposes of determining entitlement to the Guaranteed Income Supplement as well as, when applicable, for the Allowance and the Allowance for the Survivor. Retirement pensions as well as all other benefits from the Canada (and Quebec) Pension Plan are considered income for purposes of federal and provincial/territorial income tax.

The Canada Pension Plan has undergone many changes over the years in response to changing social and economic circumstances. Some of the most important of these have been (Social Development Canada 2004):

- introduction of full annual cost-of-living indexation (1974);
- availability of the same benefits to male and female contributors as well as to their surviving spouses and dependent children, and the elimination of the retirement and employment-earnings test for receipt of a retirement pension at age 65 (1975);
- exclusion of periods caring for a young child when calculating earnings-related benefits (1978);
- division of pension credits between spouses in the event of divorce (1978) or separation (1987);
- payment of retirement pensions as early as age 60 (1987);
- continuation of survivors benefits if the surviving spouse remarries (1987);
- sharing of retirement pensions between spouses (1987); and
- extension of survivors benefits to same-sex common law partners (2000).

The objective of the Canada Pension Plan is income replacement. By setting the ceiling of earnings subject to contributions at the average wage, the plan's income-replacement objective particularly focuses on those with earnings at or below the average. For contributors with earnings above the average, retirement pensions from the plan, as a percentage of total earnings, decline as earnings increase.

In 2001, 87 per cent of Canada's elderly received benefits from the Canada and Quebec Pension Plans. The two plans together provided about 21 per cent of the aggregate income of the elderly. In 1991, 10 years earlier, only 71 per cent of the elderly received benefits from the Canada and Quebec Pension Plans, and the plans provided only about 16.5 per cent of the income of the elderly. This demonstrates the increasingly important role that the first pillar plays in Canada's overall pension system (Statistics Canada 2003).

Like the Old Age Security programme, the administrative costs of the Canada Pension Plan are low—about 1.7 per cent of the annual benefits paid[34] (Treasury Board of Canada Secretariat 2004). This compares favourably with the administrative costs of employer-sponsored pension

[33] All pensions and benefits under the Canada Pension Plan are indexed annually in line with increases in the Consumer Price Index. The amount shown is that applicable for new retirement pensions that become payable in 2005.

[34] The administrative costs of the Canada Pension Plan are higher than those of the Old Age Security programme primarily for two reasons. The first is that it is a contributory programme, so expenditures are required to collect contributions. The second is that it pays disability benefits, for which the cost of determining initial and ongoing eligibility is far higher per beneficiary/applicant than for old age or retirement benefits.

plans, which in aggregate are slightly above 7 per cent of annual benefits paid (Statistics Canada 2003).

Reforms

As just noted, the Canada Pension Plan has undergone many changes since it began in 1966. However, the most important of the changes were undoubtedly those made in 1997 to the financing of the plan.

When the Canada Pension Plan was established in 1966, it was designed as a pay-as-you-go programme, with a small reserve fund equal to two years' expenditures (benefits and administrative costs) to accommodate short-term fluctuations in the economy. The initial contribution rate was set at 3.6 per cent. The first actuarial valuation of the plan forecast that the contribution rate would eventually rise to 5.5 per cent by 2030 (Government of Canada 1996b).

Although the initial contribution rate was low, it nonetheless generated considerable surpluses in the plan's early years. These surpluses went into a reserve fund and were invested in non-marketable interest-bearing bonds of the provincial and federal governments. Each province was allowed to borrow from the fund in proportion to the contributions to the plan paid by the residents of the province. If a province did not borrow the full amount allocated to it, the federal government was required to borrow the remainder.

The bonds paid interest equivalent to the weighted average of the interest rates paid by outstanding federal government bonds with terms of 20 years or more. In this sense, therefore, the interest was linked to market rates. However, there was also an implicit subsidy to Canada's poorer provinces, which otherwise would have had to pay interest at a higher rate than the federal government when they borrowed on the market.[35]

It is impossible to determine with certainty how the provinces used the funds loaned to them from the Canada Pension Plan. The funds were simply added to general tax revenues and shown in provincial accounts under headings such as "non-market borrowing". However, the establishment of the Canada Pension Plan coincided with the start of Canada's universal health insurance system, which is administered by the provinces and territories and jointly financed by the federal and provincial/territorial governments. There is good reason to believe that, in some provinces at least, the funds from the Canada Pension Plan provided a substantial part of the financing needed for new hospitals and other health-related infrastructure in the late 1960s and early 1970s. The same period also marked the time when the first cohorts of the postwar baby boom generation began attending university. It seems likely that some of the plan's funds also went to the rapidly growing postsecondary sector.

Quebec took a different approach to the investment of the reserve fund of the Quebec Pension Plan. The provincial government established an agency, the Caisse de dépôt et placement du Québec (CDPQ), charged with the investment of the reserve fund. In the early years of the Quebec Pension Plan, the CDPQ invested much of the reserve fund in the bonds of another provincial government agency, Hydro Québec, which financed massive hydroelectric projects that were prime drivers of the province's economic modernization and growth in the late 1960s and 1970s. The CDPQ subsequently diversified its investments into equities and real estate, among others. It also became the investment arm of a number of other public sector pension and insurance programmes in the province. By 2005, CDPQ was one of the largest institutional investors in North America, and it has served as a spawning ground for a Quebec-based industry of private sector pension fund managers.

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[35] The implicit subsidy was operative only when interest rates were stable over long periods of time (which had been the case when the Canada Pension Plan was designed in the mid-1960s) or were increasing. However, when interest rates were in decline, the weighted average of the interest rates on outstanding long-term federal government bonds could be greater than market rates. This was especially the case in the mid-1980s, when interest rates declined sharply after several years of double-digit inflation and interest rates in the late 1970s and early 1980s. In such a situation, it was not advantageous for provinces to borrow the amounts allocated to them, and the federal government was obliged to do so.

A milestone in the financing of the Canada Pension Plan was reached in 1983 when, for the first time, the plan's expenditures exceeded contributions, and part of the interest from the provincial bonds was required to make up the shortfall. The federal and provincial governments subsequently decided that, starting in 1987, the contribution rate for the Canada Pension Plan would increase by 0.2 per cent a year to preserve the plan's pay-as-you-go financing. Additional increases of the same amount were made each year thereafter, until 1997.[36]

The legislation governing the Canada Pension Plan requires that the Chief Actuary in the federal government's Office of the Superintendent of Financial Institutions conduct periodic actuarial valuations of the plan's financing. These reports must be tabled in Parliament.[37] The *Fifteenth Actuarial Report* (Office of the Chief Actuary 1995), tabled in Parliament in February 1995, projected that the pay-as-you-go contribution rate for the plan (as it was then constituted) would reach 14.2 per cent by 2030. A study subsequently published by the federal, provincial and territorial governments (Government of Canada 1996b) analysed how the 5.5 per cent contribution rate for 2030 that had been forecast in 1966 had become a projected 14.2 per cent:

Pay-as-you-go contribution rate for 2030 forecast in 1966	5.5
Changed demographics[38]	+2.6
Changed economics[39]	+2.2
Enrichment of benefits[40]	+2.4
Increased number of disability pensions[41]	+1.5
Pay-as-you-go contribution rate for 2030 forecast in 1995	14.2

There was a strong view among federal and provincial ministries of finance, shared by many others (but by no means all) in Canada, that a 14.2 per cent contribution rate would have a negative effect on future economic growth (especially as regards job creation). They also felt that such a contribution rate would be politically unsustainable because it would require future cohorts of workers to pay significantly more in contributions to finance the pensions of past cohorts than would be required to finance their own pensions.

A spate of reports appeared in the Canadian media about the impending "bankruptcy" of the Canada Pension Plan. Some of the reports were balanced. Others were sensational and reflected analyses that were, at best, superficial and often of dubious merit. The fear mongering fuelled the false belief among some young people that the Canada Pension Plan would not be there for them when they retire. There was speculation, never confirmed, that the federal Department of Finance, along with some provincial finance ministries, encouraged media interest in the otherwise arcane issue of the financing of the plan in order to create a climate conducive to major parametric reform.

Irrespective of the source of the media stories or the depth of the analysis underlying some of them, a sense developed relatively quickly among Canadians that something needed to be done to make the Canada Pension Plan sustainable in the long term. This paved the way for the

36 The contribution rate for 1997 was initially increased by an additional 0.05 per cent, to 5.85 per cent. The 1997 reforms, discussed below, further increased the 1997 contribution rate to 6 per cent. The Quebec Pension Plan also increased its contribution rate from 1987 to 1997 by the same amounts.

37 Since 1997, actuarial reports on the Canada Pension Plan must be produced every three years. Prior to 1997, they had to be produced every five years. Actuarial reports must also be produced whenever major changes are proposed to benefits or to the financing of the plan.

38 Primarily lower birth rates and longer life expectancies.

39 Principally slower growth in output per worker.

40 The principal enrichments to benefits are described earlier in this paper.

41 A number of factors accounted for the increased number of disability pensions. One of the most important was an easing of the contributory requirements in 1987. Prior to that time, in order to qualify for a disability pension, a contributor must have contributed to the plan in five of the 10 years prior to the onset of disability, as well as for a minimum period of between five and 10 years (depending on the contributor's age). The 1987 changes lowered the contributory requirement to two of the three years, or five of the 10 years, prior to the onset of disability.

publication in February 1996 of the *Information Paper for Consultations on the Canada Pension Plan* (Government of Canada 1996b).

The paper described options for bringing the plan into long-term financial equilibrium, including general proposals for moving to "fuller funding" (Government of Canada 1996b:27) and a "new investment plan" (p. 29) for Canada Pension Plan funds along with relatively specific proposals for reducing the level of benefits and access to benefits. The latter included significant parametric changes such as reducing retirement pensions, increasing the years of contributions required for a full retirement pension, raising the age of eligibility for a retirement pension and indexing pensions in pay only partially. A committee of federal and provincial parliamentarians was created with a mandate to travel across the country and obtain the views of Canadians. The committee held public hearings in 18 Canadian cities. It heard more than 200 presentations from organizations and individuals and received more than 100 written submissions.

In June 1996, the federal/provincial parliamentary committee presented its report (Government of Canada 1996c) to federal and provincial ministers of finance. The report concluded that:

> Most Canadians want the CPP [Canada Pension Plan] preserved and protected now as a key pillar of the retirement income system. Canadians lack confidence in the future of the CPP and want the CPP fixed so that their confidence is restored. While the large majority support maintaining the CPP as a public pension plan, a minority want it privatized, that is replaced by individual, mandatory retirement savings plans. … Canadians need to be better informed about the CPP (Government of Canada 1996c:13).

The report of the federal/provincial parliamentary committee confirmed two basic facts. First, the great majority of Canadians wanted the plan's benefits maintained in essentially their existing form. Few supported an increase in the age of eligibility for a retirement pension or the other major parametric changes described in the consultation paper. Second, most Canadians were prepared to see substantial changes to the way in which the plan is financed, including significant short-term increases in contributions, provided they could be convinced this would ensure the plan's long-term sustainability.

Events then moved rapidly forward. In October 1996, the federal and provincial ministers of finance announced an agreement on nine principles, derived broadly from the conclusions of the report of the federal/provincial parliamentary committee, which would guide the reform of the Canada Pension Plan (Government of Canada 1996d). This was followed in February 1997 by a proposal from the federal/provincial ministers of finance on the specific reforms required (Government of Canada 1997). By the end of 1997, the federal Parliament had enacted the necessary legislation amending the Canada Pension Plan and eight provincial governments had given their approval to the reforms, allowing the legislation to enter into force on 1 January 1998.

The most important of the reforms involved the financing of the Canada Pension Plan. There were three key changes in this regard:[42] (i) a rapid increase in the contribution rate in order to bring the plan from a pay-as-you-go to a partially funded basis; (ii) a new investment policy that would substantially increase the income from the reserve fund, which itself would grow

[42] The three measures put the financing of the plan into balance on the basis of its benefits in 1997 and the actuarial valuation conducted in 1997. Two additional provisions were directed to any possible future changes to the plan's benefits and future actuarial valuations. Both provisions have become part of the legislation governing the Canada Pension Plan and can only be amended with the concurrence of the federal Parliament and the governments of at least six of the nine provinces participating in the Canada Pension Plan with, in aggregate, at least two-thirds of the combined population of those nine provinces. One provision requires that any future increase in benefits (other than annual adjustments for inflation) or any introduction of new benefits must be financed through an actuarially determined increase in the contribution rate. The second provision contains default measures that would apply if a future actuarial valuation were to indicate that the plan was no longer sustainable at the steady-state contribution rate of 9.9 per cent and if the federal and provincial governments were not able to reach agreement on the corrective steps required. In such circumstances, under the default measures, a contribution increase will automatically be triggered to bring the contribution rate up to the new steady-state rate within three years.

significantly because of the higher contribution rate; and (iii) permanently freezing the band of annual income exempt from contributions (the Year's Basic Exemption) at its 1997 level of CAD 3,500.

Under the reforms, the contribution rate to the Canada Pension Plan, which stood at 5.85 per cent in 1997, rose in yearly stages to 9.9 per cent in 2003.[43] This level, according to an actuarial valuation from the Chief Actuary (Office of the Chief Actuary 1997), is the steady-state rate—the lowest rate at which revenues from contributions, along with the investment earnings from the reserve fund, will maintain the plan for the indefinite future without further increases.[44] Table 1 shows the contributions rate that would have applied if the reforms had not been made to the financing of the plan, the contribution rate resulting from the reforms and the annual differences.

Table 1: Canada Pension Plan contribution rates before and after reform

Year	**Pre-reform** *(per cent)*	**Post-reform** *(per cent)*	**Difference** *(percentage points)*
1997	5.85	6.0	+0.15
1998	6.10	6.4	+0.30
1999	6.35	7.0	+0.65
2000	6.60	7.8	+1.20
2001	6.85	8.6	+1.75
2002	7.10	9.4	+2.30
2003	7.35	9.9	+2.55
2004	7.60	9.9	+2.30
2005	7.85	9.9	+2.05
2006	8.10	9.9	+1.80
2016	10.1	9.9	–0.20
2030	14.2	9.9	–4.30

Source: Office of the Chief Actuary 1997.

The rapid and sizeable increase in the contribution rate meant that the plan's reserve fund would grow quickly. While this would generate some of the resources required to pay the increased pension costs of the ageing of the baby boom generation, it would not, by itself, be enough to keep the plan's contribution rate indefinitely at 9.9 per cent. For this to happen, the yield on the investment of the reserve fund would have to be considerably higher than could be expected from fixed-term securities such as government bonds. In fact, the long-term average annual return would have to be at least 4 per cent in real (after inflation) terms. Such a long-term real rate of return could only be achieved by investing in a diversified portfolio that includes equities along with other asset classes.

The federal Department of Finance could easily manage a portfolio consisting entirely of non-marketable federal and provincial government bonds whose term and interest rate were fixed according to arithmetic formulas. However, neither it nor any other government department could be expected to manage a diversified portfolio invested in public and private markets. This would require an entirely new mechanism, for which the experience of the CDPQ could provide important "lessons learned".

The federal government and the nine provinces participating in the Canada Pension Plan decided to create a new specialized agency, the Canada Pension Plan Investment Board, to

[43] The Quebec Pension Plan adopted the same increases to its contribution rate.

[44] The technical definition of the steady-state rate is "the lowest level contribution rate applicable after the end of the review period (the three calendar years following the date at which the actuarial valuation is based), rounded to the nearest 0.1%, that results in the asset/expenditure ratio being the same in the 10th and 60th year following the end of the review period" (Office of the Chief Actuary 2004:37).

invest the future surplus funds resulting from the increase in the plan's contribution rate. The Investment Board would have a mandate to invest in equities, real estate, bonds and any other asset class in which employer-sponsored pension plans in Canada can invest. Just as importantly, and arguably even more so, they agreed that the board would operate at arm's length from governments and be equipped with a strong set of governance safeguards against any real or perceived political interference in its operation. The principles underlying the operation of the Investment Board, and the way the board has applied those principles, are discussed below.

The provincial bonds that were in the plan's reserve fund in 1997 can, at the discretion of each province, be rolled over once at maturity for a further period of 20 years. If a province chooses to roll over its bonds, the interest rate is set at the market rate for that province's other bonds,[45] thus eliminating the implicit subsidy of the interest formula previously used. The interest becomes available, as paid, to the Investment Board. If a province does not choose to roll over its bonds at maturity, the principal becomes immediately available to the Investment Board.

The third part of the reform of the financing of the Canada Pension Plan—freezing the Year's Basic Exemption at its 1997 value of CAD 3,500—had little short-term consequences. However, its long-term effect on the plan and on contributors will be substantial.

From the perspective of the plan as a whole, freezing the Year's Basic Exemption at CAD 3,500 rather than continuing to let it rise in line with increases to the maximum annual earnings subject to contributions reduces the steady-state contribution rate by 1.4 percentage points (Office of the Chief Actuary 1997). From the perspective of contributors, it means that increasing numbers of persons with low annual incomes, who would otherwise have remained below the Year's Basic Exemption if it rose year by year, will become subject to contributions. It is estimated that the Year's Basic Exemption of CAD 3,500 in 1997 will be worth only CAD 822 in 2030 in terms of constant 1997 dollars (Battle 2003). The sizeable increase in the contribution rate and the freezing of the Year's Basic Exemption exacerbated the existing regressivity of the programme's financing arrangement since contributions as a percentage of income decline as earnings go above the average.

In addition to the reforms of the financing of the Canada Pension Plan, some changes were also made to benefits, although the benefit changes were modest and incremental in comparison with the reform to financing. These "stealthy" changes went generally unrecognized by the media and public. They included modifying the way in which earnings from previous years are indexed to reflect current wage levels when calculating the amount of retirement pensions and the earnings-related portion of other benefits, increasing the contributory requirements for disability benefits, lowering the maximum death benefit to CAD 2,500 and lowering the maximum amount of "combined benefits" paid to persons eligible for a survivors pension as well as a disability or retirement pension. The benefit change affecting the most persons (anyone starting to receive a retirement pension in 1998 or after) is the modification in the way in which previous years' earnings are indexed. For all such persons, their retirement pensions will be slightly less than they would have been in the absence of the reforms.[46]

As a result of the 1997 reforms to the Canada Pension Plan, its assets as a percentage of the plan's actuarial liability[47] were projected to increase from 12 per cent in 2005 to 25 per cent in 2025 (Office of the Chief Actuary 2004). In effect, therefore, the plan will be pre-funded at a level

[45] Section 9(8)(b)(iii) of the regulations made pursuant to the Canada Pension Plan Investment Board Act requires that the provincial bonds "bear interest at a rate that is substantially the same as the interest that the province would be required to pay if it were to borrow the same amount of money for the same term through the issuance of a security on the open capital market".

[46] In the absence of the 1997 change, the maximum monthly retirement pension at age 65 in 2005 would have been CAD 843.75. Because of the reform, the actual maximum retirement pension was CAD 828.75.

[47] The most widely used method of determining a pension plan's actuarial liability is the accrued benefit method. "Under this method, the benefits that will be paid in respect of (Canada Pension Plan) participation on or before the valuation date must first be projected. … Next, the projected expenditures (are) discounted at interest to determine their present value, which is the actuarial liability" (Office of the Chief Actuary 2004:116).

of about 25 per cent, and its unfunded liability will be dramatically reduced. The reserve fund, which equalled about two times the plan's annual expenditures (benefits and administrative expenses) at the time of the reforms, is projected to reach five times annual expenditures in 2015, and 5.81 times by 2030. Moreover, the ratio of assets to expenditures will continue to grow after that, reaching an estimated 6.88 times in 2075 (Office of the Chief Actuary 2004).

Nearly 10 years have passed since the 1997 reforms of the Canada Pension Plan were enacted. While pension plan financing requires a long horizon and 10 years is a relatively short period, it is nonetheless encouraging that the evidence to date indicates that the reforms have contributed substantially to the plan's financial sustainability.

The actuarial valuation of the plan, tabled in Parliament in December 2004, showed that the contribution rate of 9.9 per cent was slightly higher than the latest estimate of the steady-state rate, which was 9.8 per cent (Office of the Chief Actuary 2004). A difference of one-tenth of 1 per cent may appear small, but, for a public programme covering all of the Canadian labour force outside Quebec, the amounts involved are substantial, and the cushion it provides for responding to unforeseen future economic or demographic developments is important.

The actuarial valuation projects that contributions will exceed costs until 2022, when a small part of the plan's investment earnings will be needed for expenditures. The portion of investment earnings directed to expenditures will increase in subsequent years. However, in each year in the period covered by the valuation (2004 to 2075), only a part of the investment earnings will be required for expenditures, with the remainder of the earnings being added to the reserve fund. Thus, the reserve fund will grow year over year. Total assets of the plan, which stood at CAD 77.8 billion in 2005, are projected to grow to CAD 455 billion by 2025 and CAD 4,872 billion by 2075.[48]

Annual expenditures for the Canada Pension Plan, which stood at CAD 23.6 billion (Treasury Board of Canada Secretariat 2004) in 2005, are projected to grow to CAD 97.0 billion in 2030 (Office of the Chief Actuary 2004). Taken as a percentage of GDP, the increase is from 1.8 per cent to 2.8 per cent in 2030.

Because of the critical role that the Canada Pension Plan Investment Board plays in ensuring the financial sustainability of the plan, it is important to understand the principles on which its design is based and how the board is governed.[49] Three interrelated concepts are of particular relevance in this regard: independence, accountability and transparency.

Independence refers, in particular, to safeguards to prevent political interference, or the perception of political interference, in the board's investment decisions. Among the many safeguards built into the Investment Board's governance structure, perhaps the most important is the process by which the members of the board are selected. This process is enshrined in the Canada Pension Plan Investment Board Act.[50]

A nominations committee, consisting of senior public officials and executives from the private sector, is charged with developing a list of proposed candidates for the board. The federal government and the nine provinces participating in the Canada Pension Plan each designate a representative to the nominations committee. The chair must come from the private sector. The recommendations of the nominations committee are submitted to the federal minister of finance, who, before deciding the names he will put forward for approval to the federal cabinet

[48] In terms of constant 2004 dollars, the assets, which stood at CAD 77 billion in 2004, are projected to rise to CAD 275 billion in 2025 and CAD 778 billion in 2075 (Office of the Chief Actuary 2004).

[49] For a more detailed discussion, see Tamagno (2001).

[50] Statutes of Canada 1997, c. 40. The full text of the act is available on the Web site of the Department of Justice Canada at http://laws.justice.gc.ca/en/C-8.3/index.html, accessed in December 2006.

(council of ministers), must consult with the ministers of finance of the nine provinces. The federal minister of finance is further required by legislation to take into account:

> the desirability of having directors who are representative of the various regions of Canada and having on the board of directors a sufficient number of directors with proven financial ability or relevant work experience such that the board will be able to effectively achieve its objects (Canada Pension Plan Investment Board Act, article 10(4)).

Independence from political interference is essential to the Investment Board's operation. However, independence does not mean that the board can operate as a power unto itself. It must be accountable to its stakeholders—the contributors to the Canada Pension Plan, the federal and provincial governments, Parliament and, ultimately, all Canadians.

The accountability of the Investment Board is rooted in the mandate given to it in the legislation establishing the board. Section 5 of that legislation states three clear objectives for the board:

- to assist the Canada Pension Plan in meeting its obligation to contributors and beneficiaries;
- to manage any amounts transferred to it in the best interests of the contributors and beneficiaries (of the plan); and
- to invest its assets with a view to achieving a maximum rate of return, without undue risk of loss, having regard to the factors that may affect the funding of the Canada Pension Plan and the ability of the Canada Pension Plan to meet its financial obligations on any given business day.

The absence of any objective related to social or economic development is important and deliberate. Discussions on the investment of social security funds often focus on whether, or to what extent, such objectives should be taken into account. The *Guidelines for the Investment of Social Security Funds* published by the International Social Security Association (ISSA) give a qualified endorsement of such objectives, noting that, if taken into account, they should be "subsidiary to the primary objectives of security and profitability. As well, there should be clear criteria for determining the circumstances and to what extent social and economic utility will be taken into account" (2004:7).

The World Bank, on the other hand, in remarking on the ISSA guidelines, comments that they are "less stringent than desirable on the exclusion of social mandates" (Holzmann et al. 2005:144).

In designing the Canada Pension Plan Investment Board, the federal and provincial governments decided that objectives regarding social or economic development could conflict with the board's primary goals and should, therefore, be avoided. Otherwise, for example, how would the board decide between two investments requiring equal capital, one of which might be socially beneficial (for example, increasing the stock of subsidized housing) but could result in a lower long-term rate of return or involve higher risk, and another that would be socially neutral but likely to yield a higher rate of return or involve less risk? The only means of avoiding such possible conflicts between objectives, the federal and provincial governments concluded, is to exclude any related to social and economic development.

This does not mean that the Investment Board can simply ignore the possible social and economic consequences of its investment decisions. The board, like any other prudent investor, must include these among the numerous factors used to evaluate, for example, potential rates of return and security of capital. However, they cannot become "stand alone" justifications for investment decisions.

It should be noted that the government of Quebec has taken a different approach in setting the objectives of the CDPQ. Section 4.1 of the provincial act establishing the CDPQ[51] states that:

> the mission of the [Caisse] is to receive moneys on deposit as provided by law and manage them to obtain optimal return on capital within the framework of depositors' investment policies *while at the same time contributing to Quebec's economic development* (authors' emphasis).

The Canada Pension Plan Investment Board has not operated for sufficient time to conduct a meaningful analysis of the practical consequences of its objectives in comparison with those of Quebec's CDPQ. In future years, this will be a question that warrants examination.

Setting clear objectives is a prerequisite for accountability. However, for accountability to be made real, an equally clear reporting framework has to be established. The legislation governing the Investment Board prescribes such a reporting framework.

The board is required by law to produce quarterly and annual financial statements for itself and for any subsidiaries it may establish. These statements must show the income received in the period covered, the change in net assets during the period and the investment portfolio. The annual financial statement must also include a balance sheet at the end of the financial year. The statements must conform to generally accepted accounting principles of which the primary source must be the *Handbook of the Canadian Institute of Chartered Accountants*.

The legislation further requires that the board produce a comprehensive annual report, which, in addition to the annual financial statement, must also give: (i) the report of the board's auditors for the year; (ii) a certificate stating that the board's investments during the year were in accordance with its legislation as well as its investment policies, standards and procedures; (iii) a statement of the board's operational and management objectives for the year and a description of the extent to which those objectives have (or have not) been met; (iv) a statement of the board's operational and management objectives for the next year; and (v) a description of the board's investment policies, standards and procedures.

To ensure the timely production of the quarterly financial statements and the annual report, the legislation requires that the quarterly statements must be prepared within 45 days of the end of each quarter, and the annual report within 60 days of the end of the financial year. The quarterly financial statements and the annual report must be sent to the federal and provincial ministers of finance. Within 15 days of receiving the annual report, the federal minister of finance must table it in Parliament.[52] The quarterly statements and annual report must also be made available to the public and are, in fact, posted on the Investment Board's Web site.[53]

Finally, in addition to the quarterly financial statements and annual report, the legislation governing the Investment Board requires that it hold a public meeting once every two years in each province of Canada to discuss its most recent annual report and to give the public an opportunity to comment on that report or on any other aspect of the board's operation. A notice of the public meeting must be posted in newspapers at least 10 days in advance, and at least one director or officer of the Investment Board must attend to answer questions.

The Canada Pension Plan Investment Board has consistently met, and in fact exceeded, the reporting requirements set out in its legislation. This is in keeping with the board's disclosure policy, which states that:

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[51] Act respecting the CDPQ, Revised Statutes of Quebec, c. C-2, available at www2.publicationsduquebec.gouv.qc.ca/home.php, accessed in December 2006.

[52] If Parliament is not sitting when the report is received, the minister must table it within the first 15 days of the next sitting of Parliament.

[53] www.cppib.ca.

> Canadians have the right to know why, how and where we invest their Canada Pension Plan money, who makes the investment decisions, what assets are owed on their behalf and how the investments are performing (Canada Pension Plan Investment Board 2005a).

The Investment Board's legislated reporting framework, and the proactive way in which it has implemented that framework, demonstrates the board's commitment to transparency in its operation. Consistent with that commitment, the board makes publicly available on its Web site all of its policies, including its investment policy, guidelines for the use of derivatives, conflict of interest policy, codes of conduct for directors and officers, guidelines for proxy voting and the way in which proxy votes have been cast.

In the board's annual report for 2004, the chair noted the "delicacy of balancing responsibilities and accountability". She explained that "commercial and proprietary information belonging to third parties with whom [the board does] business must be kept confidential." However, she reiterated the board's commitment to make as much information as possible available to Canadians on the board's operation (Canada Pension Plan Investment Board 2004:2).

As a safeguard for ensuring the integrity of the operation of the Investment Board, and as a further demonstration of its commitment to accountability, the board in 2003 appointed an external conduct review advisor with whom directors, officers and employees could discuss ethical issues confidentially. The board's annual report for 2004 noted that

> the advisor's role is to help people make appropriate decisions in the face of complicated choices where there may be no clear or definitive answer. Importantly, the appointment…opens an outside avenue for whistleblowers (Canada Pension Plan Investment Board 2004:4).

The experience of the Canada Pension Plan Investment Board has, to date, been positive. The board's minimum long-term investment target was a real (after inflation) rate of return of 4.1 per cent, which is the real rate of return on investments used in the actuarial valuation as of 2005 to determine the Canada Pension Plan's steady-state contribution rate. The average five-year real rate of return of the Canada Pension Plan reserve fund has been 4.48 per cent—38 basis points above the board's target (Canada Pension Plan Investment Board 2005b). This accomplishment is especially noteworthy in light of the sharp declines in stock markets from 2001 to 2003.

The Second and Third Pillars: Tax-Assisted Savings for Retirement

This paper focuses on Canada's public pension system. However, in order to understand the objectives and scope of the public system, it is necessary to have an overview of the other key part of the total pension system: voluntary tax-assisted savings for retirement. The mechanisms for such savings are registered pension plans and registered retirement savings plans (usually referred to as RRSPs).

Registered pension plans are occupational schemes, usually provided by employers.[54] The decision whether or not to have such a scheme is at the discretion of each employer. In most instances, it is the result of the collective bargaining process through which compensation, benefits and terms of employment are negotiated between an employer and the trade union or other association representing employees.

The term "registered" refers to the fact that, to obtain preferential tax treatment, a plan must conform to conditions specified in the Income Tax Act. If a plan meets these conditions, contributions (within the limits prescribed in the Income Tax Act) are deductible when

[54] There are a small number of industry-wide registered pension plans as well as a few plans sponsored by trade unions.

determining taxable income and the plan's investment earnings are sheltered from taxation as long as they remain in the plan. Pensions paid by the plan, on the other hand, are fully subject to income tax.

In addition to the conditions specified in the Income Tax Act, the registered pension plans of private sector employers must also conform to federal and provincial legislation regarding minimum standards, funding, investments and governance. Regulatory agencies of the federal and provincial governments oversee the operation of the registered pension plans in their respective areas of jurisdiction.[55]

In 2005, about 40 per cent of paid workers in Canada were covered by a registered pension plan.[56] This represents a decline from around 45 per cent in the early 1990s (Statistics Canada 2004). Coverage was highest in the public sector and among large unionized enterprises in the private sector. It was lowest in the agricultural sector and in many parts of the service sector. The great majority of persons covered by registered pension plans—82 per cent—belonged to defined-benefit schemes.

RRSPs are voluntary individual accounts available to anyone aged under 70 with earnings from employment or self-employment. Individuals may contribute up to 18 per cent of their earnings into an RRSP, subject to an annual maximum.[57] For 2005, this maximum was CAD 16,500. The federal budget of February 2005 announced that this maximum would be increased in stages to CAD 22,000 by 2010 (Department of Finance Canada 2005). As with registered pension plans, contributions to an RRSP are deductible when determining taxable income, and investment earnings are sheltered from taxation as long as they remain in the RRSP. However, withdrawals from an RRSP are fully taxed.

By the end of the year in which someone with an RRSP reaches age 69, the person must exercise one of three options regarding the funds in the plan: (i) they can be withdrawn (in which case they are subject to income tax at the time of withdrawal); (ii) they may be used to purchase an annuity (in which case payments from the annuity are taxed in the year in which they are made); or (iii) they may be transferred to a registered retirement income fund (RRIF). An RRIF is like an RRSP in the sense that investment earnings remain sheltered from taxation as long as they remain in the fund. However, a prescribed minimum percentage of the total assets in an RRIF must be withdrawn each year and, as a result, become subject to income tax. The prescribed minimum percentage increases with age.

In any given year, about 38 per cent of all persons of working age who file an income tax return[58] contribute to an RRSP (Statistics Canada 2003). However, this does not entirely reflect the coverage by RRSPs because many persons contribute in some years and not in others. A better sense of the proportion of persons who contribute to an RRSP can be obtained from longitudinal data. A study by Statistics Canada shows that nearly two-thirds of Canadians aged

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[55] Federal legislation, the Pension Benefits Standards Act, administered by the Office of the Superintendent of Financial Institutions, applies to the registered pension plans of employers in those sectors of the economy such as banking, communications and interprovincial transport that are regulated by the federal government. Provincial legislation applies to the plans of employers in all other sectors of the economy. Each province, except for Prince Edward Island, has pension standards legislation comparable to the federal legislation and a regulatory agency to administer its legislation. Under a reciprocal agreement between the provincial regulatory agencies, if an employer operates in more then one province, that employer's pension plan is registered in the province in which the greatest number of employees work. However, the pension standards legislation of each province applies to the employees in that province.

[56] The term "paid workers" means employed persons having an employer-employee relationship. It excludes self-employed persons who, by definition, cannot belong to an employer-sponsored pension plan. If the entire labour force is taken into account (paid workers as well as self-employed and unemployed persons) almost a third of the Canadian labour force is covered by registered pension plans.

[57] For persons who are members of registered pension plans, the maximum annual contribution to an RRSP is reduced, taking into account the contribution to the occupational scheme.

[58] This estimate is based on data for 2001. "Persons of working age", in this instance, refers to tax filers aged 25 to 64. It should, of course, be noted that tax filers are a larger group than persons in the labour force, and include those with taxable income exclusively from sources other than employment and self-employment (for example, persons who retired before age 65). The figure of 38 per cent, therefore, somewhat underestimates the proportion of persons in the labour force who contribute to an RRSP.

20 to 59 who filed an income tax return in 1992 made at least one contribution to an RRSP between 1993 and 2001 (Giles and Maser 2005). Persons with higher incomes are far more likely to make contributions than those with lower incomes and, on average, make higher contributions—a reflection of the fact that higher-income persons have a greater capacity to save for retirement than lower-income persons. In addition, the value of their tax deduction for contributions to RRSPs—in terms of savings in federal and provincial/territorial income taxes—increases with the tax filer's top marginal tax rate.

Since employed persons can contribute to both a registered pension plan and an RRSP, the total percentage of the labour force contributing to tax-assisted retirement savings schemes is not simply the sum of those contributing to a registered pension plan and those contributing to an RRSP. In 2001, slightly more than 51 per cent of all persons aged 25 to 64 who filed an income tax return contributed either to a registered pension plan or to an RRSP or to both (Statistics Canada 2003).

Persons with above-average incomes—those for whom the public pension system alone will not suffice to meet the income-replacement objective—are the most likely to contribute to a registered pension plan, an RRSP, or both. Among tax filers in 2001 with annual incomes above CAD 40,000, almost 87 per cent contributed to one or the other or to both (Statistics Canada 2003). These data demonstrate clearly the critical role that tax-assisted savings play in Canada's overall pension system. They also show why the second pillar of the multipillar model—mandatory individual savings accounts—is unnecessary in Canada. For persons with above-average incomes, mandatory retirement accounts would, in most cases, only displace existing voluntary savings for retirement. For persons with below-average incomes, such accounts would compel them to choose future consumption (retirement savings) over current consumption rather than allowing individuals and families to decide for themselves what is in their best interests. In any case, the public pillars of Canada's pension systems—the Old Age Security programme, provincial supplements for seniors, and the Canada and Quebec Pension Plans—play the dominant role in income replacement for Canadians with low or modest incomes.

Tax-assisted savings for retirement is not without considerable cost to governments. The cost, however, is not explicit as in the case of public pension programmes. Instead, it takes the form of tax expenditures—foregone tax revenues.[59]

In the case of tax-assisted savings for retirement, three factors have to be taken into account in estimating the related tax expenditures: (i) the tax revenues foregone because of the deduction of contributions when determining taxable income; (ii) the tax revenues foregone because of the non-taxation of the investment income retained in registered pension plans and RRSPs; and (iii) the tax revenues realized by the taxation of payments or withdrawals from registered pension plans and RRSPs. The net tax expenditure is the sum or the first two factors, minus the third factor.

According to estimates from the Department of Finance Canada, the federal government's net tax expenditure in 2005 related to registered pension plans was CAD 7.3 billion. The tax expenditure related to RRSPs was an additional CAD 8.6 billion (Department of Finance Canada 2004). Moreover, the provincial and territorial tax systems also lose revenues from these pension-related tax expenditures, averaging 47 per cent of the federal revenues foregone. Thus, the total estimated cost to Canadian governments in 2005 came to about CAD 10.7 billion for registered pension plans and another CAD 12.6 billion for RRSPs. When looking at the total costs to governments of the Canadian pension system, these sizeable sums should be taken into account.

[59] The Department of Finance Canada defines a tax expenditure as follows: "In order to define tax expenditures, it is necessary to establish a 'benchmark' tax structure that applies the relevant tax rates to a broadly defined tax base—e.g. personal income, business income or consumption. Tax expenditures are then defined as deviations from this benchmark" (Department of Finance Canada 2004).

In 2001, 55 per cent of Canada's elderly received income from registered pension plans or RRSPs.[60] This represented slightly more than 30 per cent of the aggregate income of the elderly. In 1991, 10 years earlier, only about 38 per cent of the elderly received income from these sources, and this income represented in aggregate only about 19 per cent of the total income of the elderly (Statistics Canada 2003). As with the Canada and Quebec Pension Plans, income from tax-assisted mechanisms for retirement savings has taken on an increasingly important role in Canada's overall pension system.

Lessons Learned from Canada's Experience

Four criteria are often used in evaluating a pension system: adequacy, affordability, sustainability and robustness (Holzmann et al. 2005:15–16, 79–82). The Canadian system, as the preceding discussion has attempted to show, scores well on each.

A number of "lessons learned" can be drawn from the experience of Canada's pension system:

- A multipillar pension system can be an effective means of achieving the dual objectives of poverty alleviation among the elderly and income replacement after retirement. By employing different financing systems for different components of the system, the risks inherent in relying exclusively or primarily on one means of financing are significantly mitigated. However, risk can never be eliminated. Vigilance, therefore, is constantly required.
- A zero pillar is essential for poverty alleviation. In a country like Canada, with a progressive income tax system covering virtually the entire population, it makes sense to finance the zero pillar from the government's general tax revenues rather than from contributions. In other countries, this may not be the case.
- The zero pillar does not need to be implemented all at one time. Different elements can be introduced progressively as economic circumstances permit.
- Fully indexing the benefits from the zero pillar to prices is not only essential for the economic well-being of the elderly, but also a prudent means for ensuring the pillar's long-term affordability in the face of an ageing population. However, when government finances permit, ad hoc adjustments should be made to the minimum income guaranteed by the zero pillar to reflect real (above inflation) increases in wages. This practice ensures that the standard of living of the poorest of pensioners will not fall behind that of other members of society in relative terms.
- A relatively modest mandatory public defined-benefit first pillar, combined with the zero pillar, can substantially achieve the income replacement objective for persons with lifetime earnings at or below the average. For persons with lifetime earnings above the average, such a first pillar plays a progressively smaller relative role in terms of income replacement as income rises. However, it continues to play some role.
- Provided that decisions are made sufficiently in advance of the onset of population ageing, a pay-as-you-go first pillar can be changed, if required, to a partially funded one with a stable contribution rate. Drastic parametric changes to benefits are not always needed or even possible. Depending on national circumstances, changes in financing can be more feasible politically than reductions in benefits, although the latter may be palatable if they are modest and stealthy.
- The investment of the reserve funds resulting from a shift to partial funding requires careful thought and planning. Management of reserve funds by a public agency operating at arms' length from government is an option worth exploring. Whatever mechanism is used to manage the reserve funds, independence from

[60] Income from RRSPs includes direct withdrawals from RRSPs and RRIFs as well as payments from annuities purchased with the proceeds of RRSPs.

political interference in investment decisions, accountability and transparency are essential for maintaining the confidence of stakeholders.

- A second pillar consisting of mandatory individual accounts is not necessarily required to achieve a pension system's income-replacement objective. Depending on national circumstances, voluntary tax-assisted mechanisms for retirement savings can be sufficient to complement a public first pillar. Such mechanisms can be especially important to ensure that the living standards of middle- and upper-income households are maintained after retirement.

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