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RETIREMENT INCOME STRATEGY FOR CANADA

Creating the Best Retirement
Income System in
the World



ACPM

The Association of Canadian Pension Management

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SECTION I WHY THIS PAPER NOW

The Origins Of This Paper

The Association of Canadian Pension Management (“ACPM”) is the national voice of corporate and public sector pension plan sponsors in Canada as well as the professional firms they retain. The almost 1,000 members of the Association represent more than 500 pension plans which have aggregate assets of \$226 billion.

The mission of the ACPM is to promote the growth and health of Canada’s retirement income system. Thus it is natural that the ACPM should want to contribute constructively to the current debate over the status of the retirement income system, and what should be done to improve it.

To that end, in April of this year, the ACPM sponsored an Executive Forum on the status of Canada’s retirement income system. The Executive Forum invited six experts to assess the current health of the system, and propose remedies for whatever afflictions they felt the system suffered from.

A common theme at the Executive Forum was that Canada lacks a framework for assessing the health of its retirement income system. As a result, the problems and solutions Canadians have been considering have lacked cohesion, consistency, and focus. A good example of this is the current debate over the Federal Government’s Seniors Benefit proposals. It is difficult to consider the advantages or disadvantages of these proposals in the absence of a larger vision of where Canada’s retirement income system is, and where it should be going. These were the factors which led to the ACPM’s decision to create a retirement income policy discussion paper (the “Paper”).

How This Paper Was Written

This Paper was commissioned by the ACPM’s Advocacy and Government Relations Committee (the “AGR Committee”). The AGR Committee is made up of 21 professionals from across Canada. AGR Committee members have broad and varied expertise in retirement finance and economics, law, actuarial science and investments. The AGR Committee appointed a Task Force chaired by Gretchen Van Riesen. The members of the Special Task Force were Keith Ambachtsheer, Wendy Gauthier, Malcolm Hamilton, Ian Markham and Bruce Near. The Task Force was asked by the AGR Committee to outline what an ideal national retirement income system should look like. A first draft of the Paper was completed in August of this year with Keith Ambachtsheer acting as editor.

The first draft of the Paper was reviewed by the AGR Committee. A second draft was reviewed by a number of respected industry participants and the Board of Directors of the ACPM. The Paper was revised to reflect comments received. The ACPM believes that the Paper has benefited from the best thinking available in Canada on retirement income policy issues.

As with all ACPM papers and submissions, the members of the Task Force involved in preparing the Paper were not compensated for their time. The ACPM wishes to thank each of the members of the Task Force for having made such an important contribution to the ongoing discussion of Canada's retirement income system. In addition, the ACPM acknowledges the assistance of various groups and organizations who have made financial contributions to permit the Paper to be printed and distributed.

The ACPM believes that the Paper reflects the views of its members. At the same time, the ACPM recognizes that individual members may not endorse certain recommendations and that such members may choose to express themselves independently on any or all of the issues set out in the Paper.

Goals of The Paper

The goals of the Paper are to (a) describe what an ideal national retirement income system looks like; (b) assess Canada's current system against the ideal; and (c) identify the steps necessary to get us from here to there. The ACPM believes the Paper accomplishes these three goals. The ACPM welcomes your comments and reactions to the Paper. The ACPM believes that the Paper can play an important role in helping to shape the current debate on Canada's retirement income system.

Send your comments to:

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SECTION II PAPER OVERVIEW AND RECOMMENDATIONS

Overview

- Canada has built a reasonably balanced 3 pillar retirement income system – tax funded minimum income support for all seniors (Pillar 1); mandatory CPP/QPP (Pillar 2); and voluntary employer pension plans and RRSPs (Pillar 3). The Federal and Provincial Governments have reached agreement on revisions to Pillar 2. Now, Pillars 1 and 3 must each be revised in a consistent co-ordinated manner.
- The ACPM believes that further efforts to reform the Canadian retirement income system must flow from a unifying vision and seeks to achieve the following goals: adequacy, fairness, sustainability, transparency and efficiency.
- The Paper describes a number of barriers standing in the way of achieving these goals. One is the lack of cohesion and consistency in Federal Government policies related to income support for Seniors and for working Canadians. Another is policies which seriously hamper the ability of Canadians to provide for their own retirement. Yet another is the inadequate state of information and knowledge about Canada's retirement income system. Finally, the system suffers from a number of impediments preventing the conversion of retirement savings into the maximum pensions possible.
- The ACPM believes that the retirement income system problems identified in the Paper can be overcome, and to that end makes specific recommendations for action by the Federal Government, Provincial governments, employers and the financial services sector.
- The ACPM believes that the implementation of these recommendations would give Canada the best retirement income system in the world and that such a system would give Canada an important competitive advantage as it enters the 21st century.

Summary of the Recommendations

A lack of cohesion among the three retirement income system goals of adequacy, fairness and sustainability is leading to a system which increasingly favours seniors at the expense of lower income workers, and spenders at the expense of savers. The following measures are required to re-establish an appropriate balance:

- A common view of the income that a Canadian single person or family needs to live a decent life should be established for both the proposed Seniors Benefit and the Income Tax Act.
- The Federal Government should adopt consistent minimum income support levels for all Canadians, whether working or retired.
- By 2001 the basic personal tax credit and married tax credit should be increased to minimum income support levels established by the Federal Government.
- The Seniors Benefit should commence in 2001 at the proposed levels - \$11,400 for single persons and \$18,400 for senior couples. Thereafter, the benefits should be increased at the rate of 1% lower than the rate of increase in the average wage, until they equal the minimum income support levels established by the Federal Government.
- Canadians earning more than twice the average wage should have a reasonable opportunity to maintain their standard of living when they retire.
- The proposed grandfathering of Old Age Security benefits should be abandoned.
- The maximum clawback related to the proposed Seniors Benefit (i.e., the sum of reductions and taxes) should be less than 50%.
- Requirements for employer sponsored public sector and private sector pension plans should apply and be applied equally.
- Pension adjustment rules should be modified to reflect differences in indexing provisions of employer sponsored pension plans.
- Opportunities for pension income splitting between spouses under RRSPs and pension plans should be equalized.

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- Employers should ensure that the pension vehicles they create for their employees reasonably balance the goals of the employer and those of the employees.
 - The Federal Government should institutionalize a regular 5 year review of the retirement income system that evaluates performance against pre-set standards and benchmarks.

To make Canadians pension-literate (i.e., increase transparency) the ACPM recommends:

- The findings of the recommended regular 5 year review of the retirement income system should be widely disseminated to Canadians in understandable language.
- Governments and their agencies (e.g., Statistics Canada) should be encouraged to turn data and research on the retirement income system into information that will better inform Canadians about their retirement income system.
- Canada's education system should design and teach life cycle financial management courses at the high school level.
- Canada's financial services sector should better inform customers about the basics of pension and investment economics.

To maximize the dollars of pensions going out, per dollar of contribution coming in (i.e., increase efficiency) the ACPM recommends:

- The 20% limit on foreign property held by pension plans and RRSPs should be raised by 2% annual increments until it reaches 30% and then completely eliminated.
- Legislators and Canada's pension regulators should make the creation of a simplified, unified pension regulatory system a high priority.
- Canada's financial services sector should offer to Canadians a series of low cost, easily accessible retirement savings-oriented products.

SECTION III WHAT IS RIGHT AND WRONG WITH CANADA'S RETIREMENT INCOME SYSTEM

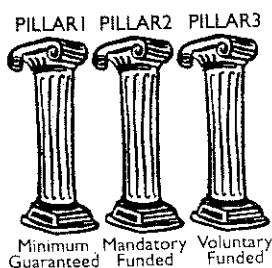
What Does the Ideal "Retirement Income System" Look Like?

"Retirement income systems" have been around for a long time. In agrarian societies they involved large families where those who could, took care of those who could not. In the late-1800s, the state began to play a formal role in the developed economies, initiating modest forms of broadly based national social security schemes. At the same time, the industrial revolution spawned large-scale employers, and the beginnings of employment-based pension plans. Over the course of the last 100 years, both the public and the private sides of these formal retirement income system components have grown to the point where they now play critical, visible roles in both peoples' lives, and in how developed economies function.

What does the "ideal" national retirement income system look like as we enter the 21st century? The chart below outlines the key dimensions of the World Bank version of the ideal pension system [1]. We believe that this "three pillar" model is a useful starting point for our discussion:

The Pillars of Old Age Income Security

OBJECTIVES	Redistributive plus coinsurance	Savings plus coinsurance	Savings plus coinsurance
	Means-tested minimum pension guarantee, or flat	Personal savings plan or occupational plan	Personal savings plan or occupational plan
	Tax-financed	Regulated fully funded	Fully funded
	Mandatory publicly managed pillar	Mandatory privately managed pillar	Voluntary pillar



- Pillar 1 is a tax-financed, means-tested, minimum pension guaranteed by the state.
- Pillar 2 is an employment-based, fully funded, privately managed, mandatory pension plan to which everyone in the workforce belongs.
- Pillar 3 is comprised of a variety of fully funded, privately managed retirement savings or pension plans, constituting a voluntary third layer of the retirement income system.

However, the above chart cannot tell the whole story. To breathe life into it requires articulating the five goals that a national retirement income system should strive to achieve.

Five Goals For Our Retirement Income System

Qualitatively, the five goals are easy to articulate: 1. Adequacy, 2. Fairness, 3. Sustainability, 4. Transparency, and 5. Efficiency. However, as with many things in life, the devil is in the details. Specifically, what do these five words mean in practical, and where relevant, quantitative terms? We begin to address this question next:

- 1. ADEQUACY:** An ideal retirement income system creates the opportunity for individuals to maintain a target income level (e.g. 70% of pre-retirement income) through pension plan membership and/or individual retirement savings programs. Where individuals fail to do so, or are unable to do so, the state provides a means-tested, minimum pension.
- 2. FAIRNESS:** A fair retirement income system rewards self-reliance, and applies the same set of rules and standards to all citizens, past, present, and future.
- 3. SUSTAINABILITY:** A sustainable system is one where there is proper alignment between what participants expect the retirement system to deliver, and what it actually can deliver. Its rules must be adaptable to changing demographic and economic circumstances.

- 4. TRANSPARENCY:** In a transparent system, participants know what is going on in the retirement income system generally, know where they stand specifically, and know what is expected of them.
- 5. EFFICIENCY:** An efficient system delivers a target level of retirement income at minimum cost.

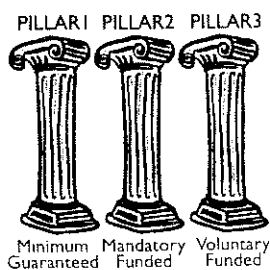
We now assess Canada's current retirement income system by these standards.

Canada has built a reasonably balanced three-pillar retirement income system over the post-WWII period

Canada's Current Retirement Income System: The Good News

Canada has built a reasonably balanced three-pillar retirement income system over the post-WWII period. Its Pillar 1 is the tax-supported OAS-GIS program, Pillar 2 is the partially funded CPP/QPP, and Pillar 3 is a variety of employment-based, funded pension plans and individual RRSPs. Together, the three pillars have materially raised the income levels of Canada's seniors over the last 30 years. This balanced approach compares favorably with the highly unbalanced approaches adopted by, for example, France, Germany, and Italy which have placed most of their retirement income eggs in single, huge, unfunded Pillar 2 baskets. The large, unfunded Pillar 2 systems are now running into serious financing difficulties. These difficulties will only get worse over time. In contrast, Canada has recently taken steps to stabilize CPP/QPP funding at a still affordable 9.9% of earned income up to the average wage. Meanwhile, federal and provincial operating budgets are coming into balance, which is beginning to reduce the size of our public debt as a proportion of GDP.

In addition to being less risky, Canada's more balanced three-pillar approach is easier to change when adjustments become necessary. A good example is the recent CPP/QPP revisions. A federal-provincial working group hammered out a proposal over the course of 1995-1996 involving mainly additional funding and the creation of a CPP Investment Board. Canadians were consulted on the CPP in a reasonably open, transparent manner in 1996. Legislation has now been drafted to effect the agreed-upon changes, which should pass in to law before the end of 1997. Meanwhile, Quebec has agreed to make parallel changes to the QPP, so that the CPP and QPP systems will continue to operate in tandem in the future. Thus Canada's Pillar 2 was renovated in a relatively short two-year period of time.



Canada's Current Retirement Income System: The Bad News

The bad news about Canada's current retirement income system is that its Pillars 1 and 3 are in need of renovation too. Unfortunately, unlike the recent Pillar 2 CPP/QPP renovation, there is no apparent similarly effective process in place to address a number of serious Pillars 1 and 3 problems. For example, the Seniors Benefit proposals attempt to make changes to Pillar 1 in isolation by establishing a minimum after-tax income for senior citizens after the year 2001[2]. A more comprehensive, integrated reform strategy would focus on all five ideal retirement income system characteristics simultaneously:

1. ADEQUACY:

Canada's Federal Government is the logical agent for leading a process towards consensus on what target and minimum levels of income replacement Canada's retirement system should achieve, and what the respective roles of Pillars 1, 2, and 3 should be to help us get there. While the Federal Government has in a number of ways acknowledged that it should be playing this role, its success to date in actually doing it has been limited. As a result, system changes such as the recent CPP reform process have an "ad hoc" feel to them. The same can be said for the Seniors Benefit proposals, and the continued "temporary" freezes on raising the contribution limits on registered pension plans and RRSPs.

2. FAIRNESS:

Canada's current system is fundamentally unfair in a number of ways. For example, the last 30 years have seen seniors receive current and accrue future Pillar 1 and 2 retirement benefits well in excess of the moneys they contributed towards funding those benefits. The additional cost of the benefits was pushed forward to future generations in the form of additional government debt and unfunded CPP/QPP pension liabilities. The proposed replacement of the OAS-GIS benefits with the Seniors Benefit does little to remedy this situation. There are many other examples. The tax system disadvantages the working poor relative to retired seniors, and private sector employees in relation to public sector employees. Those who earn more than twice the average wage have no viable retirement savings opportunities to replace 70% of their pre-retirement income. The private sector itself could do more to ensure pension plans are genuine "win-win" arrangements between employers and employees.

The tax system disadvantages the working poor relative to retired seniors, and private sector employees in relation to public sector employees. Those who earn more than twice the average wage have no viable retirement savings opportunities to replace 70% of their pre-retirement income

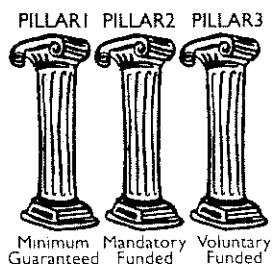
3. SUSTAINABILITY:

A sustainable retirement income system is able to deliver on its promises. This becomes a serious issue when the assumptions on which the original (presumably sustainable) system was based no longer hold. This in fact describes current reality: birthrates and economic growth have been much lower than originally assumed, while real asset returns have been higher. These conditions greatly increase the attractiveness of funded systems relative to pay-go systems. To its credit, Canada has now swung its Pillar 2 to greater funding. However, the Federal Government seems intent to continue to suppress the growth of its funded Pillar 3, with repeated contribution limits freezes on corporate pension plans and RRSPs. Yet, Pillar 3 is the primary source of long term savings, which are the foundation of wealth expansion in Canada. At the end of the day, the size of both private and public pensions will be determined by what the Canadian economy is able to produce, and the claims we have accumulated on the global economy through global investing. The larger the pie, the more there is for everyone.

Surveys suggest that Canadians are generally not very knowledgeable about how their retirement income system works in general, and whether their personal retirement income goals are reasonable in relation to what it will take to attain them

4. TRANSPARENCY:

Surveys suggest that Canadians are generally not very knowledgeable about how their retirement income system works in general, and whether their personal retirement income goals are reasonable in relation to what it will take to attain them. Aside from this general problem, there are three specific areas where a lack of system transparency is especially troubling and harmful to good public policy. One is a wide perception that Canada's Pillar 3 is hugely "expensive" in the form of "tax expenditures" (i.e. foregone tax revenues which would be collected in the absence of tax incentives for retirement savings). The second is a wide perception that RRSPs are a "sop to the rich" because higher income Canadians take greater advantage of RRSPs than lower income Canadians. Both of these perceptions are based in analyses that are, at best, incomplete. Canada's financial services sector and media must take some responsibility for a transparency problem of a different nature. Too many Canadians have unrealistic expectations about future investment returns and pay inadequate attention to the costs of investing.



5. EFFICIENCY:

An efficient retirement income system delivers the maximum retirement dollars going out, per dollar of contribution coming in. Canada's system is currently hampered in three important ways. Two government-induced inefficiencies are (a) the Federally-imposed 20% Foreign Property Rule which has slowed the wealth creation, and proper diversification processes in Pillar 3 pension assets (this problem will soon affect Pillar 2 assets as well, as the CPP Investment Board gears up to invest CPP assets), and (b) burdensome and fragmented pension regulatory regimes which have hampered the growth of Pillar 3 pension coverage among working Canadians. A private sector-induced inefficiency is the current high sales and management fees being charged by the Canadian financial services industry on many of their RRSP-eligible investment products to participants, which will ultimately make it difficult for these participants to achieve their retirement income goals at affordable contribution rates.

An efficient retirement income system delivers the maximum retirement dollars going out, per dollar of contribution coming in

SECTION IV of this paper examines each of these problem areas in greater detail.

SECTION IV THE PROBLEMS AND THEIR CONSEQUENCES: A CLOSER LOOK

Analyzing The Problems Facing Canada's Retirement Income System

The most fundamental weakness of Canada's retirement income system today is its inability to deliver the things expected of it: adequate pensions, fair opportunities, and sustainability

As discussed in Section III, Canada's retirement income system has strengths, but also weaknesses. The purpose of SECTION IV is to analyze these weaknesses in some detail. The impediments to achieving the adequacy, fairness, and sustainability goals will be discussed jointly, as they are related. For example, systems that set their minimum pension guarantee too high, or are seen to be patently unfair, simply will not be sustainable. SECTION IV will conclude with separate discussions on current system transparency and efficiency problems.

We do not document these shortcomings merely to complain. Indeed, The ACPM believes that each of the problems identified in this Paper has a viable solution. Each of these solutions is set out in SECTION V of this Paper. The ACPM believes that implementing them would give Canadians the best retirement income system in the world. Such a system in turn would be a major source of competitive advantage for Canada.

PART A: THE INEFFECTIVE PURSUIT OF ADEQUACY, FAIRNESS, AND SUSTAINABILITY

The most fundamental weakness of Canada's retirement income system today is its inability to deliver the things expected of it: adequate pensions, fair opportunities, and sustainability. It is important to understand the origins of our current situation:

- Our social security system was set up in the 1960s on a pay-as-you-go basis. Large pay-as-you-go pillars were viable when the population and the economy grew quickly, but they are unlikely to withstand the challenges of the next century and they threaten to impose unreasonable costs on future generations.

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- Government programs are adjusted for inflation in often inconsistent ways. For example, government benefits are fully indexed but the Income Tax Act is not. With the passage of time the recipients of non-taxable government benefits, such as the Guaranteed Income Supplement or its successor, the proposed Seniors Benefit, are better protected from inflation than are people who support themselves by working and saving.
 - Sometimes problems arise from oversight or neglect. Examples include the proposed Seniors Benefit, which is not well coordinated with the Income Tax Act, and frozen retirement savings limits, which give many Canadians no viable way to adequately save for retirement.
 - Finally, an unhealthy gap has developed between retirement savings in the private sector and retirement savings in the public sector – a gap that threatens to create two classes of retired Canadians: public sector employees retiring early and in comfort, while others continue to work into their mid-60s, and beyond. The concern is not that Canada’s retirement system has weaknesses – time will expose the weaknesses of even the best designed system. Rather the concern is that government efforts to reform the system do not flow from any unifying vision or from any clear, consistent statement of goals regarding system adequacy, fairness, and sustainability. As a consequence, our retirement system increasingly stands on pillars which are not well-coordinated. For example, the clawbacks of Pillar 1 benefits render the second pillar (CPP/QPP) largely redundant. Meanwhile, the government targets the third pillar (retirement savings plans) on those who do not need it (i.e. lower income Canadians who are well supported by Pillars 1 and 2) while ignoring those who do (i.e. other Canadians who receive little from the first two pillars).

Our retirement system increasingly stands on pillars which are not well-coordinated

Intergenerational Inequities

Until recently, Canada’s social security system paid little attention to future generations. There seemed to be little recognition that the long-term viability of programs rested on our ability to raise the taxes of, and/or reduce the benefits payable to, future generations. Recent government decisions on fiscal policy and the funding of the Canada Pension Plan are important first steps towards building a sustainable social security system that serves the interests of future generations as well as our own.

Unfortunately, the proposed Seniors Benefit and the government’s handling of RRSP and pension limits do not build on these precedents and impose larger burdens on future generations than on today’s workers and pensioners. The Seniors Benefit guarantees seniors a tax-free income well in excess of what

working people are allowed to earn before being subjected to income and payroll taxes. Grandfathering Old Age Security benefits for those born prior to January 1, 1936 while denying them to those born later is unfair, made worse by the absence of a gradual transition or the provision of additional RRSP room to replace the lost income. The freezing of RRSP and pension limits until they are, in real terms, much lower than those enjoyed by today's seniors is yet another example of passing on to future generations the costs of treating those now retired or nearing retirement generously.

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Today's seniors are fortunate in the sense that they were lightly taxed during their working lives, at least by today's standards. They received universal Old Age Security and medical benefits financed, in part, by debt passed to future generations. They received Canada or Québec Pension Plan benefits for which they paid a fraction of the true cost. They earned a high tax-free rate of return on their houses and enjoyed the highest real interest rates this century during their retirement years. These facts are difficult to reconcile with raising the payroll and income taxes paid by young people while freezing their RRSP limits and cutting back their Old Age Security benefits. Those seniors who can, should now contribute something to salvaging the system that has treated them so well. We point these realities out not to be disrespectful, or to deny that today's seniors have contributed to making Canada a great country. We simply assert that the financial interests of the working poor and the young deserve equal consideration.

Irreconcilable Views of "Low Income"

The proposed Seniors Benefit establishes a minimum after-tax family income for senior citizens in 2001. A senior couple will be guaranteed \$18,400, while single seniors will receive \$11,400. In many provinces, this guaranteed minimum will be further supplemented by provincial assistance plans and tax credits.

In setting these benefit levels and the corresponding amounts payable under today's programs (Old Age Security, the Guaranteed Income Supplement and Non-Refundable Tax Credits for Seniors), the Federal Government is presumably guided by a view of the income that senior citizens require to live a decent life. This view is difficult to reconcile with the government's treatment of taxpayers. Working people are asked to pay income tax when their employment income exceeds \$6,500 for a single taxpayer and \$12,000 – \$13,000 for a tax paying couple. Working people must contend with payroll taxes and employment expenses. They have not had an opportunity to pay for their principal residences, as have many seniors, and they do not qualify for discounts on everything from banking services to public transit.

These inconsistencies create real problems. Money earned by low income workers is going to seniors who are already adequately provided for.

Dismantling Savings Incentives

The ideal retirement system balances support for those in need with the promotion of savings incentives, which in turn underpin a healthy, growing economy. The proposed Seniors Benefit illustrates the problems that can arise when one element, support for the needy, is pursued without addressing how this measure might impact savings and economic growth. The Seniors Benefit, after tax, is about 150% of the cost of food, clothing and shelter. It guarantees retired seniors a modest, but comfortable life even if they have no other means of support.

Some of today's programs which are to be replaced by the Seniors Benefit are universal or near universal. Many well-to-do seniors currently derive some benefit from Old Age Security and the Pension Income Tax Credit. The clawback of today's benefits occurs primarily at low-income levels. At higher income levels the clawback rates are modest and do not create a significant disincentive for retirement savings. The Federal Government has decided this is no longer a viable option because the cost of today's universal programs will accelerate dramatically after 2015 when the baby boomers start to retire. The cost of today's programs can be reduced either by: (a) reducing benefits for all recipients, or (b) maintaining benefits for lower income recipients and dramatically reducing them for those who save for their own retirement (i.e., more specific targeting).

The new Seniors Benefit relies entirely on the second approach, preserving benefits for the majority while dramatically reducing them for the minority. In so doing, it creates significant retirement savings disincentives – marginal “tax” rates (including clawbacks) in the 50% to 80% range for seniors with relatively modest incomes. The Federal Government believes that this combination of relatively generous support for the needy and steep tax/clawback rates will somehow encourage Canadians to rely more heavily on themselves. The opposite is likely to happen. Middle income Canadians might simply decide to supplement government programs through the accumulation of non-income producing capital, such as homes or interest-free mortgages for their children. They may decide to simply avoid retirement savings plans that generate heavily taxed incomes.

A good retirement system rewards those who work and save. Clawback rates should be coordinated with income tax rates such that the total, at any income level, is lower than 50%. If 60% to 80% tax/clawback rates are needed to make a program affordable, then the benefit level has been set too high.

A good retirement system rewards those who work and save

Inflation-Induced Distortions

In the 1960s no-one was protected from inflation:

- The beneficiaries of government programs (C/QPP, OAS) received frozen benefits.
- Workers were exposed to bracket creep i.e., as inflation increased their earnings, the Income Tax Act, which was not indexed to inflation, took an ever-increasing percentage of these earnings.
- Retirement savers and investors had to contend with frozen RRSP and pension limits. Moreover, any investment income earned outside tax shelters was not properly adjusted for inflation, i.e., the investment gains that were needed to preserve purchasing power were taxed at full marginal rates as if they were real profits.

During the last 25 years some groups achieved inflation protection while others have not. The Federal Government effectively established a pecking order

During the last 25 years some groups achieved inflation protection while others have not. The Federal Government effectively established a pecking order. At the top we find the recipients of tax-exempt government benefits such as the Guaranteed Income Supplement and the proposed Seniors Benefit. These groups receive fully indexed benefits, and because their benefits are tax exempt, they keep all of their inflation protection.

Next we have recipients of taxable government benefits and workers whose wages keep up with inflation. The income of these groups rises with increases in the cost of living, but because the Income Tax Act is only partially indexed (and in many years, not indexed at all) these groups pay an ever-increasing percentage of their income as tax, and their after-tax incomes do not keep up with inflation.

Next come individuals who contribute to retirement savings plans. The pension limit has been frozen since 1976 and is scheduled to remain frozen until 2005. The RRSP limit has been adjusted from time to time, but is now frozen until 2004.

Finally we have those who save for retirement outside tax shelters, a group that has no inflation protection at all. Government benefits have been indexed, the tax system partially indexed, and RRSP limits adjusted from time to time. But those who save outside tax shelters are taxed on interest and capital gains at ever increasing rates without any adjustment for the steady erosion in the purchasing power of their savings.

Canadians are not well served by systems that protect some and not others. Such systems are never truly sustainable. Inflation slowly, but inexorably, alters their character. In this instance as time passes seniors do well, workers less well and savers least well. Ultimately what starts as a balanced system ends up looking like what we have today:

- generous benefits for those who rely on government;
- high taxes for everyone else;
- lower income Canadians with little incentive to save (because government benefits replace most of their income); and
- other Canadians with little ability to save due to shrinking (in real terms) limits and the inhospitable tax treatment of savings outside tax shelters.

Canadians are not well served by systems that protect some and not others. Such systems are never truly sustainable

No Viable Savings Opportunities for Those Earning More than Twice the Average Wage

According to government policy, the Canadian retirement savings system (RRSPs and RPPs) is to be better targeted to modest and middle-income Canadians. This will be accomplished by denying those earning more than twice the average wage the opportunity to save an amount commensurate with their earnings. What, then, does the Federal Government expect citizens earning more than twice the average wage, and who pay a disproportionately high share of the taxes which support Canada's social programs, to do? [3].

- If they buy bonds or GICs, half their interest is consumed by taxes. After tax and inflation, they will be lucky to earn a positive rate of return.
- If they buy equities, taxes consume 40% of their dividends and 40% of their capital gains. After tax and inflation, they will be lucky to earn a 2% rate of return.

Unlike their counterparts in continental Europe, they can expect little from social security – a modest pension from CPP/QPP and little or nothing from the Seniors Benefit. Relative to their counterparts in most other industrialized countries, they have limited ability to defer taxes (less than half the limits in the U.S. and the U.K.), high marginal tax rates and high tax rates on capital gains.

Having lost half of their employment income to taxation, retirement savers will, without tax deferral capability, lose half of their savings as well. The Canadian retirement savings system was supposed to protect Canadians from being taxed twice on their retirement savings. Saving outside a tax shelter is prohibitively expensive because the tax rules tax not only real returns, but also the component of return merely intended to maintain purchasing power. The burden falls predominantly on those in the private sector, as most public sector workers earn government-guaranteed pensions on earnings without limit.

The Gap between the Public and Private Sectors

The retirement savings practices of public and private sector employees are markedly different.

- Public sector employees constitute 25% of our workforce, 50% of our pension plan members and close to 70% of our pension assets and contributions.
- The Canadian Institute of Actuaries study "Troubled Tomorrows" found that the retirement savings rate for public sector employees (total contributions to pension plans and RRSPs as a percent of payroll) was more than double that of employees in the private sector. The Canadian Institute of Actuaries concluded that this difference would allow public sector employees to retire, on average, about 10 years earlier than their private sector counterparts [4].

Undoubtedly, these pension plan membership and retirement savings behaviour differences to some degree reflect differences in compensation philosophies between the private and public sectors. Nevertheless, the disparity is striking and deserves further examination.

In 1990, the Federal Government rewrote the rules governing RRSPs and pension plans to create a system where all Canadians would enjoy equal access to tax sheltered retirement savings plans. Rather than lessen sectoral differences, the new rules accommodated the traditional richness of public sector plans. The PA system accepted as normative the value of indexing, early retirement options and bridge benefits - common features in public sector plans but not as common in the private sector. As a consequence, the Canadian Institute of Actuaries estimated that in 1992, contributions to public sector plans exceeded the RRSP room forgone by the members of these plans by over \$5 billion. Conversely, contributions to private sector plans were \$1.4 billion less than the RRSP room forgone by the members of these plans.

Having lost half of their employment income to taxation, retirement savers will, without tax deferral capability, lose half of their savings as well

In the past, Revenue Canada has been inconsistent in its administration of the Income Tax Act, with respect to public versus private sector pension plans. For example, before 1992, most public sector plans were exempted from the pension limits imposed on private sector plans (the maximum pension being approximately \$60,000 per annum after 35 years of service). This practice was grandfathered in 1992 when the Income Tax Act changes were introduced – which means that virtually all public sector plans are not subject to the maximum for pre-1992 service. In addition, the Federal Government, on three occasions has postponed promised growth in maximum pensions. This treatment is disproportionately unfair to private sector plans.

Second, the Income Tax Act requires plan sponsors to suspend their contributions to pension plans once the surplus exceeds 10% of the plans' actuarial liabilities. The plans covering employees of the Federal Government have a surplus that exceeds 25% of their actuarial liabilities, yet the Federal Government continues to contribute about \$1.5 billion per annum of taxpayers' money.

If we want our retirement system to meet the needs of all Canadians, we need policies at both the federal and provincial levels that apply fairly and equally to the public and private sectors.

Unfair Treatment of Families with One Pension

Canadians are taxed as individuals but they are treated as families for the purposes of programs like the Seniors Benefit. One-income families, and more generally families where one spouse earns most of the family's income, are not well treated by this system. During their working lives they are heavily taxed relative to comparable families whose incomes are more evenly divided between the spouses. When the one-income family retires, however, the low-income spouse loses his or her Seniors Benefit due to the income of the highly taxed spouse. Under the Old Age Security benefit, this did not happen. The low-income spouse kept his or her OAS benefit, which compensated, in part, for the family's heavy tax burden.

The Income Tax Act permits one-income families to divide their post-retirement incomes between the spouses by using spousal RRSPs. The family will still lose its Seniors Benefit based on family income, but its tax burden will be diminished. However, if the employed spouse participates in a pension plan the family has no ability to divide its post-retirement income between the spouses. On retirement, it remains a one-income family – highly taxed with few government benefits.

If we want our retirement system to meet the needs of all Canadians, we need policies at both the federal and provincial levels that apply fairly and equally to the public and private sectors

One-income retired families can improve their financial situations by separating or divorcing. The low-income spouse could take non-income-producing assets, such as the family home, and qualify for the full Seniors Benefit. Alternatively the low-income spouse could take income-producing assets (such as a share of the working spouse's pension) in which case the couple's tax burden would be reduced.

A system that treats divorced couples better than married couples and families with RRSPs better than families with pensions is not particularly fair. Ideally, we should move to a tax system based on family income as recommended in the 1960s by the Carter Commission. Failing this, some steps should be taken to improve the situation of one-pension families.

Canadians enter the workforce ill-equipped and unprepared to understand how the retirement system works and the role they have to play in it throughout their working lives

PART B: POPULAR MISCONCEPTIONS

One measure of the success of a retirement system is widespread and consistent understanding on the part of all the stakeholders about the system's goals and objectives. Only broad understanding ensures that each of the system participants (i.e. policy makers, governments, employers and individuals) know their respective roles and responsibilities. This is a challenging objective for any country to meet, including Canada. We can point to a number of reasons why Canadians are not as well informed about pension issues as they should be.

First, there is relatively little information on the retirement system that is clear, understandable, and widely accessible. Furthermore, both government and private sector sources often present the subject matter in a highly technical manner, perceived as understandable by only an expert handful. The situation is exacerbated by the fact that retirement savings principles are not addressed in the school system. The result is that Canadians enter the workforce ill-equipped and unprepared to understand how the retirement system works and the role they have to play in it throughout their working lives. Often, they don't acquire "the facts" until after it is too late to take charge of their own financial futures.

The Federal Government, in particular Statistics Canada, is the main source of information on how the current system is working, and who is benefiting from it. However, the information from Statistics Canada and other government departments is sometimes presented by the media in ways that don't tell the whole story. As a result, public policy in Canada is being formulated based on information which is incomplete, and which at times creates serious misconceptions about Canada's retirement income system. We will now

cite four examples of this problem: poverty among seniors, pension plan coverage, RRSP utilization rates, and the measurement of pensions-related “tax expenditures”.

Distinguishing Between Minimum Income Support Levels and Poverty Lines in Canada

Many Canadians believe that the poverty rate for Canadian seniors is high and that senior citizens in Canada are poor. Statistics Canada publishes a “low income cutoff” table which, although it was never intended to define poverty lines, is now being used by social policy analysts and by the media as though that was in fact the intention. As a result, for example, its \$18,000 “low income cutoff” for a couple without children in an average community has become the unofficial poverty line for that couple. In contrast, in the United States, \$9,200 is the official poverty line. The difference lies in the definition of poverty. The U.S. defines the poverty line as the amount required to purchase 100% of life’s necessities: food, clothing and shelter. Clearly, minimum income support for seniors is being set at considerably higher levels in Canada. It is not correct to say that these minimum income support targets are equivalent to poverty lines in Canada [5].

Statistics Canada publishes a “low income cutoff” table which, although it was never intended to define poverty lines, is now being used by social policy analysts and by the media as though that was in fact the intention

Pension Plan Coverage

Every two years, Statistics Canada publishes data on the number of Canadians covered by registered pension plans. Their information at January 1, 1995, shows that employees covered by registered pension plans represented 43% of the paid workforce or 34% of the total labour force. Their publication does not, however, reflect the fact that many other Canadians are covered by employer sponsored Group RRSPs, and that many are adequately protected by government social security programs. The reader is left with the impression that Canada has a major coverage problem, inferring that many employers need to be more responsible. There may well still be a pension plan coverage problem in Canada, particularly in the private sector. However, it is difficult to assess the magnitude of the problem without good information on pension coverage by relevant labour market segments, and on Group RRSP coverage.

RRSP Participation Rates: Low Or High?

Statistics Canada publishes studies of the amounts Canadians are contributing to RRSPs. The message that has often accompanied this data is that the current system is unfair because it only benefits higher income Canadians. Statistics Canada encourages this view by emphasizing statistics that, while

not incorrect, are arguably misleading. For example, in 1995, Statistics Canada reported that only 29% of Canadians contributed to RRSPs and that 81% of those who did not save earn less than \$20,000 per annum. Statistics Canada did not point out that lower income Canadians do not need to contribute to retirement savings plans in order for their standard of living in retirement to compare favourably to their standard of living before retirement.

Statistics Canada would serve Canada's retirement income system better if it pointed out that while only 29% of tax filers contributed to RRSPs in 1995, if one excludes those under age 25 and over 65, the participation rate increases to 36%. If those with earnings less than \$20,000 per annum are excluded the participation rate increases further, to 56%. If those individuals who participate in registered pension plans instead of contributing to RRSPs are also factored in, the overall percentage of Canadians participating is 77%. Based on this analysis, a much brighter picture emerges. The participation level goes from 29% to 77%, just by focusing on those who need to use RRSPs to save for retirement.

The Department of Finance has published estimates that Canada's retirement savings system "cost" the Federal Government \$15 billion in 1991. However, this figure does not tell the whole story

Measuring "Tax Expenditures"

Canadians are told that the Federal Government foregoes an enormous amount of tax revenues on tax-assisted retirement savings plans. The inference drawn from this "information" is that the Federal Government should resist raising contribution limits, which would only end up costing taxpayers more. While some tax revenues may be lost providing tax deferrals for retirement savings, the magnitude of those losses is very difficult to determine.

The Department of Finance has published estimates that Canada's retirement savings system "cost" the Federal Government \$15 billion in 1991. However, this figure does not tell the whole story. For example, it does not properly capture the revenue that is recovered later when taxpayers withdraw their money and pay the appropriate taxes. Also, it is based on the highly unrealistic assumption that taxpayers would save and invest in exactly the same way if the tax incentives for retirement savings were eliminated.

The Canadian Institute of Actuaries, in its policy paper titled "Troubled Tomorrows", determined that a more reasonable estimate of the impact of the retirement savings system on federal and provincial government tax revenues is about \$5 billion. Given the overstatement of the tax expenditures involved by a factor of three, it is no wonder that, when stacked-up against other countries such as the United States, the United Kingdom and the Netherlands, the Canada's retirement income system falls well behind with respect to facilitating the accumulation of retirement savings.

Finally, the issue of “tax expenditures” goes beyond simply publishing reasonable (as opposed to unreasonably high) estimates. The very terminology “tax expenditures” suggests there is something bad going on, that somehow these tax deferrals are directly linked to government deficits. It completely ignores the fact that by deferring taxes payable on retirement savings now, the resulting accumulations of capital create new investment and new wealth. This new wealth in turn funds future pension payments and produces additional future tax revenues. In this broad sense, the issue is whether we spend more now to have less later when we really need it, or save more now so that we can have more wealth down the road when we really need it (i.e. when the boomer wave begins to retire).

Private Sector also Contributes to Misconceptions

Not all of the misconceptions about retirement finance and investments result from the actions of the Federal Government and its agencies. Canada’s financial services sector has been a significant beneficiary of the decisions by thousands of Canadians to invest their RRSP contributions in the stock and bond markets through investment products. Some financial services companies and financial advisors have done a good job informing their clients about the nature of capital markets, about reasonable future return prospects, about diversification, and about the negative impact high fees can have on the accumulation of an adequate retirement nest egg at an affordable contribution rate.

Others, however, have focused on communicating the high returns achieved during financial markets periods which are unlikely to be good proxies for future experience. The impression is created that high double-digit returns are normal, and can be expected to continue. Further, the achieved returns are seldom benchmarked against those of a passively managed index fund with the same investment objectives. As a result, it is difficult for participants to sort out whether the managers of those funds are creating sufficient value to offset the fees being charged, and the risks being undertaken.

PART C: STRUCTURAL DEFECTS

Thus far we have analyzed current retirement system problems related to achieving the adequacy, fairness, sustainability, and transparency goals. This final part of SECTION IV focuses on impediments to achieving the system efficiency goal. We examine four specific problems: (1) the 20% Foreign Property Rule, (2) a burdensome regulatory regime, (3) the continued lack of flexibility in the design of some employment-based pension plans, and (4) the too high cost of RRSP investing through many investment products.

The issue is whether we spend more now to have less later when we really need it, or save more now so that we can have more wealth down the road when we really need it (i.e. when the boomer wave begins to retire)

The 20% Foreign Property Rule: A Lose-Lose Proposition

The Income Tax Act prohibits more than 20% of the book value of the assets of a registered pension plan or RRSP from being invested in foreign assets. Current plans call for the Canada Pension Plan Investment Board to be similarly constrained. This is known as the Foreign Property Rule (FPR). It was devised over 25 years ago, at a time when Canada was a major importer of foreign capital, and when its own financial markets were deemed to need being nurtured by government assistance. The ACPM does not wish to argue here whether the foreign investment limitation on Canadian pension funds and RRSPs ever made sense.

The FPR makes no sense today

However the ACPM does assert the FPR makes no sense today. Here are some of the more important reasons [6]:

- Canada is now a major exporter, as well as importer of financial capital. It now exports and imports roughly equal amounts. Thus capital flow imbalances no longer need to be offset by keeping domestic capital captive.
- Some of Canada's major investment institutions are becoming disproportionately large in relation to the size of Canada's stock and bond markets. The new CPP Investment Board will soon become another case in point. With the continuation of the 20% FPR, this causes unnecessary illiquidity and market impact risks in Canadian financial markets.
- The FPR does not make more investment capital available in Canada. It merely displaces foreign capital, replacing it with domestic capital. When there is too much local, and not enough foreign capital in Canada's financial markets, the Canadian cost of capital is higher than it needs to be, hurting Canadian issuers of stocks and bonds.
- The estimated future annual cost of the FPR is about 0.2% of Canadian pension fund and mutual fund-based RRSP assets. On a combined asset base of over \$500 billion, this amounts to more than \$1 billion per annum in pension wealth foregone by Canadians. In a typical pension plan, this translates to a 3-4% decrease in pension benefits or increase in cost.
- The FPR prevents Canadian investors from achieving optimal diversification of their pension assets, by forcing them to hold at least 80% of their assets in the securities of a market which represents 2% of the global portfolio.

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- The FPR is inconsistent with Canadian pension fund managers carrying out their fiduciary obligations, which requires them to maximize return for pension stakeholders.
 - The FPR is inconsistent with evolving competition law and with the spirit of NAFTA.
 - The FPR inhibits the development of a Canadian-based global investment capability.

The final irony is that while Canadian investors clearly lose because of the 20% FPR, there are no winners. While some naively believe it reduces the cost of capital inside Canada, the ACPM notes above that it may in fact have the opposite effect. A related misconception is that pension funds do not make sufficient small business investments in Canada. This view does not recognize the reality that Canada in fact has a thriving small business investment industry, in which some of Canada's large pension funds which have the capability, are beginning to play an important role [7]. The 20% FPR is a clear cut case of government intervention that harms many and benefits no-one.

The final irony is that while Canadian investors clearly lose because of the 20% FPR, there are no winners

A Burdensome Regulatory Regime for Pensions

Extensive and complex pension regulation has discouraged the growth of registered pension plans in Canada. Pension regulations differ significantly from province to province, creating unnecessary difficulties for a national employer with employees in many provinces. In addition, these provincial regulations, as well as the equivalent federal regulations and the Income Tax Act, are all excessively complex with, inconsistencies and even conflicts between them.

The roles of the provincial and federal regulators are to review and give prior approval to many of the proposed actions of the employers, plan administrators and employees. In addition, these regulators are given authority, in a police-like manner, to investigate alleged failures to comply. This "review and approve" system creates unnecessary delay and expense to plan sponsors and other participants in the pension system. In some instances, compliance is discouraged because the cost of compliance, both time and expense, outweigh the risks of non-compliance. As a result, the relationship between many plan sponsors and administrators, on the one hand, and the pension regulators on the other, can be confrontational.

The ACPM notes that there has been some recent movement on this issue at the federal level, and in Ontario and the ACPM hopes that this movement accelerates. Reduced and simplified regulation is a vital necessity not only to encourage growth of registered pension plans but also to avoid further erosion in registered pension plan coverage [8].

Private Sector Problems with Plan Design

Not all of the Pillar 3 problems in the Canadian retirement income system can be laid at the feet of government. Some can be attributed to the continuation of outdated attitudes toward the purpose of private retirement income plans. For example, the original privately-sponsored pension plans were designed to provide a reward for long service to those employees whose loyalty to their employer resulted in their retirement after a long career with that employer. While most employers today would deny that this is the motivation behind their pension plan, there continue to be many defined benefit pension plans today that contain features that reflect this outdated principle. The result is that many defined benefit (DB) plans continue to have heavily back-end loaded patterns of pension credit accrual, hampered pension portability, and unnecessary complexity for employees.

Not all of the Pillar 3 problems in the Canadian retirement income system can be laid at the feet of government

These considerations are increasing the popularity of various forms of defined contribution (DC) plans. However, this type of arrangement is no panacea. Unless carefully designed and explained, DC plans can re-allocate risks and costs in unforeseen ways. On the risk side, for example, younger participants should take advantage of long investment horizons, while older participants are increasingly exposed to "annuitization" risk, as the time approaches to convert the accumulated pension assets into a stream of pension payments. These considerations make life cycle risk management a considerable challenge for DC plan participants. On the cost side, plan participants often bear the costs (investment and record keeping) of DC plans. These costs can be considerable unless careful attention is paid to managing them. The higher the costs, the lower the ultimate pensions.

Pensions, Costs, and Investment Products

An important basic rule in pension finance is that an additional 1% of investment return over the life of a plan participant produces a 20% higher ultimate pension. Thus, if a DC plan costs 2% per year more to administer than a DB plan, this is equivalent to a 40% reduction in the pensions the DC plan can ultimately generate, all other things equal. There in fact is a 2% per annum cost gap between some of Canada's large DB pension plans, and the investment options being offered by a number of Canadian financial services providers.

While financial services providers necessarily bear a number of additional costs which very large DB plans don't, a 2% per annum cost differential, which leads potentially to a 40% reduction in ultimate pensions generated, seems excessive. We see two reasons for the current very large cost differentials. First, capital market returns have been abnormally high in recent years, making investment product fees seem relatively unimportant. This factor will disappear when returns become more normal. The second factor is more problematical, and results from simply a lack of knowledge on the part of most investment product participants. They are simply not aware of the critical role costs play in generating adequate pensions at affordable contribution rates [9].

Capital market returns have been abnormally high in recent years, making investment product fees seem relatively unimportant

SECTION V CREATING THE BEST RETIREMENT INCOME SYSTEM IN THE WORLD

Realizing Canada's Potential

We noted earlier in this Paper that one of the strengths of Canada's national retirement income system is its ability to adapt to changing circumstances. SECTION IV laid out those changing circumstances and its consequences for the system in considerable detail. Set out below is a series of rational responses to the system problems which have emerged, and which need fixing. The recommendations are organized into sets related to each of the five goals of the ideal retirement income system: adequacy, fairness, sustainability, transparency, and efficiency.

ADEQUACY:(A) Establishing a Fair and Reasonable Minimum Income for Senior Citizens

Recommendation 1

The Federal Government should adopt consistent minimum income support levels for single persons and families.

These minimum income support levels should be no lower than the cost of life's necessities, and no higher than Statistics Canada's after-tax low income measure, adjusted for the impact of payroll taxes and employment expenses. In all likelihood these levels should fall somewhere between the incomes at which individuals and families now become taxable and the higher incomes guaranteed by the Seniors Benefit. Once established, these levels become reference points for minimum income support in both Federal social policy and the Income Tax Act [10].

Recommendation 2

A common view of the income that a Canadian single person or family needs to live a decent life should be established both for the proposed Seniors Benefit and the Income Tax Act.

At the present time, the Federal Government taxes working singles whose incomes exceed \$6,500 and working couples whose incomes exceed \$12,000 to \$13,000. The Seniors Benefit guarantees single seniors an after-tax income of \$11,400 and senior couples an after-tax

income of \$18,400. If seniors need incomes of \$11,400 or \$18,400 to live a decent life, working people with substantially lower incomes should not be subject to tax. Conversely, if working people with incomes of \$6,500 or \$12,000 can afford to pay tax, seniors shouldn't be guaranteed tax-free incomes of \$11,400 or \$18,400.

Recommendation 3

By 2001 the basic personal tax credit and the married tax credit should be increased to the official minimum income support levels established by the Federal Government. Thereafter, the personal and married tax credits should increase at the same rate as the official levels.

This recommendation follows logically from Recommendations 1 and 2.

Recommendation 4

The Seniors Benefit should commence at the proposed levels – \$11,400 for single seniors and \$18,400 for senior couples in 2001. Thereafter, the benefits should be increased at the rate 1% lower than the rate of increase in the average wage until they equal the official minimum income support levels, and they should be maintained thereafter at those levels.

While it would be difficult to change the initial levels of the Senior Benefit already proposed, this does not mean that the Federal Government cannot achieve the goal of consistency between what it deems to be appropriate minimum support levels for seniors and for low income wage earners. Recommendations 3 and 4 show a way in which it can be accomplished.

ADEQUACY: (B) Giving All Canadians an Opportunity to Save Enough to Maintain their Standards of Living upon Retirement

Recommendation 5

Canadians earning more than twice the average wage should have a reasonable opportunity to maintain their standard of living when they retire.

The Income Tax Act does not give all Canadians an equal opportunity to provide for a retirement income target which is related to their pre-retirement earnings (70% is a commonly suggested target). The time has come to correct this obvious bias against Canadians who pay a disproportionate share of the taxes which support Canada's social

safety net. The argument that this is “too expensive” because of the tax expenditures involved has no basis in fact. There are several ways in which the current bias can be addressed:

Extend the Scope of RPPs and RRSPs

The limits on the pensions payable from defined benefit pension plans and on contributions to defined contribution pension plans and RRSPs could be increased. The current dollar limits (\$1,722.22 for pensions and \$13,500 for RRSP contributions) could be increased to cover earnings up to 5 times the average wage as is the case in the U.S. and the U.K., and as was the case for Canadian pension plans as recently as 20 years ago.

Reduce Taxes on Non-Sheltered Investment Income

If unsheltered investment income was taxed reasonably, Canadians would not need tax-sheltered retirement savings plans so badly. If interest income was taxed only to the extent that it exceeds the prevailing rate of inflation, if dividends were tax exempt because they represent the already taxed earnings of corporations, if the cost base for equity investments was indexed so that only the real portion of a capital gain was taxed, then Canadians earning more than twice the average wage would not need tax-sheltered retirement savings to the same extent.

Introduce an “After Tax” Supplementary Retirement Savings Vehicle

The Income Tax Act could be amended to create a new retirement savings vehicle – the Supplementary Retirement Savings Plan (SRSP). Each year, a taxpayer would be permitted to contribute 9% of taxable employment income in excess of the earnings covered by RRSPs (\$75,000 at the present time). Contributions would not be tax deductible, but all investment income earned in an SRSP would be tax exempt and withdrawals would not be taxable. SRSPs would be subject to the same withdrawal requirements as registered pension plans and RRSPs. In particular, accumulated funds would need to be withdrawn in a systematic fashion starting at age 69.

FAIRNESS: Treating all Canadians, past, present, and future equally using the same set of rules and standards.

Recommendation 6

The proposed grandfathering of Old Age Security benefits should be abandoned.

Recent government decisions on fiscal policy and the funding of the Canada Pension Plan are important first steps towards building a sustainable social security system that serves the interests of future generations as well as our own. Unfortunately, the proposed Seniors Benefit and the Federal Government's handling of RRSP and pension limits do not build on these precedents and impose larger burdens on future generations than on today's workers and pensioners. Grandfathering of Old Age Security benefits for those born prior to January 1, 1936, while denying them to those born later is an obvious example of intergenerational inequity.

Recommendation 7

The maximum clawback of the new Seniors Benefit (defined as the sum of the proposed Seniors Benefit reductions and taxes) should be less than 50%.

The incentive to work and save, which is essential to reinforcing the notion of individual responsibility for planning for one's retirement, must be preserved. This principle is compromised when more than half of additional income is clawed back through a combination of Seniors Benefit reductions and taxes as it rises above the proposed minimum targets.

Recommendation 8

Requirements for public and private sector employer pension plans should apply and be applied equally.

Employer contributions to private sector plans are prohibited when the surplus in these plans exceeds a certain threshold. Such limits have not always been applied to many public sector plans, producing an inequity in savings opportunities for employees in these sectors. All registration requirements in the Income Tax Act should be applied equally to all pension plans.

Recommendation 9

Pension adjustment rules should be modified to reflect differences in indexing provisions of employer-sponsored pension plans.

Specifically, the current “factor of 9” should be adjusted to a “factor of 7” for plans which provide for indexing of benefits at a rate which is less than 50% of increases in CPI. The “factor of 9” was developed based on a model pension plan, containing many ancillary provisions commonly found in public sector plans. Notably included in these ancillary provisions are indexing provisions which can dramatically affect the value of benefits. The result of using this type of model plan to develop the “factor of 9” is to generally overstate the value of plans commonly found in the private sector. Varying the factor according to the level of indexation provided by a plan will produce a more equitable system without adding undue complexity.

Recommendation 10

Opportunities for pension income splitting between spouses under RRSPs and pension plans should be equalized.

For example, either spouse should be able to declare as taxable income benefits received from a registered pension plan of the other spouse up to a maximum of, say, \$30,000 per year. Spousal RRSPs afford an opportunity for income splitting which is not available to members of registered pension plans. This recommendation could be adapted for all types of pension income, thereby eliminating the need for spousal RRSPs. An alternative, but more difficult solution, would be to adopt a taxation system based on the family unit rather than individuals as exists in the U.S.

Recommendation 11

Employers should ensure that the pension vehicles they create for their employees reasonably balance the goals of the employer and those of the employees.

Changes in pension practices and legislation over the past 10 years have gone a long way toward improving such pension features as vesting and portability. However, there are still barriers in many plans which impede a steady buildup of pension credits, and the easy movement of pension benefits from one plan to another.

SUSTAINABILITY: Ensuring an Ongoing, Reasonable Balance between Income Redistribution and Economic Growth

Recommendation 12

The Federal Government should institutionalize a regular 5 year review of the retirement income system process that evaluates performance against pre-set standards and benchmarks.

Part of this review process should be the capability to systematically assess the interactive effects of changing demographics, who pays for and benefits from Canada's social policies, and their likely impacts on savings, investments, and economic growth. However, sophisticated modeling capability by itself is not enough. That capability must be integrated into a participative, transparent review process that leads to corrections of the strategy if and when they are needed.

TRANSPARENCY: Making Canadians Pension-Literate

Recommendation 13

The findings of the recommended 5 year review of the retirement income system should be widely disseminated to the Canadian public in understandable language.

The discussion paper on CPP Reform produced in 1995 represents a commendable beginning of this process. While parts of the discussion paper were not well received by all participants in the CPP reform debate, it nevertheless served the useful purposes of educating Canadians and provoking encouraging debate.

Recommendation 14

Governments and their agencies (eg. Statistics Canada) should be encouraged to turn data and research on the retirement income system into information that will better inform Canadians about their retirement income system.

For example, regular meetings between Statistics Canada and pension industry experts should lead towards a more balanced flow of information about Canada's retirement income system. Similarly, the question of pension system "tax expenditure" estimation should be subject to more scrutiny and debate than has been the case to date. The media in turn must take advantage of a better information flow to better inform Canadians about their retirement income system.

Recommendation 15

Canada's education system should design and teach life cycle financial management courses at the high school level.

Personal finance should have the same priority as other "life skills" secondary school subjects as sports and health.

Recommendation 16

Canada's financial services sector participants should better inform Canadian customers about the basics of pension and investment economics.

For example, retirement savers should know that over the long run financial markets will likely only produce single digit investment returns, and that the level of fees charged is a major determinant of whether an affordable contribution rate will produce an adequate pension. If all Canadians understood that for every 1% of additional annual fees their ultimate pensions will likely be reduced by 20%, for example, they would become much more fee-sensitive in their selection of investment services providers.

EFFICIENCY: Maximizing the Dollars of Pension going out, per Dollar of Contribution coming in.

Recommendation 17

The 20% limit on foreign property held by pension plans and RRSPs (FPR) should be raised by 2% annual increments until it reaches 30%, and then should be completely eliminated.

The move from 10% to 20% was accomplished smoothly though five 2% increments in the early 1990s. This process should be re-instituted immediately. At 30%, the FPR is no longer an issue, as this is likely to be the average target foreign weighting for Canadian pension funds [11].

Recommendation 18

Legislators and Canada's pension regulators should make the creation of a simplified, unified pension regulatory regime a high priority.

Ideally, a single set of simplified pension laws administered by a single regulator would be achieved. As a first step, the Federal Government and the provinces could agree on a simplified uniform pension standards statute that would be administered consistently across the country.

Recommendation 19

Canada's financial services sector should offer to Canadians a series of low cost, easily accessible retirement savings-oriented investment products.

The financial services industry should introduce a series of low cost index-linked stock, bond, and balanced investment products. In the U.S. for example, the Vanguard organization offers these at fees in the 0.2% to 0.3% per annum range. In Canada, the stock exchanges could greatly expand their efforts in this area. The Toronto Stock Exchange already offers a listed product that replicates the performance of the TSE35 stock index.

A Plan for Implementation

This is an opportune time to implement the recommendations set out in this paper. Canada is turning the corner in bringing its public debt problems under control. At the same time, there is still a 10 year window before the leading edge of the boomer generation hits retirement age.

The ACPM welcomes the willingness of the Federal Minister of Finance to address the outstanding retirement income issues. A number of the recommendations set out in this Paper could be implemented in the February 1998 budget. Other recommendations will merit study and public debate and could be implemented later.

At the same time, this Paper makes clear that reforming Canada's retirement income system is not just a task for the Federal Government. Provincial governments and the private sector have important roles to play.

In the final analysis, if we all pull together, creating the best retirement income system in the world is within our grasp.

END NOTES

- [1] "Averting the Old Age Crisis", a World Bank Policy Research Report, Washington D.C., 1994. While we do not necessarily endorse everything which is in this 402 page report, we do believe it provides an excellent starting point for examining national income retirement systems. The focus of the report on the relationship between retirement income system design, demographics, savings, and economic growth is especially important.
- [2] For a detailed description of the Seniors Benefit proposals and their possible ramifications, see David Slater's "The Pension Squeeze: The Impact of the 1996 Federal Budget" published by the C.D. Howe Institute, Toronto, 1997.
- [3] "TAX FACTS TEN", published by the Fraser Institute, Vancouver, 1997, reports, for example, that income tax return filers with reported income over \$70,000 in 1994 constituted about 5% of all filers in that year. However, they earned 24% of all reported income and paid 34% of the 1994 total income tax bill.
- [4] "Troubled Tomorrows", published by the Canadian Institute of Actuaries, Ottawa, 1995. This research paper, written in 1994, made an important contribution to helping Canadians understand the issues surrounding large pay-go retirement systems in an aging society with low economic growth prospects.
- [5] See Michael Wolfson and John Evans, "Statistics Canada's Low Income Cut-Offs: Methodological Concerns and Possibilities, A Discussion Paper, Statistics Canada, Ottawa, 1990;" "Poverty in Canada", Christopher Sarlo, Fraser Institute, Vancouver, 1992; and "Social Contract and Seniors Preparing For the 21st Century", Monica Townson, Canada National Advisory Council on Aging, Ottawa, 1994, for more extensive discussions on measuring poverty in Canada.
- [6] For further elaboration of these points, see Keith Ambachtsheer's "The 20% Foreign Property Rule: Why and How It Should Be Eliminated", a research paper sponsored by the Investment Funds Institute of Canada and the Pension Investment Association of Canada, Toronto, 1995.

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- [7] The research firm Macdonald & Associates Ltd. monitors venture capital investing in Canada on a regular basis. It reports record amounts of new capital being directed towards Canada's high growth small businesses, with much of it coming from the labour-sponsored venture fund sector. Before 1997 Budget measures slowed the flow of new money into this sector, LSVFs were accumulating investible cash more rapidly than they were able to invest it in qualifying Canadian ventures.
- [8] The ACPM has played a leadership role in helping the Government of Ontario identify some of the blockages to growth in pension coverage in Ontario as part of that Government's Red Tape Review Commission initiative.
- [9] For example, an article in the September 1997 issue of Canadian Business by Jonathan Harris titled "Big Fees, Small Results" cites a survey of 2000 Canadian investment fund participants which indicates that an astonishing 45% of them did not even know they were paying fees.
- [10] See End Note [5] above for further information on poverty line measurement issues.
- [11] This mirrors the recommendations made in the 1995 paper cited in End Note [6].