“Everybody take a valium: The non-crisis in Canada’s retirement system”

Calgary School of Public Policy Conference: The Future of Canada’s Retirement System

Panel: What are the problems with the existing retirement income system?

Comments by MLI Managing Director, Brian Lee Crowley
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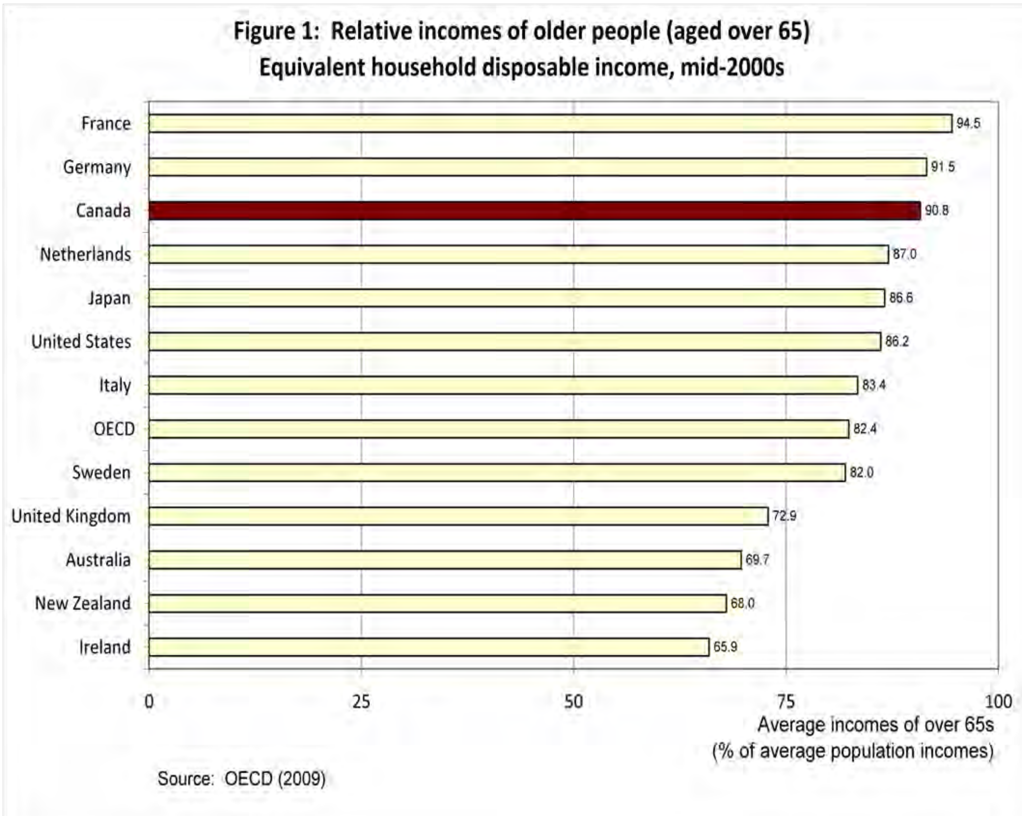
Thank you, especially to Jack Mintz, for the kind invitation to be here with you today.

Larry Kotlikoff has given us a very good first cut at some of the issues around the problems with Canada’s existing system of retirement income, but as federal finance minister Jim Flaherty quite properly said in his speech to this conference last night, changes to the retirement income system can have enormous long term consequences and they should not be undertaken lightly. This is doubly true when the evidence that there is a problem with the current arrangements is actually rather thin.

What we know about Canada’s retirement income system

Consider that only 2 major OECD countries, France and Germany, give their average retiree a higher percentage of the average pre-retirement disposable income of their countrymen in retirement. Other allegedly generous countries, such as the Netherlands (87%), Sweden (82%) and even the US (86.2%), with their much more generous social security, end up giving their retirees less retirement income, relative to average population disposable income, than Canada (91%).[1]



Let me just dwell for a second on the US-Canadian comparison, because the US is actually a country that relies far more than Canada on compulsory savings through payroll taxes than Canada does. This is important given that a significant expansion of the CPP is an oft-mooted option in this round of pension reform discussions. The current maximum social security benefit provided for someone retiring in 2009 at age 66[2] with maximum earnings eligibility is $2,323 per month. These benefits are financed (unsustainably!) by a payroll tax of 12.4 percent on taxable earnings up to $106,800 (2009).[3] By contrast, the maximum monthly

[1] Source: Jack Mintz, Palmer Chair in Public Policy, University of Calgary. Powerpoint presentation: Retirement Income Adequacy in Canada: Is there a crisis? March, 2010. Because I have cherry-picked graphs and tables from various sources, I would ask the reader please to ignore the numberings of these (e.g. "Figure 1" or "Table 3"). These numbering schemes have nothing to do with this paper – I just don't have the ability to edit out the numbering scheme that accompanied these graphics. In some cases I have reproduced graphics I have had on hand for some time and the original sources have been lost. The data sources, however, are always clearly indicated.
[2] Please note that the normal age of retirement for those born after 1959 is being raised to 67.
[3] The 12.4 percent tax is technically split between employer and employee (6.2 percent each). The 6.2 percent is actually further broken down between 5.3 percent for Old-Age and Survivors Benefits and 0.9 percent for Disability Insurance.

benefit for the Canada Pension Plan for 2009 was $909.75[4] and the payroll tax that underwrites the CPP is set (sustainably) at 9.9 percent.

Yet Canada, not the US, is the society that gives its average retiree a higher share of average disposable income and by almost 5 percentage points. This is not a system that is broken, but actually outperforms most of its peers, on average.

Moreover, we know that people in the lowest income quintile are so well provided for by our retirement income system that poverty levels among Canadian seniors are not only very low by international standards, but poverty is less widespread among Canadian seniors than among the Canadian population generally. According to the OECD, in the mid-2000s the Canadian poverty rate among seniors was 4.4%, one of the lowest in the OECD, compared to an average of 13.3% (the poverty rate being defined as 50% of median income in a country).

So the case for retirement income reform is not driven by social equity considerations or a concern for income distribution at the bottom of the income scale. If that were the concern, the evidence is that scarce public dollars, for example, would be better spent on other parts of the Canadian population. We also know that people in the top income quintile are quite capable of making their own quite adequate retirement income arrangements, so they are not a group that public officials need to spend a lot of policy energy on.

The evidence is also that Canadians do ***not*** save too little when we measure savings appropriately, via their individual or family balance sheets, rather than by their national accounts saving levels. While savings measured by the national accounts has, it is true, declined in recent years, balance sheet saving, which takes into account important assets like home ownership, has actually been remarkably stable, even when one considers the hit that many people took in the recent recession.[5]

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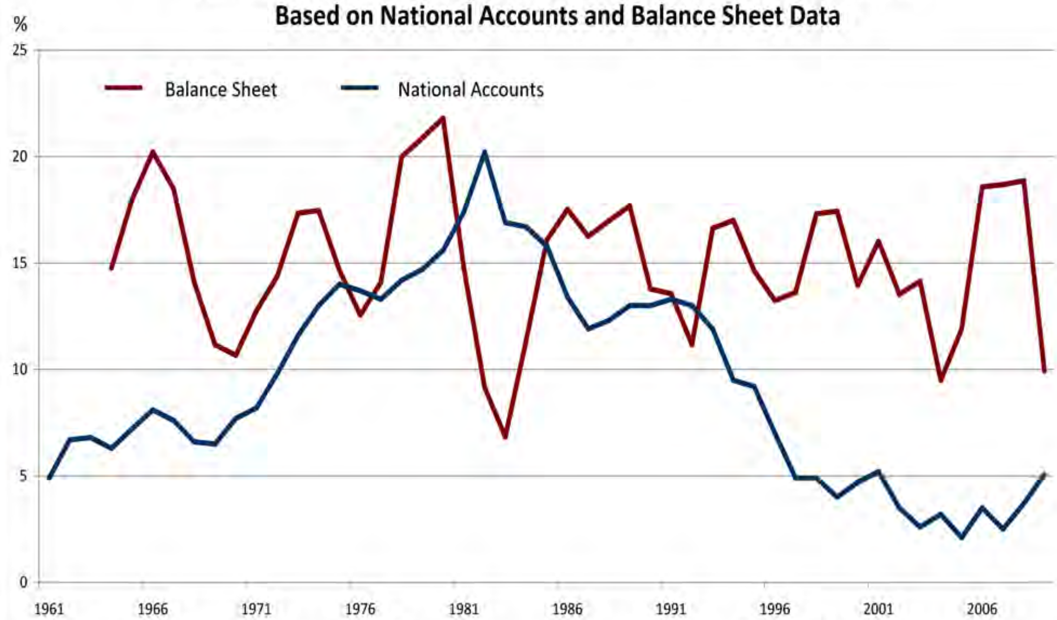
[4] Canada Pension Plan payments can be augmented by Old Age Security benefits (maximum monthly benefit of $516.96 as well as a number of other smaller federal and provincial benefits.

[5] See chart. Source: Jack Mintz, Palmer Chair in Public Policy, University of Calgary. Powerpoint presentation: Retirement Income Adequacy in Canada: Is there a crisis? March, 2010.

Figure 2: Personal Savings as Percent of Personal Disposable Income: Based on National Accounts and Balance Sheet Data



Note: National Accounts personal saving is the difference between personal income minus outlay. Balance sheet saving is equal to change in net worth at book value, which includes net accumulation of all household assets (including consumer durables) and capital gains. Balance sheet saving rate is adjusted for inflation by removing inflation (based on GDP deflator) on the beginning-of-year household wealth from numerator and denominator. Balance sheet saving rate is a smoothed 3-year moving average measure. 2009 value is based on 2009Q2 data assuming no change in 2009Q3 and 2009Q4.
Source: Department of Finance

Canadians' share of net assets relative to disposable income has, after many years of tracking US rates, now diverged fairly sharply in favour of Canadians. And our tax system rewards Canadians for investing in their houses as their principal asset (as opposed to Americans, whose government rewards them for treating their house as a credit card), and Canadians respond: in very large numbers they retire in mortgage-free homes paid off over their working lives.

People are concerned that the recent recession devastated some people's retirement savings, and this is a legitimate concern. But this is hardly the first time that downturns have resulted in disappointed retirement expectations for some. The issue is whether Canadians will take on board this new information and change their behaviour, for example by increasing their savings further to compensate for poor investment performance. I think the evidence is strong that Canadians do respond to these changes and are perfectly capable in most cases of making choices that are appropriate for their circumstances.

They now have an impressive array of vehicles available to help them in that regard. RRSPs are actually quite widely used in Canada when usage is appropriately adjusted for age and income.[6] The removal of the foreign property rule now allows Canadians to diversify their investments and hence their risk more than ever before. The introduction of the tax free saving account has added an important new saving vehicle whose impact we cannot even begin to measure yet.

If there's a problem, where does it lie?

Yes, there is evidence that **some** people in the middle three income quintiles appear not to be setting aside enough money to ensure an adequate retirement income (which is somewhere in the 60-70% of pre-retirement income range), and if there is a policy problem, it is concentrated in this population.

But we actually don't know a great deal about these people or their real circumstances. For example, the models that show this shortfall for this minority in the middle income brackets do not allow us to capture all possible sources of retirement income, and therefore may be misleading. And in any case, some middle- and high-income Canadians may need even less than 60% of their pre-retirement income to sustain an adequate standard of living (for example, the OECD suggests 50% replacement is adequate for individuals with incomes over $90,000 in Canada).

And because we don't have a full understanding of the entire retirement income available to this important minority of the middle class, and because we don't yet understand well enough what might explain their divergent retirement saving behaviour, it is entirely premature, in my view, to make major policy changes if the purpose of those changes is to deal with the circumstances of this minority since we don't understand well what those circumstances are. According to one expert author: "It is not always clear precisely which Canadians are under-saving, by how much, and why, especially given data limitations on assets. Several factors are involved including job losses, inadequate saving discipline, losses in wealth due to bad luck or poor investment choices and late migration to Canada without significant existing savings."[7]

[6] http://www.fraserinstitute.org/commerce.web/product_files/FraserForum_March2001.pdf
[7] http://network.nationalpost.com/np/blogs/fpcomment/archive/2009/12/18/jack-mintz-no-pension-crisis.aspx

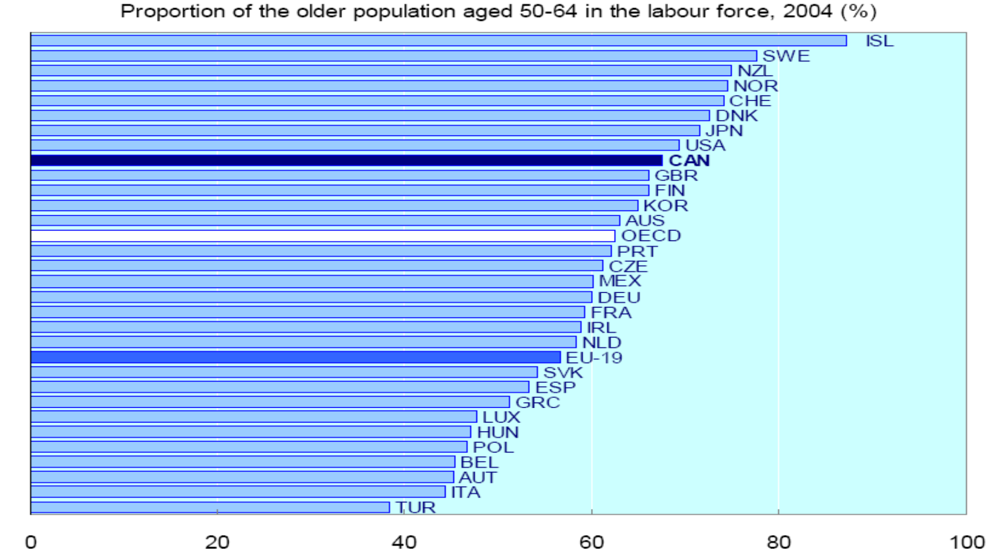
Some people are of the view that we need to constrain Canadians to save more through various kinds of official pension plans. But if that were the solution to the narrow problem we've identified, wouldn't you expect that Canadians currently participating in such registered pension plans would have higher incomes than those who do not? How then do we understand the recent data from Ostrovsky and Schellenberger that, across every income quintile, retirees who did NOT participate in RPPs, on average, had higher incomes than those who did? I'll come back to this matter in a moment, because the reasons behind the difference are significant.

Is Canada's system TOO generous?

Indeed, I could easily make the case that Canada's retirement income system is TOO generous. After all, surely that system is a major factor behind the fact that Canada actually has a relatively poor record at keeping people over 55 in work – we are only slightly better than the middle of the pack as far as OECD countries are concerned for labour force participation for those over 55.

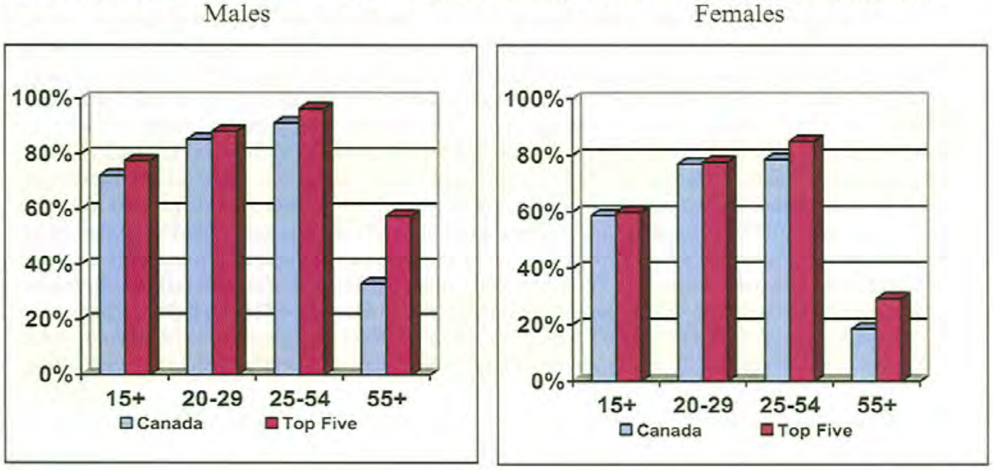
Figure 2. **There is much room for raising labour market participation of older Canadians**

Proportion of the older population aged 50-64 in the labour force, 2004 (%)



Source: OECD (2005), *Labour Force Statistics, 1984-2004*, Paris, forthcoming.

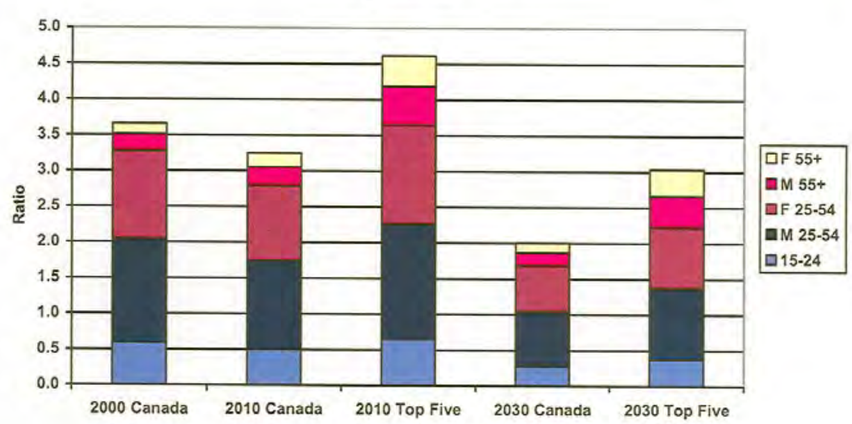
Labor Force Participation Rates: Canada v Top Five OECD Country Composite



Source: OECD, Corporate Data Environment database on labor statistics, current though 2002

This fact is hardly mentioned at all in the pension discussions we are having, and yet there is a widespread consensus in the policy community that we are about to enter an era of tight labour supply occasioned by the ageing of the Boomers and their retirement. There is large agreement that Canada's economic prospects will be held back by shortages of workers, and yet the largest single source of labour available to us in the coming decades will be people who, in the recent past, would have been retired. Changing the retirement behaviour of Canadians in favour of working more past 55 and even 65 is going to be absolutely crucial to our national economic success.

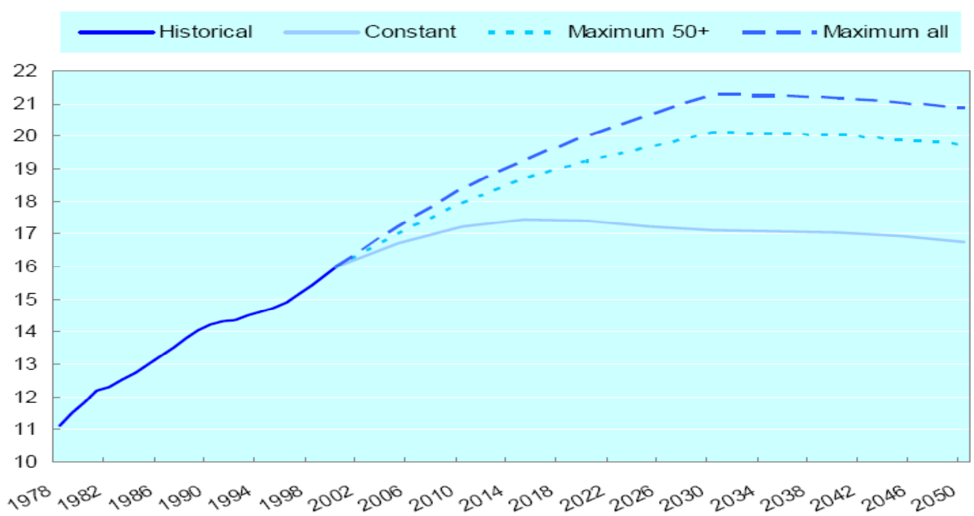
Ratio of Workers in Canada 15+ to Retirees 60+ in 2000, 2010 and 2030 and Under Alternative Assumptions of Old Age Participation Rates for the Top Five OECD Countries



Source: UN Population Division, World Population Prospects (The 2000 Revision); OECD, Corporate Data Environment database current though 2002

If we started a long term effort to shift Canadians thinking so that 70 rather than 65 became the age at which people expected finally to withdraw from the workforce, and we raised the current retirement age of 65 by three months a year starting now, and continued with that incremental shift until 2025, our retirement age would then be 70 (i.e. it would be back to what it was before the Sixties[8], a time when out life expectancy was much shorter). Our old-age dependency ratio would go from about 3 workers per retiree (the current projection) to about 5 by 2025.

Figure 1. Labour force growth scenarios in Canada, 1978-2050[a]
Millions, projections after 2000



a) The constant scenario assumes that current participation rates by five-year age group and gender remain constant over the period 2000 to 2050. The maximum scenario applies the maximum participation rates (for workers aged 50 and over for "Maximum 50+" and for all workers for "Maximum") in the OECD area (except Iceland and Mexico) by five-year age group and gender from 2030 through to 2050, with a gradual adjustment over the period 2000-30 to reach these maximum rates.
Source: OECD (2005), *Ageing and Employment Policies: Canada*, Paris.

Moreover every year a Canadian delays full retirement is a year they contribute their productivity and their taxes while not drawing public retirement benefits, giving the economy and public finances a double benefit. And that doesn't even take account of the fact that the greatest beneficiaries are the workers themselves; the evidence is compelling that people who continue to work live longer, happier and healthier lives. And finally, if we revert to my comparison of a moment ago of the incomes of retirees who participated in Registered Pension Plans and those who did not, it is noteworthy that far and away the single biggest

[8] See Andrew Coyne, "Social Spending, Taxes and Debt: Trudeau's Just Society," in Andrew Cohen and J.L. Granatstein (eds.) *Trudeau's Shadow: The Life and Legacy of Pierre Elliott Trudeau*, (Toronto: First Vintage Canada Edition, 1999), p. 234.

factor explaining the difference in income in favour of non-RPP participants is the employment income they continue to earn.[9]

Some people may ask what reason we could give to Canadians to encourage them to retire later when they have been assured by their political leaders that the CPP has been "fixed" and is now sustainable. I have already given several reasons that I think are important. To them I would just add that the CPP was fixed at the cost of a contribution rate of 9.9%, which is hardly negligible and is a payroll tax which increases the cost of employing workers. As Canada struggles to differentiate itself from the Americans economically-speaking, as a destination for investment for example, being able to lower this rate would be no bad thing in itself.

Table 3: Retirement income received in 2006 as a percent of average annual earnings 1989-1991: Men aged 70-72 and by RPP status

	First Quintile		Second Quintile		Third Quintile		Fourth Quintile		Fifth Quintile	
	No RPP	RPP	No RPP	RPP	No RPP	RPP	No RPP	RPP	No RPP	RPP
Transfer Income*	0.67	0.58	0.40	0.38	0.30	0.29	0.23	0.22	0.11	0.13
Market Income (excluding employment earnings)**	0.37	0.38	0.32	0.33	0.36	0.36	0.39	0.40	0.40	0.47
Capital Gains and Losses	0.05	0.02	0.07	0.02	0.05	0.02	0.04	0.02	0.10	0.05
Earnings and Self-employed Income	0.09	0.06	0.09	0.02	0.11	0.02	0.11	0.02	0.16	0.06
Total	**1.18**	**1.04**	**0.89**	**0.75**	**0.83**	**0.69**	**0.77**	**0.66**	**0.77**	**0.71**

Source: Ostrovsky and Schellenberg (2009).
Lower bounds of income to determine quintiles (average 1989-91 earnings of non-RPP and RPP members in brackets)
First: $10,000 ($22,300, $25,500)
Second: $32,800 ($39,850, $40,150)
Third: $45,750 ($51,450, $51,800)
Fourth: $58,200 ($65,800, $66,500)
Fifth: $76,100 ($138,500, $107,750)
*Transfer income includes payments made by governments to individuals including C/QPP, OAS, GIS and other.
**Includes pension income, RRSPs and other superannuation, interest, dividends and other investment income and other market sources.

Don't forget to look at the public sector retirement system

No one seems to want to point out that this disproportionate share of early-retirements in Canada is led by public sector workers. According to one report[10], self-employed people retired on average at age 66 in 1975, and that retirement

[9] See table. Source: Jack Mintz, Palmer Chair in Public Policy, University of Calgary. Powerpoint presentation: Retirement Income Adequacy in Canada: Is there a crisis? March, 2010.
[10] See the CFIB's analysis at: http://www.cfib.ca/research/reports/rr3028.pdf

age has remained intact over the intervening 30 plus years. Private sector workers taken as a whole were retiring at 65 in 1976, and that had fallen to 62 by the early part of this decade. Public sector workers, by contrast, were retiring on average at 64 in 1976-79, but by 2000-05, that average age of retirement had fallen to 59.

This research shows that since the late 1980s, the public sector has driven the early retirement trend. The proportion of early retirees within the public sector was around 56 per cent in 2005, while in the private sector it was just over 33 per cent and for self-employed individuals it was only 20 per cent.

And this is only one area in which public sector plans are more generous than what is available to the average private sector worker, and those public sector plans, being backed by the taxpayer, are not subject to the kind of market risks that affect both the Defined Benefit plans and the private investments of those same taxpayers. If I were writing the agenda for retirement system reform in this country, I would be unable to let the glaring gap between the pensions available in the public and private sectors to pass without comment.

Conclusion

To sum up:

1) There <u>may</u> be a problem in a fairly narrowly defined part of the population, but we need to understand it better and not take hasty action that at best may not help and at worst may leave people worse off;
2) The real issue is risk pooling in a way that doesn’t undermine personal and corporate and government responsibility and accountability. We should look carefully for ways to remove obstacles to such appropriate risk sharing or pooling;
3) Improved financial literacy for Canadians? Of course! Who could be opposed to that?
4) Retirement income reform must be put in the context of demographic change and other factors; looking at it in isolation can be highly misleading and lead to wrong-headed policy changes.

Thank you.