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## FROM A MANDATE FOR CHANGE TO A PLAN TO GOVERN

# Helping Canadians Achieve a Secure Retirement

Philip Cross and Sean Speer

### INTRODUCTION

Last month's meeting of Canada's federal and provincial finance ministers concluded without a consensus on whether to expand the Canada Pension Plan (CPP). Instead the ministers agreed to consult on further options that range "from doing nothing because of the economy to more significant changes" (Harris 2015). The issue of the retirement income system in general and a CPP expansion in particular therefore remains on the federal policy agenda in 2016.

The new Liberal government is among the chief proponents of a CPP expansion. It committed to one in the federal election campaign and new finance minister, Bill Morneau, advocated for such a policy at the December meetings. The government's support for an expanded CPP stems from the perception that Canadians are saving inadequately for retirement and that more mandatory savings is the best solution to this problem. It is the reason, for instance, that Mr. Morneau's mandate letter instructed him to work with his provincial and territorial counterparts "to enhance the Canada Pension Plan [in order] to provide more income security for Canadians when they retire" (Trudeau).

The government's focus on helping Canadians prepare for retirement is understandable. Ensuring that Canadians have adequate resources for their post-employment years is a critical public policy issue. An

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aging population, changing labour force participation, and new expectations about post-work consumption are bound to put Canada's retirement income system under the microscope. The real question though is whether there is *indeed* a widespread undersaving problem and, to the extent that there is, that a CPP expansion is the right solution.

As we show in this essay, concerns about a so-called retirement income "crisis" are overblown and a CPP expansion is the public policy equivalent of a sledgehammer when a scalpel is more fitting.

The Macdonald-Laurier Institute's mission is to help to inform sound public policy at the federal level. Our goal in this essay series is to help the new government best achieve its top policy objectives.

This fourth essay in the series will help Canadians better understand Canada's retirement income system and how it is currently serving them and their families. The purpose is to help inform the government's thinking as the new finance minister considers policy options with his provincial and territorial counterparts.

We will then offer what we think the Canadian and international evidence establishes as the best policy options to strengthen our retirement income system. The ultimate goal, as the Liberal Party (2015) platform rightly puts it, is to "help Canadians realize their goal of a secure retirement."

## CANADA'S RETIREMENT INCOME SYSTEM

The debate about the state of Canada's retirement income system is bedeviled by competing definitions and measurements. What retirement income sources are accounted for and what assumptions are made with regards to measuring retirement income adequacy (income or consumption replacement, for instance) can have significant effects on the outcome of one's analysis. Often times the definitions and measurements are blurred in public commentary and can even be purposefully wrought to support specific policy solutions. It is our contention, for instance, that a tendency towards a narrow, state-centric characterization of retirement income sources is a major factor behind the push for a CPP expansion.

Canada's retirement income system has evolved considerably over the years. Post-confederation social services were limited. The concept of the modern welfare state was anathematic and expectations were that individuals and families were predominantly responsible for social insurance and retirement income security. As historian Doug Owram explains:

No one was interested in the devices which a later generation would call the "welfare state" . . . Neither Canadian governments nor fashionable "reformers" were much interested in sickness insurance, old age pensions, disability insurance, or unemployment insurance (not to speak of day-care centres!). Imperial and undemocratic Germany had provided sickness insurance and old-age pensions since the 1880s. Britain introduced such pensions, and a form of health insurance, in 1911, and New Zealand had already done likewise. These examples were not followed [here in Canada]. (quoted in Crowley, Clemens, and Veldhuis 2010, 26)

This limited conception of social welfare was hardly a partisan issue. Prime Minister Wilfrid Laurier shared his Conservative predecessor's narrow view about the role of government with respect to social insurance and retirement security. It was only in the 1920s that the precursor to Old Age Security was established. The 1927 *Old Age Pension Act* created a public pension (up to \$20 per month to British subjects who were at least 70 years of age, had been residents of Canada for a minimum of 20 years, and earned less than \$365 per year). This formed the basis of the federal government's involvement in retirement income security until the second half of the twentieth century (Dewetering 1990). Thereafter the federal role began to expand and the modern "pillars" of our retirement income system gradually took shape.

The system is comprised of three formal pillars. The pillars can be described as (1) social security including Old Age Security (OAS) and Guaranteed Income Supplement (GIS), (2) mandatory employment-based government pension plans in the form of the CPP/QPP, and (3) non-state funded or administered savings in the form of voluntary savings in Registered Retirement Savings Plans (RRSPs) and Tax-Free Savings Accounts (TFSA) and employer-provided pension plans (see table 1). This typical presentation of Canada’s retirement income system excludes other resources available to Canadians in retirement such as savings and assets held outside of formal pension plans. But this so-called fourth pillar ought to be considered in any evaluation of the system’s overall adequacy.

**Table 1: Three pillars of Canada’s retirement income system**

Pillar 1: Social Security	Old Age Security and Guaranteed Income Supplement (financed by general tax revenues)
Pillar 2: Mandatory Employment-Based Government Pension Plans	Canada (Quebec) Pension Plan (financed by contributions from both employees and employers)
Pillar 3: Non-State Funded or Administered Savings	Employer-Provided Pension Plans (Registered Pension Plans or Pooled Registered Pension Plans) and Voluntary Savings (Registered Retirement Savings Plans and Tax-Free Savings Accounts)

The *Old Age Security Act* in 1952 modernized the initial program by creating the OAS program, which increased the monthly payments and changed the means testing for eligibility. The GIS was established in 1966 to provide basic support to low-income seniors. These two mean-tested programs financed from general government revenues form the basis of the system’s first pillar and provide for a basic social security pension for Canadian seniors.

These steps were taken in conjunction with the establishment of the CPP as a pay-as-you-go plan for employed Canadians between the ages of 18 and 70 (Chawla and Wannell 2004). It is often forgotten that the CPP was modelled after the Quebec Pension Plan similar to how the national medicare system was ultimately based on the Saskatchewan government’s experimentation with universal health care (Tamagno 2008). The plan functions as a mandatory, employment-based savings vehicle paid through equal contributions between employers and employees. The plan’s eligibility age was ultimately lowered to 65 by 1970, the contribution rates were gradually raised from 1.8 percent for both the employer and employee to 4.95 percent at present, and pensionable earnings have increased from \$5000 at the outset to \$54,900 in 2016. The CPP underwent significant reforms in the mid 1990s, which sought to put the plan on a more solid and independent footing by increasing contributions and supplementing its pay-as-you-go funding with investments administered by the Canada Pension Plan Investment Board (Crowley, Clemens, and Veldhuis 2010, 102–105). It now provides annual retirement benefits to approximately 4.4 million beneficiaries as the system’s second pillar (Service Canada 2015).

The retirement income system’s third pillar is comprised of non-state funded or administered savings in the form of tax-preferenced voluntary savings and employer-provided pension plans. The purpose of this pillar is to support personal savings as a key source of retirement income security. Personal savings rest on top of the foundation of basic pensions provided by the first two pillars and account for personal preferences with respect to savings and consumption during one’s working years and in retirement. These include RRSPs, employer-based pension plans, and new vehicles such as TFSA.

RRSPs were created in 1957 to support personal savings as the primary foundation of retirement preparation. RRSPs are tax-preferenced savings vehicles in which contributions are deductible from earned income for

tax purposes and the investment income that accumulates over time is not subject to income tax until withdrawn. Take-up was slow initially (only 2 percent of tax filers contributed) but has expanded over time (Frenken 1990). RRSPs now represent a major share of Canadians' retirement savings (Cross 2014).

These tax-preferenced private savings are often augmented by the presence of some form of workplace pension plans. Workplace pension plans grew rapidly in the post-Second World War era and received preferential tax treatment similar to RRSPs beginning in the early 1960s (Maser and Bégin 2003). The incidence of employment-based defined benefit plans has fallen in recent years. This decline is concentrated in the private sector where the percentage of employees covered by employer-provided pension plans fell from 73 percent to 48 percent between 2002 and 2012 (Office of the Superintendent of Financial Institutions Canada and Office of the Chief Actuary 2014). Now defined benefit pension plans are largely limited to the public sector. Defined contribution plans, which, unlike defined benefit plans do not guarantee a certain level of pension income benefit for its members, have become the more common vehicle for employer-provided pensions in the private sector.

There have been other changes to the system's third pillar in recent years. The introduction of new savings vehicles, including TFSAs in 2008 and Pooled Registered Pension Plans (PRPPs) in 2012, bolstered non-state funded or administered savings. It is premature to assess the long-term impact of TFSAs and PRPPs on retirement savings but early signs are that TFSAs in particular have emerged as a useful vehicle especially since they do not affect one's OAS or GIS eligibility.

The debate about the adequacy of Canada's retirement income system focuses on these three pillars and can even at times become limited to the first two pillars. Politicians often compare the level of benefits from the CPP to those available from similar programs in other jurisdictions without recognizing that that savings that come from the third pillar also receive government support in the form of tax preferences. The Ontario government's 2014 budget is a good example: it frequently excluded third pillar assets in its analysis in favour of a CPP expansion.<sup>1</sup>

Moreover the principal measure of the system's effectiveness should be the extent to which it is ensuring that most Canadians have adequate resources for retirement. That the relative share derived from government sources is low compared to other jurisdictions is hardly an indictment. In fact, one can argue that it is a relative strength that Canadian public policy has been able to achieve high rates of income replacement (third among OECD countries) primarily by promoting voluntary savings through tax incentives rather than costly entitlement programs. Yet the rhetoric sometimes can leave the impression that retirement income adequacy ought to be achieved by the first two pillars alone.

The reality is that a narrow view about the resources available to Canadians for retirement can lead to an incomplete picture of Canada's retirement income system and the wrong prescriptions for reform. This is exacerbated by a tendency to ignore any other forms of savings or assets such as real estate, equity in a business, or financial assets held outside of the tax-preferred accounts that form the basis of the third pillar. But these assets – often called “Pillar 4” assets – can be a major source of income as retirees downsize their family home, collect investment property income, sell their businesses, or earn dividend income from equities. As the current federal finance minister writes in a 2013 book: “Pillar 4 assets in Canada are greater than all the assets that we have in the first three pillars combined” (Vettese and Morneau, xii).

As of 2013, Canadian households had, in total, a net worth of \$7.7 trillion. Pension assets in the second and third pillars of the retirement income system represented about a third of household net worth. Non-pension assets amounted to \$5.4 trillion, with home equity representing about half of this value (see table 2). Thus any analysis that ignores these assets misses the lion's share of Canadians' net worth.

**Table 2: Components of household net worth, 2013**

<b>Components of Household Net Worth</b>	<b>Aggregate (billions)</b>
Pension Assets (RRSPs, employer-based pension plans, CPP/QPP net assets, TFSAs)	\$2970
Real Estate Equity (net of mortgage) including residential and other structures and land	\$2567
Other Financial and Non-Financial Assets (other financial and non-financial assets, excluding financial assets held through registered plans)	\$2807
Consumer Debt (consumer credit and loans)	(\$634)
<b>Household Net Worth</b>	<b>\$7711</b>

Source: Department of Finance Canada 2015.

Another often ignored form of support to retirees is provided by family members and friends. Consider that over 10 percent of seniors live with their families and over a quarter of Canadians are caregivers (Cross 2014). Estimating the significance of financial support within families is difficult but that does not necessarily diminish its importance.

The key takeaway, then, is that an evidence-based analysis of the strengths and weaknesses of Canada's retirement income system requires a comprehensive view of the resources available to Canadians in retirement and should be neutral about the composition of state-funded or administered retirement income and voluntary or personal savings. The ultimate goal should be to ensure that, overall, the system is helping most Canadians prepare for their retirement and not concerned with shifting a greater share to the state to meet an arbitrary target.

## **ARE CANADIANS PREPARED FOR RETIREMENT?**

Evaluations of how well the system is serving Canadians are also fraught with definitional and measurement issues. It is critical that we have a clear understanding of how the system is working before determining what, if any, reforms are needed.

The first problem with the policy debate about whether Canadians are saving adequately for retirement is that the concept of income adequacy is largely a reflection of personal circumstances and preferences. Some individuals voluntarily retire early and thus accept a lower pension and standard of living in exchange for shorter working careers. Others may wish to travel extensively in retirement and, as a result, require more income in order to cover their leisure costs. The optimal income replacement rate for these two fictitious individuals would necessarily be different. Yet there is a tendency in policy commentary to discuss income replacement rates with inflated degrees of precision and universality.

One of the virtues of Canada's retirement income system's reliance on third pillar assets is that it accommodates personal preferences. Individuals can make trade-offs between savings and consumption during their employment years and in retirement based on their needs and preferences. A shift to more reliance on state-funded or administered savings would diminish this flexibility and conceivably force some Canadians to over save irrespective of their needs or preferences.

The second problem with measuring income adequacy is the use of different definitions for income replacement. The distinction between income replacement and consumption replacement is critical for policy purposes yet these two measures of retirement income adequacy are often used interchangeably in public commentary. It is worth clarifying the difference. As the current finance minister writes: “Canadians seem to believe that we must somehow replace our income when we retire, when in fact what we really need to do is to replace *consumption*” (Vettese and Morneau 2013, xii, italics not added).

The income level in retirement needed to maintain living standards is typically lower than one’s pre-retirement income. People can maintain their consumption patterns in retirement with less income because they have fewer expenses such as saving for retirement or work-related costs like commuting. An individual’s tax bill often declines as he or she stops paying payroll taxes such as Employment Insurance and CPP premiums and can take advantage of income splitting with his or her spouse for taxation purposes and also receive a credit for pension income. Consumption also tends to fall as an individual gets older and moves through the different stages of retirement. These include having paid off the mortgage and the expense of raising children. Seeking to achieve a 100 percent income replacement rate relative to one’s pre-retirement disposable income fails to account for these consumption changes.

The optimal replacement rate to maintain consumption patterns is generally based on one’s own circumstances and preferences. There are, however, some useful rules of thumb. Actuary Fred Vettese (2015, 39–40) has produced analysis showing that most retirees only need to replace about 50 percent of their income to finance what they call “regular” consumption such as food, clothing, and utilities. Another study by pension expert Malcolm Hamilton (2001, 51) describes the common benchmark of 70 replacement ratio for income as “faulty” and finds evidence that the proper range is between 30 and 70 percent depending on individual circumstances, with an average close to 50 percent. These estimates accord with work by Vettese and the current finance minister that finds the so-called “neutral retirement income target”<sup>2</sup> ranges from as low as 41 percent for high-income couples with children to as high as 56 percent for middle-income couples with no children. The consensus of all these studies is that, for the vast majority of Canadians, the target range is probably between 40 percent and 60 percent (Vettese and Morneau 2013, 127).

With these important definitional and measurement considerations in mind, how are Canadians faring with respect to retirement income security? Overall, Canada’s retirement income system performs well. Canadian retirees achieve relatively high levels of post-employment income and compare well to those in other OECD countries. The median Canadian senior earns about 91 percent as much as the median Canadian – well above the OECD average of 84 percent (Department of Finance Canada 2015). A number of recent studies have found that most working-age Canadians are on track to maintain their standards of living in retirement (Evans 2015). In fact, calculations by Vettese (2013) suggest that virtually all Canadian households will achieve adequate replacement rates when all assets – including the so-called “Pillar 4” assets – are accounted for.

As for perceptions of a widespread problem of seniors in poverty, the data tell a much different story. We may have thought of seniors as a vulnerable group in past decades but today the proportion of seniors living near the poverty line is less than half of what it is for working-age Canadians. As one of us writes:

Building on the three pillars of Canada’s pension system, the problem of poverty among the elderly, which drove many of the reforms in the 1970s and 1980s, has largely been eliminated. Seniors are living longer, healthier, wealthier, and more productive lives. This is one of our society’s great achievements in recent decades. (Cross 2014, iii)

To the extent that there are issues with respect to low-income seniors, there is some evidence that a small group of single, unattached seniors may remain at an elevated risk of poverty (Bazel and Mintz 2014). As we discuss later in the essay, there are targeted steps that can be taken to help this cohort.

Another issue that has driven policy debates about pension reform is the decline of employer-provided pension plans in general and defined benefit plans in particular. As mentioned in a previous section, the percentage of employer-provided pension plans that are a defined benefit have fallen precipitously in recent decades. This is due in large part to competitiveness issues and solvency challenges. Now most defined benefit pension plans are found in the public sector and even those are under pressure. The pension coverage rate – the proportion of all employees covered by a Registered Pension Plan – was 37.8 percent in 2013 (Statistics Canada 2015). It has fallen from 43 percent since just 1995 (Office of the Superintendent of Financial Institutions Canada).

This decline in employer-provided pension plans has contributed to the perception that Canada’s retirement income system is in need of an overhaul. But the evidence is that when one accounts for a comprehensive view of the assets available to Canadians the system continues to function well. It is interesting that while the shift from defined benefit to defined contribution plans has been widely noted, no attention is given to how little impact this has had on retirement income or poverty among pensioners. People adapted either by saving more or working longer. This underscores how often the most important adjustments are made outside of government-administered plans and the reason that any reforms ought to be incremental and targeted rather than sweeping.

## **NEW GOVERNMENT’S PLAN**

The new government has made improving Canada’s retirement income system among its policy priorities. The prime minister argues that the “pillars of retirement security [need] to be strengthened” and that a CPP expansion ought to be part of the solution (Trudeau 2014). The December meeting of federal and provincial finance ministers was the first opportunity for the government to advance this policy objective.

The underlying assumptions behind the government’s support for a CPP expansion have not been fully fleshed out. The prime minister says that part of the problem is “economic strain” and the Liberal Party talks about the need to make the CPP “more generous” but thus far the government has generally favoured caution and incremental action.

The recent inconclusiveness of the meeting of federal and provincial finance ministers may mean that there is room for a broader policy discussion about Canada’s retirement income system. Finance Minister Morneau calls the agreement to further study a CPP expansion “an important milestone” and will meet with the provincial and territorial ministers in June to discuss the subject in more detail (Curry 2015).

This is a positive development for evidence-based policy, especially with Mr. Morneau leading the exercise. His thinking and writing on pension policy shows that he understands the nuances of the retirement income system and how best to measure its effectiveness. As he writes, “the foundation of our retirement system remains strong. There are cracks, but they appear to be manageable” (Vettese and Morneau 2013, 29).

## **RECOMMENDATIONS TO IMPROVE CANADA’S RETIREMENT INCOME SYSTEM**

To the extent there are “cracks”, what targeted steps can the government take to fill them? While the evidence does not support a broad-based solution such as CPP expansion, that does not preclude Mr. Morneau from pursuing some modest, incremental reforms to Canada’s retirement income system.

The minister said in a 2013 speech that the key is to ensure that government doesn't "create a solution that is bigger than the problem." This is a good basis from which to consider policy options. Here are three that would meet his criteria.

The first step would be to update the comprehensive study of Canada's retirement income system led by Dr. Jack Mintz in 2009. This extensive probe that drew on publicly-available and government data finds that "overall, the Canadian retirement income system is performing well, providing Canadians with an adequate standard of living upon retirement." It suggested that there may be a small minority of Canadians who were ill-prepared for retirement but refuted suggestions that a systemic overhaul was required. It continues to be the foundational study on the state of Canada's retirement income system even though some of the data are now 10 years old. An updated analysis would ensure that future policy discussions are relying upon current data rather than extrapolations.

A second step would be to follow through on the government's commitment to expand the GIS for a subset of single low-income seniors. There appears to be an empirical basis for this type of targeted top-up. Analysis from Philip Bazel and Jack Mintz (2014) finds that roughly 11.5 percent of all elderly individuals, especially those who have never married or have lost a spouse through death, live in households with incomes below \$20,000. Directing public resources to this cohort would represent the sort of targeted, incremental policies needed to improve Canada's retirement income system along the lines envisioned by the minister.

The third option would be to reform the PRPP model. The legislation enacted by the previous government was overly cautious and could be strengthened. PRPPs are large-scale, low-cost pension plans that can pool resources from multiple members and are managed by third parties such as financial institutions or insurance companies. The purpose is to provide a low-cost option for employer-provided pension plans that can be easily adopted by small- and medium-sized businesses that do not have the capacity to offer their employees more sophisticated plans. PRPPs were conceived with the percentage of Canadians without employer-provided pension plans in mind and, in this sense, represents a targeted, scalpel-like reform to the system to address this specific group.

The federal legislation enabling PRPPs has since been replicated in several provinces, including in Quebec, which has experimented with different criteria and requirements.

Federal legislation for PRPPs could be improved. It neither requires employers without other pension plans to offer PRPPs to their employees nor does it contemplate mandatory employer contributions for those who do. Quebec's legislation, by contrast, requires employers with five or more employees that do not already offer a group retirement savings plans to enrol their employees in a PRPP (though the employees have the option to opt-out). This model is specifically designed to target the "un-pensioned" – a group of people named by one Canadian economist for being in the labour market but not having an employer-provided pension plan – rather than applying to everyone (Meredith 2015b). The new government in Ottawa should consider amending the federal PRPP rules to adopt the Quebec model and may even go further to mandate employer contributions (Meredith 2015a; Ambachtsheer and Waitzer 2011). At a minimum, moving to an automatic enrollment regime with an opt-out would be a nudge in the direction of greater retirement savings for the un-pensioned cohort.

None of these steps represents a full-scale reform of Canada's retirement income system because the evidence suggests that a scalpel rather than a sledgehammer would ensure that Canadians continue to have the support that they need for a secure retirement.

## CONCLUSION

The adequacy of Canada's retirement income security has been the subject of considerable policy debate and analysis for several years. Ensuring that Canadians have adequate resources for their retirement is a key public policy question. The new government is right to examine these issues closely.

The recent meeting of federal and provincial finance ministers failed to reach a consensus on whether there is indeed a problem and what, if any, policy solutions are required. Finance Minister Morneau has committed to studying options with his provincial and territorial counterparts. A follow-up meeting is tentatively scheduled for midway through 2016 to further discuss a CPP expansion.

The preoccupation with an expanded CPP is based on the viewpoint that Canadians are not adequately saving for retirement and that state-mandated savings are the only solution to this problem. Both assumptions lack solid evidence and are largely the result of definitional and measurement problems. The reality is that concerns about a so-called retirement income "crisis" are overblown and a CPP expansion would be a blunt solution to a narrow and largely subjective issue.

An evidence-based policy would be neutral with respect to the composition between state-funded or administered retirement income and voluntary or personal savings, and adopt a comprehensive view of the resources available to Canadians in retirement. The ultimate goal should be to ensure that overall the system is helping most Canadians prepare for their retirement and not concerned with shifting a greater share to the state to meet an arbitrary target.

To the extent that there is room for incremental action, the government ought to consider targeted policies such as increasing the GIS for single seniors and expanding the PRPP model to help those Canadians without an employer-provided pension plan. These ideas would represent a step in the right direction for greater retirement income security for Canadians.

## ABOUT THE AUTHORS



### PHILIP CROSS

Philip Cross is a Senior Fellow at the Macdonald-Laurier Institute. He is also a member of the Business Cycle Dating Committee at the CD Howe Institute. Before that, he spent 36 years at Statistics Canada, the last few as its Chief Economic Analyst. He wrote Statistics Canada's monthly assessment of the economy for years, as well as many feature articles for the *Canadian Economic Observer*.



### SEAN SPEER

Sean Speer is a Senior Fellow at the Macdonald-Laurier Institute. He previously served in different roles for the federal government including as senior economic advisor to the Prime Minister and director of policy to the Minister of Finance. He has been cited by *The Hill Times* as one of the most influential people in government and by *Embassy Magazine* as one of the top 80 people influencing Canadian foreign policy. He has written extensively about federal policy issues, including personal income taxes, government spending, social mobility, and economic competitiveness. His articles have appeared in every major national and regional newspaper in Canada (including the *Globe and Mail* and *National Post*) as well as prominent US-based publications (including *Forbes* and *The American*). Sean holds an M.A. in History from Carleton University and has studied economic history as a PhD candidate at Queen's University.

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## Endnotes

- 1 The 2014 Ontario budget states: “Canada’s publicly administered Canada Pension Plan (CPP) is fundamental to the retirement income security of all Canadians, but its benefits alone are too low to meet the needs of middle-income earners.” See: Sousa, Charles. 2014. *2014 Ontario Budget: Budget papers*.
- 2 Vettese and Morneau (2013, 116) define the neutral retirement income target as “the retirement income, expressed as a percentage of final pre-retirement gross income, that provides for the same consumption before and after retirement.”

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**CONTACT US:** Macdonald-Laurier Institute  
8 York Street, Suite 200  
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