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REFORM PROPOSALS FOR REPLENISHING RETIREMENT SAVINGS

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SUMMARY

The 2008-2009 economic crisis dealt a serious blow to Canadians' retirement savings. While markets have since partially recovered, the ratio of Canadians' household net-worth relative to disposable income still remains below where it was in 2007. So much wealth that workers had accumulated to prepare for retirement has been wiped away, while the years since 2008 that might have otherwise been spent compounding retirement savings have been spent, instead, on trying to recover losses in a low-interest-rate environment that has limited returns. With large waves of older workers approaching retirement age, and these future retirees projected to live longer than previous cohorts, Canada now faces the very realistic scenario that a significant number of people will reach retirement age without the funds they will need to provide a comfortable post-working-life income.

Canadian policy-makers may not have the ability to restore that destroyed wealth. And with most governments already struggling to resolve serious deficits, the situation is not likely to be ameliorated with anything that requires additional spending, or that could reduce tax revenues. But there are policy reforms available that can help at least in better preparing the coming waves of retirees for a financially secure retirement. The reforms need not be far-reaching to have a meaningful impact. And they need not be costly, either.

They can include a modest expansion of the Canada Pension Plan (CPP) to allow larger contributions — shared by employers and employees, or covered entirely by employees — that would, in turn, allow retiring workers to draw a larger maximum pension, rather than having to rely on the guaranteed income supplement (GIS). CPP contributions could also be made deductible from taxable income, like RRSP investments, to encourage workers to maximize contributions. To minimize an increase in payroll taxes, the eligibility age for CPP benefits could be increased to 67 years of age, similar to old-age security eligibility. Meanwhile, the tax treatment of group RRSPs — for which employer contributions are currently subject to payroll taxes — should be made the same as it is for defined-contribution registered pension plans (RPPs).

There is also the option of increasing the age limit for RPP and RRSP contributions, from 71 to 75 years, to reflect the increase in life expectancies. RRSP contributions can be altered to allow lifetime-averaging, allowing workers to take advantage of additional contribution room. Contribution limits on Tax-Free Savings Accounts should be increased as well. Policy-makers should also look at creating a capital-gains deferral account, to allow investors to sell off underperforming assets, without fear of triggering a tax bill, as long as they reinvest the proceeds. The freedom to unlock unwanted investments, and make better ones, will improve revenue prospects for investors and the government.

Many of these reforms can be phased in gradually, to assess their effects on government revenue and savers' behaviour. But they all appear to have the potential to encourage increased saving, without significantly harming long-term government revenue, helping Canadians better prepare for comfortable retirements, even after the serious wealth destruction that accompanied the recent economic crisis.

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INTRODUCTION

With the 2008-2009 financial crisis and a continuing low-interest-rate environment, many Canadians have seen a reduction in their accumulated net wealth to fund retirement, compared to earlier years when financial markets provided better returns. As well, federal and provincial governments are more constrained in their abilities to fund future retirement benefits as a result of Canadian federal and provincial debt burdens growing in the past four years.

In this paper, we examine the current state of Canadian saving patterns and discuss reform options to ensure adequate retirement income in the face of public-sector fiscal constraints. We suggest a broad number of pension and tax reforms that would address many challenges that currently exist. We argue that it makes a lot of sense to undertake policy reforms that recognize that Canadians live and work longer. Tax savings can be achieved by increasing age eligibility for a host of public-pension and tax benefits provided to the elderly. It also makes sense to ensure that adequate policies are in place to provide income security for low-income Canadians through a modest expansion of the Canada Pension Plan (CPP) program and improving the guaranteed income supplement (GIS), with the additional costs covered by fiscal savings in other areas especially with respect to a higher eligibility age for public benefits. Further tax-policy changes could also be undertaken to help Canadians fund their retirement and invest in productive activities.

OVERVIEW OF CANADA'S RETIREMENT INCOME AND SAVINGS SYSTEM

Public pensions — the old-age-security (OAS)/GIS system and CPP/Quebec Pension Plan — provide a basic core of retirement income. These systems are designed to provide reasonably adequate replacement income ratios (retirement income/pre-retirement income) for lower-income groups. As pre-retirement incomes increase however, the replacement ratio provided by these public pensions declines. Households must therefore rely on private pensions and other sources of retirement income to provide adequate replacement ratios. Retirement savings may be accrued in registered pension plans (RPPs) — either defined-benefit or defined-contribution — or through Registered Retirement Savings Plans (RRSPs). Currently, contributions to these registered plans are limited to 18 per cent of earned income, with an overall annual limit of $23,820. In recent years another registered savings option has become available: the Tax-Free Savings Account. Currently, individuals may contribute up to $5,500 annually into these accounts. Although contributions are made from after-tax income, the earnings in these accounts are tax-free. The use any of these registered plans eliminates the double taxation of savings that would otherwise occur.

Another vehicle for retirement savings is the buildup of equity in owner-occupied residences. Although personal homes are paid for out of after-tax income, this form of housing equity is not subject to double taxation, since imputed rent is not taxed and capital gains on the sale of a personal residence are exempt from tax.

Finally, individuals may provide for their retirement by acquiring other assets — stocks, bonds and mutual funds — or by building up equity in private businesses.

The focus of this paper is on improving access to both public and private sources of retirement income. Regarding the public-pension system, we recommend increased flexibility regarding the date of retirement, with appropriate actuarial adjustments to OAS/GIS as well as pensions from CPP/QPP. We also recommend that increased life expectancies near retirement be taken into account by increasing the maximum age at which these pensions must begin.

Another important issue is the prevention of poverty among retired Canadians. We recommend appropriate changes to GIS to mitigate the effect of increasing the normal retirement age for OAS to age 67. We also recommend a modest augmentation of the CPP/QPP system. We recommend that the CPP be increased to 35 per cent of the average wage, at age 67 (from the current 25 per cent at age 65), and that this increase be fully funded through increased contributions.

Regarding private retirement-savings, we recommend that the RRP/RRSP system be modified to increase flexibility, to raise the age limit for contributions, and to raise annual contribution limits.

We also recommend the reintroduction of income averaging, and allowing for rollovers of capital gains upon reinvestment. Both of these measures would increase the rate of return on investments made outside of registered plans.

The next section reviews the current state of retirement savings in Canada.

THE CURRENT STATE OF RETIREMENT SAVING

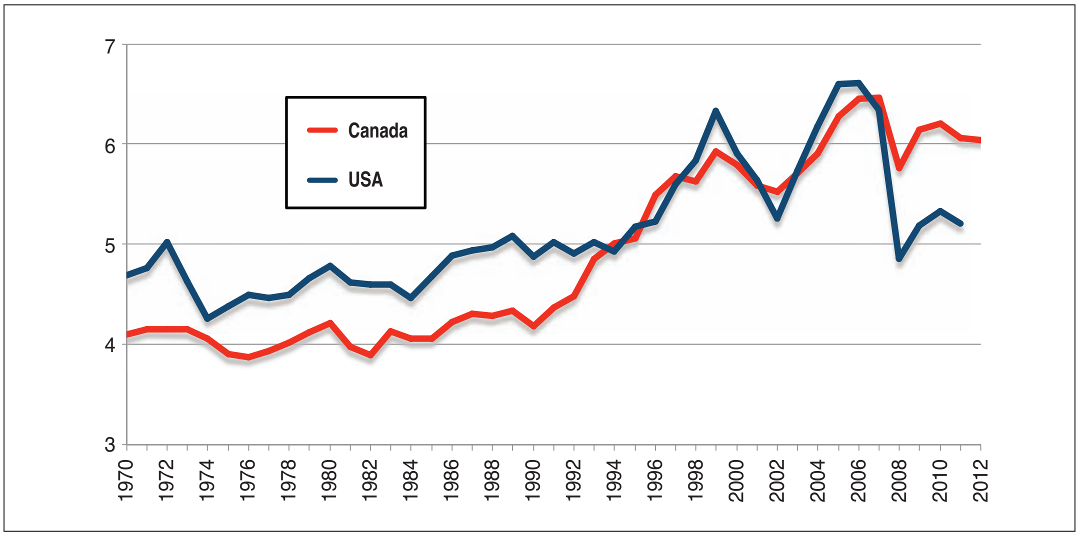
Studies based on data before the 2008-2009 financial collapse show that at least 80 per cent of Canadians had adequate retirement income based on their saving patterns.[1] The lowest-income Canadians are generally adequately protected, resulting in Canada having one of the lowest poverty rates among seniors in OECD. Prior to 2009, once taking into account not just pension and RRSP assets but also housing equity and other financial or business assets, four-fifths of Canadians had adequate wealth for retirement income. The most important incidence of inadequate retirement income prospects was among Canadians with modest incomes ($25,000 - $50,000).

With the financial crisis of 2008-2009, Canadian pension and financial assets substantially declined. Since then, stock markets have recovered back to 85 per cent of their 2008 peak and the value of housing equity is higher than in previous years. As shown in Figure 1 below, average net household wealth as share of disposable income has not fully recovered from its 2007 peak, although Canadians are much better off than Americans, whose net wealth is not much better than it was in the early 1990s.

[1] Jack M. Mintz, *Summary Report on Retirement Income Adequacy Research*, Finance Canada, Ottawa, 2009.

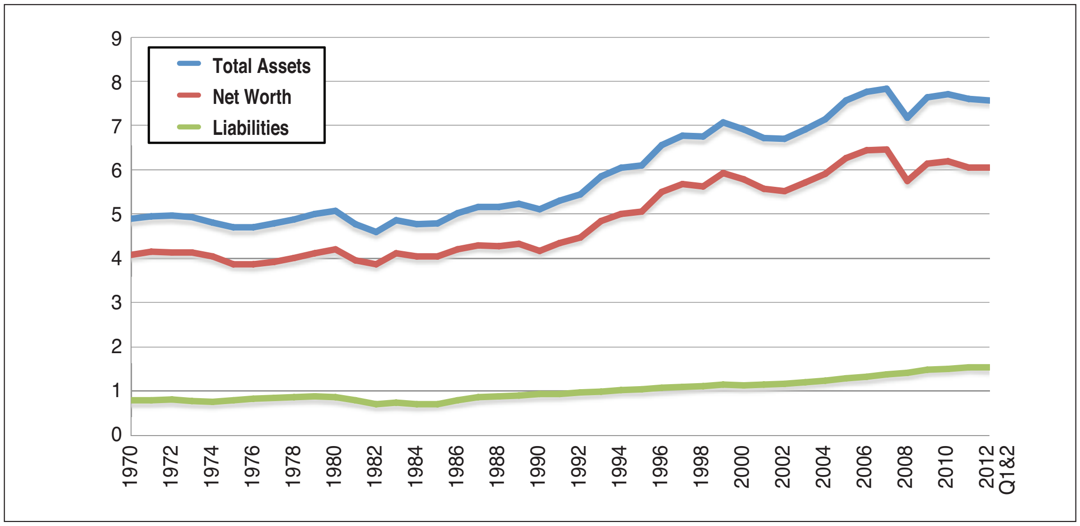
While Canadians' net worth is about 600 per cent of disposable income, household debt levels have reached over 160 per cent of disposable income in 2011 (Figure 2). Housing equity as share of total housing value has declined to 67.5 per cent in 2011 from 71 per cent in 2007, although it is not that much different from where it was in 1990, at 68 per cent.[2]

FIGURE 1: HOUSEHOLD NET WORTH TO PERSONAL DISPOSABLE INCOME



Source Data: Cansim Tables 380-0019 & Table 378-0051; Federal Reserve Z.1 Statistical Release

FIGURE 2: RATIO OF HOUSEHOLD ASSETS & DEBT TO PERSONAL DISPOSABLE INCOME

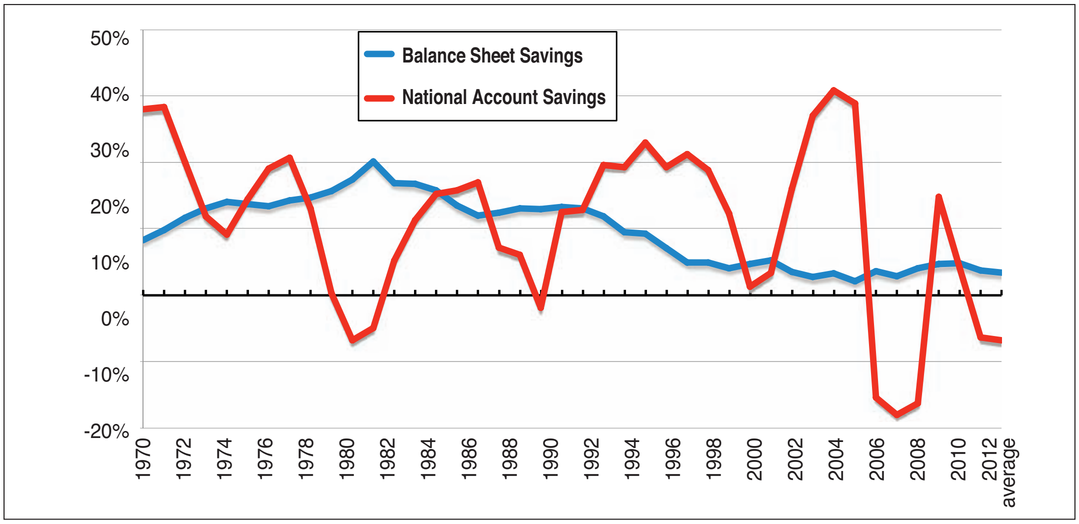


Source Data: Cansim Tables 380-0019 & Table 378-0051.

[2] Statistics Canada 378-0012. See, in particular, the forecast made by Keith Horner, Retirement Savings by Canadian Households, Finance Canada, 2009. Horner points out inadequate retirement income for Canadians with modest and middle incomes. See also Keith Horner, *A New Pension Plan for Canadians: Assessing the Options*, IRPP Study 18, Institute for Research on Public Policy, 2011; and Michael Wolfson, *Projecting the Adequacy of Canadian Retirement Incomes: Current Prospects and Possible Reform Options*, IRPP Study 17, Institute for Research on Public Policy, 2011. While results differ, particularly with respect to incorporating home equity and other financial and business assets in the analysis, most studies agree that a significant share of future retirees with modest and middle incomes will be challenged to provide adequate saving for retirement.

Indeed, aggregate personal savings as a share of disposable income has fallen since 2009 when accounting for accrued capital gains and adjustments for inflation and three-year averaging (Figure 3). Although volatile due to market fluctuations, balance sheet saving was roughly 20 per cent of disposable income prior to 2008. Recently it has fallen precipitously, with modest dissaving in 2012. National accounts measures of saving rates that do not correct for capital gains and inflation generally increased somewhat after 2009 but remain much lower than before 1995.

FIGURE 3: PERSONAL SAVINGS AS A PERCENTAGE OF DISPOSABLE INCOME



Source Data: Cansim Tables 380-0019 & 378-0051

Notes:

1) Balance sheet savings are calculated as a three-year moving average.

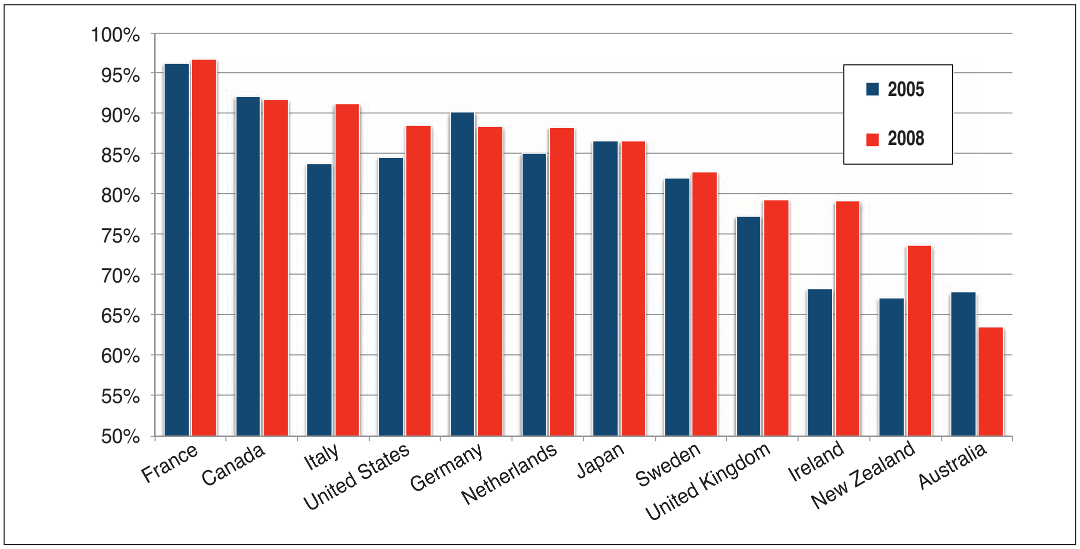
2) Balance sheet savings are calculated as change in real net worth, counting consumer durables as savings.

3 "Full" disposable income is adjusted from sector accounts data to include capital gains.

4) 2012 data is Q1 & Q2 averaged.

On the whole, many Canadians have certainly felt the stresses of a weak economy since 2009. On average, however, Canadians fare better than most OECD countries (Figure 4), at least prior to 2009, according to the latest data.

FIGURE 4: 65+ AVERAGE INCOME AS A PER CENT OF THE TOTAL POPULATION AVERAGE INCOME



Source Data: OECD 2012 – Social and Welfare Statistics, Income distribution – Inequality

Note: 2004 figures used for Italy, Germany, Sweden, United Kingdom, Ireland, New Zealand and Australia. 2003 and 2006 figures used for Japan.

CURRENT ISSUES

Current retirees, on average, are achieving adequate retirement-income replacement ratios.[3] However, future retirees are affected by existing financial-market conditions that make it more difficult to support retirement.[4]

Replacement rates are highest for the lowest-income quintiles. This is due to the design of the OAS/GIS system, supplemented by CPP/QPP. As a result, 5.9 per cent of older Canadians are below the poverty line, still one of the lowest in the world.[5]

Participation in registered pension plans (RPP) is an important source of current retirement income. For retirees who are members, RPPs constitute the most important source of income,[6] although housing equity, on an after-tax basis, is more valuable than all public and private pension and RRSP assets held by Canadians.[7]

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[3] Across the wide spectrum of income classes, current male retirees replace 70 per cent or more of their pre-retirement incomes, and females about 80 per cent. Yuri Ostrovsky and Grant Schellenberg, "Pension Coverage, Retirement Status and Earnings Replacement Rates among a Cohort of Canadian Seniors," *Analytical Studies Branch Research Paper Series* No. 329, Statistics Canada, 2009.

[4] There is no ex-post data, post-2010, to assess how Canadians are responding to existing financial market conditions with low interest rates. Instead, one must rely on projections based on pre-2010 data, which is more difficult to do given that asset data are not incorporated in tax-based income data.

[5] OECD, Pensions Outlook, 2012.

[6] Morley Gunderson and Thomas Wilson, "Encouraging Small and Medium Sized Firms to Participate in Pension Plans," A Report Prepared for Advocis, September 2009.

[7] Jack M. Mintz, *Summary Report on Retirement Income Adequacy Research*, Finance Canada, Ottawa, 2009.

Interestingly, individuals who did not participate in RPPs had post-retirement incomes, on average, slightly above those with RPPs in 2006, although there is much more variance in incomes in a particular income class for individuals without RPPs.[8] This is attributable to post-retirement earned income from employment and self-employment, and investment income from other assets (RRSPs and non-registered assets). When including the annuitized value of housing equity, income replacement at retirement can be significantly higher for most income groups.[9]

While public-sector participation in RPPs — mainly defined-benefit plans — remains high, private-sector participation in RPPs is declining, and particularly for participation in private-sector defined-benefit plans. The advantage of defined-benefit plans is that they reduce both longevity and investment risk faced by employees, since such risks are transferred to employers who are, in principle, better able to deal with these risks pooled over employees. While participation in private-sector defined-contribution plans has increased, it is not enough to offset the decline in defined-benefit plans. Overall, fewer private-sector employees are participating in RPPs. Group RRSPs and the proposed Pooled Registered Pension Plan could be substituted for defined-contribution RPPs.

The overall design of Canada's retirement-savings system is far from perfect, and financial market developments in recent years have made these imperfections more important to address. If current low-interest-rate trends continue, more Canadians will find it difficult to meet future needs when they retire.[10] Specifically:

- Some individuals with modest incomes do not save enough to provide adequate retirement income-replacement ratios, in part as a result of job loss during careers, family breakups, poor investment returns and inadequate saving.
- Serious disincentives to savings and work-effort are a consequence of the interaction of the clawback of GIS and the personal income tax. Clawbacks of certain tax credits and the OAS also increase marginal effective tax rates on earned and investment income of seniors.
- Inequities exist between the best public-sector defined-benefit RPPs and savings by private-sector participants through RPPs, group RRSPs and individual RRSPs that will be discussed further below.
- The tax system does not adequately allow for lifetime averaging of contributions to RSPs. The RRSP system determines allowable contributions on an annual basis. Although unused RRSP contribution room may be carried forward to future years, individuals with fluctuating incomes, or those with low incomes early in their careers followed by higher incomes later, have lower average contribution limits relative to individuals with stable incomes.

There are also many technical issues that separate group RRSPs, defined-contribution pension plans and defined-benefit pension plans that need to be addressed.

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8 Yuri Ostrovsky and Grant Schellenberg, "Pension Coverage, Retirement Status and Earnings Replacement Rates among a Cohort of Canadian Seniors," 2009.

9 J. Baldwin, M. Frenette, A. Lafrance and P. Piraino, "Income Adequacy in Canada: Accounting for the Annuitized Value of Wealth in Canada," *Research Paper*, Statistics Canada, Ottawa, 2011. The data are based on 1999 retirees, however, and are therefore not explicitly comparable with other studies.

10 See also Kevin Moore, William Robson and Alexandre Laurin, "Canada's Looming Retirement Challenge: Will Future Retirees be able to Maintain their Living Standards Upon Retirement?" *C.D. Howe Institute Commentary* No. 317, C. D. Howe Institute, Toronto, 2010.

COST IMPLICATIONS OF FORTHCOMING CHANGES TO AGE ELIGIBILITY FOR OAS PENSIONS

The federal budget of 2012 announced important changes to OAS/GIS. The qualifying age would increase to 67, to be phased in from 2023 to 2029. Since the sustainability of the federal old age security (OAS) and guaranteed income supplement (GIS), among other commitments to support the elderly, has been raised in the debate, we begin with an evaluation of the aggregate costs of the OAS/GIS system.

We draw upon two long-term projections for the Canadian economy prepared by the Policy and Economic Analysis Program (PEAP) at the University of Toronto. The first projection was prepared in February 2012 before the federal budget. The second projection was proposed in July 2012, and incorporates the announced changes to OAS/GIS.[11]

Table 1 below shows the February 2012 PEAP long-term projections of the share of OAS/GIS payments relative to nominal GDP. In 2012, these transfers to elderly Canadians constitute 2.2 per cent of GDP. These payments will gradually increase with the aging of the population, as the baby boom cohort reaches the age of 65 in increasing numbers. With the OAS/GIS system in effect prior to the 2012 budget, the projection shows that OAS/GIS payments would rise from $21.8 billion in 2012 to $139.2 billion in 2040. As a share of GDP, the projected payments would reach a peak of 2.72 per cent of GDP in 2029/2030, and then gradually decline to 2.37 per cent at the projection horizon in 2040.[12]

With the changes announced in the budget, the qualifying age for OAS/GIS would gradually move from 65 to 67 from April 2023 to January 2029. The July 2012 PEAP estimate incorporating these changes is shown in Table 2. As is clear, the changes reduce these transfers as a share of GDP after 2022. In 2029, when the changes are fully phased in, the share of GDP is projected to be 2.43 per cent, 0.29 per cent below the share shown in the February 2012 projections. At the projection horizon in 2040, the share is down to 2.16 per cent, 0.21 per cent below the February 2012 estimated share of GDP. The value of these transfers is projected to be reduced by $15.3 billion by 2040.[13]

The ratios of OAS/GIS transfers to GDP under the two scenarios are also shown in Figure 5.

Note that these reductions in OAS/GIS transfer payments do not translate directly into an increase in the federal budget balance. Since OAS is taxable, reductions in OAS will, all other things being equal, reduce federal income tax revenues (provincial income tax revenues will also be reduced). If GIS is postponed to age 67 along with OAS (as is proposed), provincial welfare payments to elderly poor aged 65 - 67 could increase. This could increase federal transfers to the provinces — either directly under shared-cost formulas, or indirectly through federal-provincial negotiations.

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[11] Note that these projections assume that OAS/GIS will continue to be indexed to the Consumer Price Index (CPI). This implies that the contributions of these pensions to post-retirement replacement ratios for earned income will gradually decline as real wages rise. If these pensions were increased through ad hoc adjustments, the future decline in replacement ratios could be mitigated, but the future cost of the program would increase substantially.

[12] The projected cost of OAS/GIS in 2030 in Table 1 is $102.5 billion, or 2.7 per cent of GDP. The recent Report of the Auditor General to the House of Commons (Fall 2012) states that these expenses would be “just over $100 billion (2.9% of GDP) in 2029-30” (Ch. 7 p. 14).

[13] A comparison of the figures for 2030 in Tables 1 and 2 indicates that OAS/GIS costs would decline by $11.1 billion. The report of the auditor general states: “The higher age of eligibility could reduce government expenses by $10 billion in 2029, when the government will have fully implemented the new policy” (loc. cit.).

Since the GIS system has been a major factor in the near elimination of poverty among individuals above age 65, a case can be made for a decoupling of GIS from OAS for individuals aged 65 - 67 when the age limit for OAS is increased.

Otherwise, we would argue that increasing the eligibility age for OAS itself is an appropriate policy given how long Canadians can expect to live. When OAS began in 1952, eligibility for payment was 70 years of age, at a time when, on average, Canadian men lived until 66 and women until 71.[14] In the period 1965-1969, eligibility for OAS was reduced to 65 years of age while average life expectancy rose to 69 for men and 76 for women. Today, average Canadian life expectancy at birth is 79 years of age for men and 83 for women. Life expectancies at age 65 have increased significantly over the past 30 years. For females, life expectancy when one reaches the age of 65 has increased from 18 years to 21.6 years, for males it has increased from 14 years to 18.5 years.[15]

TABLE 1: OAS/GIS AS SHARE OF GDP, AGE OF ELIGIBILITY: 65
PEAP FEBRUARY 2012 PROJECTION

Year	Transfers to Persons OAS/GIS	Nominal GDP	Share
2000	23790	1076577	2.21
2010	35864	1624608	2.21
2020	62470	2501838	2.50
2030	102472	3765149	2.72
2040	139215	5872659	2.37

TABLE 2: OAS/GIS AS SHARE OF GDP, AGE OF ELIGIBILITY INCREASING TO 67 BY 2029
PEAP JULY 2012 PROJECTION

Year	Transfers to Persons OAS/GIS	Nominal GDP	Share
2000	23790	1076577	2.21
2010	35864	1624608	2.21
2020	61803	2492783	2.48
2030	91263	3742892	2.44
2040	123915	5744845	2.16

We would go even further in recommending delaying certain transfers and tax credits for seniors to recognize that Canadians work and live longer, as we will discuss further, below. These include the Canada Pension Plan (people could contribute longer and receive a larger benefit), the age credit, and the pension income credit.[16]

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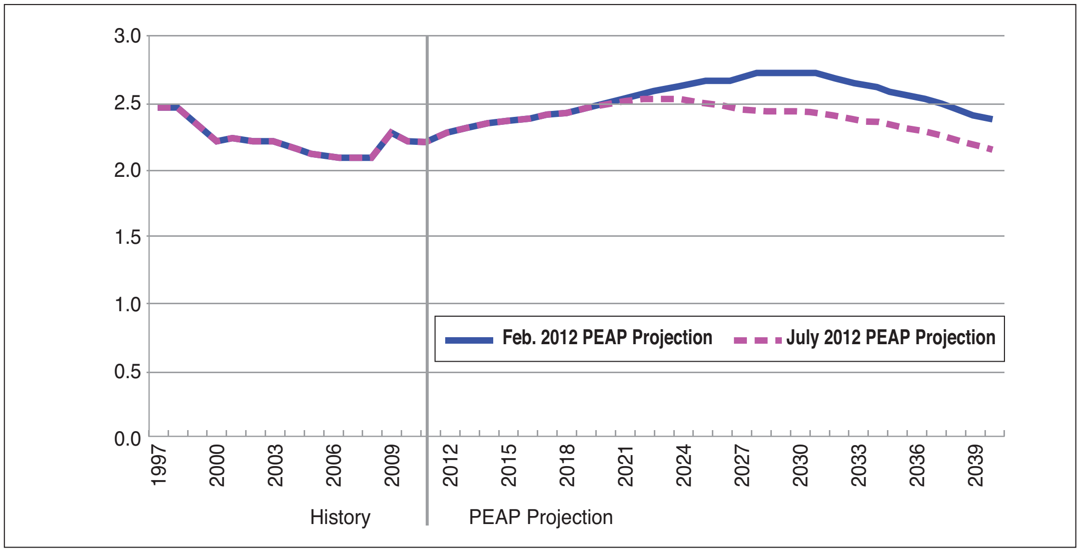
[14] Statistics Canada, Life Expectancy at birth, by sex, Canada, table 102-0512, catalogue 84-537-XIE.

[15] Statistics Canada, CANSIM table 102-0512.

[16] If the federal government were to change these age-related transfers and tax brackets to age 67, the provinces should consider implementing similar changes to age-related transfers and tax credits.

FIGURE 5. OAS+GIS % SHARE OF GDP, 1997 TO 2040



MODIFYING THE GIS WHEN THE AGE OF ELIGIBILITY IS RAISED TO 67

The GIS program has been an important factor generating a reduction in poverty among Canadians above age 65. When the OAS qualifying age is raised to 67, individuals aged 65 - 67 who would receive GIS under the current system could well be pushed below the poverty line if the GIS were not modified, or if provincial welfare payments were not increased. The cost of preventing poverty among this age group would be approximately the same, whether the GIS is modified or if provincial welfare payments to poor, elderly persons are increased by an equivalent amount.[17]

The modification of the GIS as discussed below would be fully borne by the federal government. The costs of increased welfare payments would likely be shared between the federal and provincial governments.

The GIS could be modified by decoupling GIS from OAS for individuals aged 65 - 67, and adjusting the payment schedules for GIS to include an amount equivalent to what would have been provided by OAS under the current system. The 50-per-cent clawback rate for other income could remain unchanged.[18]

In order to reduce disincentives to saving and employment, it is important to eliminate the overlap between GIS clawbacks and the Personal Income Tax. As proposed in a previous paper,[19] this could be accomplished by providing a personal tax credit for individuals who receive GIS payments.

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[17] This would require the provinces effectively to replace OAS/GIS for these individuals.

[18] The federal government also provides a "spousal allowance" and allowance for survivors that supports spouses of recipients of GIS. Currently, individuals in the 60 - 64 age group are eligible for these benefits. When the effective age for OAS is increased to 67, the age range for these spousal benefits would also increase to 62 - 66. Our recommended modification to GIS for those aged 65 - 67 should therefore be accompanied by modifications to spousal benefits for those aged 60 - 62.

[19] Morley Gunderson and Thomas Wilson, "Encouraging Small and Medium Sized Firms to Participate in Pension Plans," September 2009.

PROPOSALS FOR REFORM

Given the concern that many working Canadians are not making adequate provision for their future retirement income, a number or proposals for pension reform have been made. These include:

- A major expansion of the CPP to include a supplementary fully funded defined-benefit add-on to the existing CPP: "Big CPP."[20]
- Government involvement in establishing a supplementary defined-contribution pension scheme. This could be a public-sector plan, in which private-sector employees who do not have their own RPPs could, or must, participate, or government mandatory provision of RPPs or group RRSPs in the private sector.[21]
- Reforming the regulation of pensions and group RRSPs, to eliminate barriers to the establishment of multi-employer registered saving plans, defined-benefit RPPs, defined-contribution RPPs and group RRSPs.[22]

Our view is that the Canadian Retirement Income System is not in crisis, but it can be improved. The three-tiered system — OAS/GIS, CPP/QPP and contributory pension and savings plans — is generally working well. Therefore we do not believe that radical changes — such as establishing a "Big CPP" or mandating compulsory participation in registered saving plans — is warranted. Forcing increased savings for retirement for a large group of Canadians may well make many of them worse off. As in medicine, we believe the first mandate of pension reform should be to "do no harm."

What we propose are a set of reforms that will provide:

- A modest expansion of the CPP/QPP designed to ensure that employees at or above the average industrial wage would not have to rely on the GIS to maintain minimum retirement-income standards.
- Improving economic efficiencies and addressing inequities in the current retirement-income system. This includes addressing inefficiencies arising from clawbacks with respect to GIS and OAS, eliminating inequities between private- and public-sector employees (including the self-employed), moving the RRSP system to a lifetime-averaged basis, and eliminating or reducing barriers to the establishment of group RRSPs and multi-employer pooled registered pension plans, including defined-benefit plans.
- Introducing some tax provisions that would help Canadians accumulate wealth for retirement.
- Help control fiscal costs by raising age limits in recognition of changed life expectancies.

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[20] See J. R. Kesselman, "Expanding Canada Pension Plan Retirement Benefits: Assessing Big CPP Proposals," *SPP Research Papers*, The School of Public Policy, University of Calgary, 3, 6 (October 2010).

[21] For a discussion of these alternatives, see N. L. Nielson, "Should Government Facilitate Voluntary Pension Plans," *SPP Research Papers*, The School of Public Policy, University of Calgary, 3, 1 (July 2010).

[22] In 2012 the federal government enacted a "Pooled Registered Pension Plan Act" that "implements the federal position of the framework for the establishment and administration of PRPPs" (Department of Finance, Regulatory Impact Analysis Statement, Dec. 14, 2012). However, general implementation of such plans will require action by the provinces. For a review of these developments see James Pierlot and Alexander Laurin, "Pooled Registered Pension Plans: Pension Savings or a new tax on the poor?" C. D. Howe Institute, Commentary No.359, August, 2012.

CPP REFORMS

Consideration should be given to providing a modest augmentation of the CPP that would enable Canadians, especially those with modest incomes, to have a greater defined-benefit provision of retirement income. This could take the form of a supplementary, fully funded defined-benefit plan whereby individuals could contribute additional amounts to CPP in order to increase their maximum CPP pension to 35 per cent of salary (from 25 per cent, currently) to be phased-in over time. This would involve an additional contribution of about 2.5 per cent, which could be shared between employer and employees, or paid wholly by employees. To minimize these higher payroll contributions, the eligibility age for CPP could be increased from 65 to 67 to be phased in a decade from now, as further discussed below.

Contributions to CPP are currently credited against income tax at the lowest marginal rate. We recommend that these contributions, including any augmented contributions, should instead be a deduction from taxable income, like RPP and RRSP contributions.

Since its inception, the CPP has permitted individuals to start receiving their pensions as early as age 60 and as late as age 70, with appropriate actuarial adjustments. Prior to the 2012 federal budget, there was no similar arrangement for OAS pensioners. The budget proposed that individuals be allowed to defer OAS for up to five years until age 72, with actuarial adjustments similar to CPP. This would increase flexibility for OAS recipients who choose to postpone their retirement for up to five years beyond age 67.

It would also enhance individual flexibility to choose a retirement date earlier than age 67, if an individual could elect to receive an actuarially reduced pension for up to five years prior to age 67. With appropriate actuarial adjustments, this increased flexibility would not entail any increased cost to the federal government.

Indeed, if the increased flexibility and higher age limits for RPPs and RRSPs that we recommend below are implemented, the deferral periods for both OAS and CPP should be increased to age 75, providing additional flexibility for individuals' retirement choices.

IMPROVING EFFICIENCY AND ELIMINATING INEQUITIES

Although the existing Canadian system is well designed to reduce economic costs and achieve an equitable treatment of different savers in many respects, there is a need to address some continuing anomalies. Below we provide several recommendations.

The GIS clawback should be modified to eliminate the overlap with the personal income tax. Lower-income earners should have the option of electing for tax-free-savings-plan treatment of their own contributions to group RRSPs and pooled registered pension plans. Further, the clawback of OAS should be reduced to prevent the effective marginal rate on income net of transfers from exceeding the top marginal rate. To minimize the cost of this provision, one could lower the threshold at which the clawback begins, or alternatively move towards a clawback of OAS based on family rather than individual income.

The tax and regulatory treatment of defined-contribution RPPs and group RRSPs (including pooled RPPs) should be equivalent. For example, group RRSP contributions by employers should not be subject to payroll taxes. The regulatory burden on defined-contribution RPPs should be reduced.

Further several adjustments to eliminate inequities in the pension system could be adopted. Past service contributions to both group RRSPs and defined-contribution RPPs should be permitted, subject to the availability of RRSP contribution room. Contribution limits for RRSPs and RPPs should be increased to enable participants in these plans to attain approximate equivalence with retirement incomes accrued in many public sector defined-benefit plans.[23] Contribution limits to tax-free savings plans should also be increased in future years.[24]

Further, the age limit for contributions to RPPs and RRSPs should be increased from 71 to 75 years, to reflect increases in life expectancies over the past 20 years. The RRSP system needs to be moved to a lifetime-averaged basis by permitting taxable withdrawals from RRSPs to be replaced by future tax-deductible contributions and allowing individuals with incomes above the contribution limits in a year to carry back the excess to previous years that were below the annual limit, to create more contribution room.[25]

OTHER TAX REFORMS THAT WOULD ENCOURAGE SAVINGS

Taxes reduce the yield on savings that is already challenged by low inflation-adjusted rates of interest. Although the RPP/RRSP system (and Tax-Free Savings Accounts) provides the main vehicles for retirement savings, other tax reforms could encourage savings outside these registered plans. In this section we discuss some measures that would shift the personal income tax further towards a consumption base. These reforms would reduce the taxation of savings relative to consumption, making it easier for individuals to build up capital for retirement. The two areas where we recommend tax reforms involve income averaging and capital-gains rollovers.

Income averaging: Following the Carter Report, Canada implemented a very generous system of averaging: Income-Averaging Annuities (IAAC's) for income from variable sources, and five-year backward general averaging for income. The IAACs were eliminated in 1981, and general averaging was eliminated in 1987. We think that they both should be re-introduced. This would move the personal income tax more towards a consumption base.

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[23] Prior to 1991, the annual percentage limit was 20 per cent of earned income. Under the 1991 pension reforms this limit was reduced to 18 per cent of the earned income of the previous year.

[24] Some adjustment will be needed to take into account that some low-income Canadians could be claiming full GIS while holding significant assets accumulated in tax-free savings accounts. For example, the annual earnings in these accounts could be taken into account in determining the appropriate clawback of GIS.

[25] Currently, many individuals have large amounts of unused RRSP contribution room, such as younger workers who invest in housing instead, and those less able or with less desire to save. Since unused contribution room may be carried forward until age 70, it may well be rational for individuals to postpone investing in RRSPs while they make other use of their funds — e.g., building up housing equity, investing in RESPs etc. They will likely increase their current contribution room if annual limits are raised. However this does not mean that they will not take advantage of the higher limits for their future RRSP contributions.

Lifetime averaging and other retirement-income reforms: At present RPPs and RRSPs must be annuitized (or converted to RRIFs) at age 71. (This age has been used since the beginning of the RRSP system, except for 1997-2007 when it was lowered to 69). Given the increased life expectancies for seniors, the age limit should be increased to 75.

The rules for contributions to RRSPs have allowed for increased flexibility in recent years. Unused RRSP room may be carried forward for use in future years to move the RRSP system to a lifetime basis.

Earnings above the RRSP limit in a year should be able to be carried back to years when earnings were below the RRSP limits (and any residual carried forward for future periods when earnings fall below the RRSP limits). Increased flexibility for withdrawals from RRIFs should also be considered.

Capital-gains rollovers: At present rollovers are limited to real business assets that are replaced by equivalent assets within the same CCA class. Rollovers are not allowed for investments in real estate or for personal-use properties (e.g., cottages). Without rollover provisions, capital-gains taxes can induce lock-in effects for these properties, reducing economic efficiency. Note that under certain circumstances a rollover provision may entail little or no revenue cost, since locked-in investments do not generate capital gains tax revenues.

Establishing a capital-gains deferral account, where individuals could contribute assets up to a lifetime limit, would enable investors to roll over financial assets without attracting capital-gains taxation. In 2006, we suggested that "Capital Gains Deferral Accounts" be established with a lifetime contribution limit of $150,000 aimed at middle-income Canadians who invest in the stock market.[26] This would entail an annualized federal/provincial revenue cost of $450 million.

FISCAL REVENUE EFFECTS

With both federal and provincial governments coping with large fiscal deficits, it is important that any pension reform measures do not undermine fiscal sustainability. However it is also important to evaluate the effects of these measures over a relatively long time horizon. The best criterion to use is whether the adoption of a reform would significantly increase the net present value of government spending less government revenues. For example, an increase in RRSP contribution limits would initially reduce government revenues, but future revenues would be higher when larger pension and RRSP payouts are taxed. There could well be little or no effect from this increase on the net present value of government revenues.

Other measures that would initially reduce government net revenues may induce behavioural changes that generate higher future revenues. For example, eliminating the overlap of the GIS clawback and the personal income tax would reduce revenues, but the reduction of the disincentive effects on work effort and savings for low-income Canadians will encourage them to generate higher future incomes that will provide some offsetting tax revenues.

[26] J. Mintz and T. Wilson, "Removing the Shackles: Deferring Capital Gains Taxes on Asset Rollovers," *Backgrounder*, No. 94, C.D. Howe Institute, Toronto, April 2006.

Because of possible concern about the credibility of governments' commitment to deficit reduction, it may be appropriate for reform measures that reduce current revenues to be phased in over time.

For example, our recommendation that the age limit for contributions to RRSPs and conversion of RRSPs to RRIFs be increased from 71 to 75 years could be phased-in over a four-year period. Similarly, increases in contribution limits could be implemented gradually and the behavioural effects monitored.

An expansion of CPP on a fully funded basis should reduce the consolidated government sector deficit, as additional contributions to CPP should exceed any reduction in federal and provincial tax revenues. The extent to which federal and provincial tax revenues would decline depends on the extent to which the additional contributions to CPP substitute for other pension savings — e.g., for defined-benefit RPPs that are integrated with CPP.

The effects of larger CPP on the size of the CPP investment fund need to be addressed.

A major argument against a large expansion of the CPP is that the CPP investment fund would become so large that it would play a dominant role in domestic capital markets. And if the upper income limit for CPP contributions were also raised, the fund would grow even larger.

The more modest augmentation of the CPP that we recommend for consideration would entail an increase in the CPP fund of about 60 per cent. Large, but manageable, particularly if the investments of the augmented CPP fund are made passively through exchange-traded funds (ETFs) or by increasing investments in foreign equities. To offset the cost further, one could consider increasing the age of eligibility for CPP benefits to 67 years, with a gradual phase-in beginning a decade from now.

Finally, as discussed above, increasing the age of eligibility for certain senior transfers and tax credits would provide savings to the government to offset the costs of a more efficient and fairer treatment of pensions.

CONCLUSIONS

Since 2009, Canadians have had a more difficult time accumulating wealth for retirement purposes, with sharply lower returns earned on investments. In this paper, several reform options are discussed to ensure adequate retirement income in the face of fiscal constraints faced by federal and provincial governments. There are a broad number of pension and tax reforms that would address many challenges that currently exist, with the objective of recognizing that Canadians live and work longer. Tax savings can be achieved by increasing age eligibility for a host of public pension and tax benefits provided to the elderly. It also makes sense to ensure that adequate policies are in place to provide income security for low-income Canadians, such as through a modest expansion of the CPP program (with increased age of eligibility) and improved guaranteed income supplement, with the additional costs covered by fiscal savings in other areas.

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Jack M. Mintz was appointed the Palmer Chair in Public Policy at the University of Calgary in January 2008.

Widely published in the field of public economics, he was touted in a 2004 UK magazine publication as one of the world's most influential tax experts. He serves as an Associate Editor of *International Tax and Public Finance* and the *Canadian Tax Journal*, and is a research fellow of CESifo, Munich, Germany, and the Centre for Business Taxation Institute, Oxford University. He is a regular contributor to the National Post, and has frequently published articles in other print media.

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