

## **SPPG Policy Institute**

**January 28, 2015**

### **Remarks by Bob Baldwin**

#### **Introduction**

The topic for this session is “Emerging Issues and Design Questions for the Canadian Context”

For half a dozen years discussions of pension reform in Canada have been dominated by a single issue

- How to respond to the prospect that an unacceptably large portion of the future elderly will likely experience a significant decline in their standard of living in retirement

While this issue deserves the attention it gets, there are other issues that deserve more attention than they are getting

I will enumerate some of these issues and then speak to the #1 issue in the form of a response to the main proposal to address this issue – viz the proposed ORPP

- I will address the design issue part of the topic in the context of the ORPP discussion
- The resolution to some of the issues I will identify in ORPP

Before I get into the lower profile issues, I need to say a word about how I will use the terms DB and DC as I may use them in ways that some of you will find unusual.

Typically pension benefit design is discussed in terms of a binary choice between DB and DC. Personally, I see benefit design as involving a spectrum of choice. At one end of the spectrum is pure DB with all financial risks being borne on variable contributions. At the other end is pure DC with all financial risks being borne in variable benefits. But in between these pure types there is a spectrum of choice in terms of risk is allocated between contributions and benefits. Thus at times I will use unfamiliar expressions like predominantly DB or having a DB element.

Earlier discussions today drew attention to plan designs outside of Canada that mix elements of DB and DC. Over the past decade there has been a good deal of exploration of this space by Canadian RPPs.

#### **Other issues**

##### **Changing structure of adult life since 1966**

- Increased longevity gets lots of attention

- Increased late life work
- Delayed entry into employment
- These changes suggest that a later age of retirement is appropriate
  - PM announced an increase in the age of eligibility from 65 to 67 to be phased-in between 2023 and 2029
  - No change announced for C/QPP or ORPP
- The demographic and labour market changes just noted also interact with a number of important details in the CPP (e.g. the definition of the contributory period, the drop out rules and so on)
  - The continuing suitability of those rules needs to be assessed
- Moreover, if labour market experience is becoming less uniform at both young ages and older ages – as I suspect is the case – then the role of chronological age in defining pension entitlements needs to be reassessed
- The case for increasing the age of eligibility is strong, one caveat needs to be placed on this general direction of change
  - If increased age of eligibility: how to address involuntary retirement
    - Separate eligibility for Allowance/GIS from OAS (and C/QPP)
    - There are incentive issues to address in contemplating this issue

### **OAS/GIS benefit levels**

- OAS and GIS benefits are price indexed for many years this has protected not only the purchasing power of the benefits, it has also been sufficient to protect their value relative to AWS as AWS has not increased in real terms
- looking ahead, it is likely that the slowdown in labour force growth in the years ahead will lead to upward pressure on real AWS and the value of OAS and GIS will likely start to decline in relation to AWS
- declining relative value of OAS and GIS adversely affects both the achievement of a minimum income standard and an earnings replacement objective
  - The earnings replacement role of OAS tends to get under-estimated
  - OAS gives the earnings replacement function in Canada a progressive twist
  - The relative decline in OAS and GIS will have its greatest impact on total incomes at the low end of the income distribution

- MW slides highlight this issue
- Levels need a regular review

### **Incentive effects of GIS and PIT rules for people with low earnings**

- Impact retirement saving and choice of employment versus retirement
  - o Little incentive to save or to remain in retirement
- Some recent changes to GIS were designed to reduce the disincentive to engage in employment
  - o Not aware of any study of the impact

### **Workplace pensions (RPPs)**

- Even with ORPP/CPP expansion, there will still be a significant role for RPPs
- In early 2000s, RPPs were in financial difficulty and questions arose about the appropriateness of the financing requirement they faced
  - o Inquiries in several jurisdictions addressed this issue
  - o A common conclusion was that formerly pure DB plans needed to adopt designs that incorporate features of DB and DC
  - o Both regulatory law and tax law were seen as barriers to moves in this direction
- accommodating new designs: regulatory and tax laws
  - o progress made on the regulatory front; work is needed on the tax side
- organizational platforms for RPPs
  - o most individual employers are not suitable platforms
  - o creative thinking about alternatives: sector or industry organizations; community based organizations
- inquiries into the problems of RPPs lead to the current debate

### **Governance of public pensions (Skip)**

- CPPIB not a problem
- Need to open up triennial review of CPP contributions
- Support for ongoing research on pension and retirement income issues
  - o Take a page from US social security

These are some of the issues facing Canada's retirement income system that are, quite properly, lower profile than the central issue in the debate. But they probably deserve more attention than they get. They also intersect with some of the issues that I will raise with respect to the ORPP.

### **Nature of the Current Debate and its Analytical Underpinnings**

- I will begin this part of the presentation with a quick reinder of how the debate got to its current state
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- The current debate on pension reform has been going on for half a dozen years. It has been dominated by a concern that an unacceptably large portion of the future elderly will face a significant decline in their standard of living in retirement
  - o concerns driven primarily by an awareness of declining participation in workplace pension plans
  - o also by concern about the high cost of retail saving for retirement
- Governments and stakeholders moved very quickly to recommend a modest increase in CPP benefits as part of the solution to this problem
- But the Govt of Canada terminated discussion of this issue among FPT finance ministers
- Ontario has responded by saying it would create an ORPP
  - o Most prominent policy response to the issue by a Canadian government
  - o The ORPP proposal has become the focal point for discussions of pension reform
  - o Ontario has presented the ORPP proposal as a second best solution to CPP expansion
  - o The ORPP design is still a work in progress but what has been said about it to date, indicates that its design and underlying analytics draw quite freely from the CPP
    - In part to set the stage for future CPP expansion

The concern that animates the current debate has a strong analytic underpinning. A number of detailed studies that affirm the concern about a sizable portion of the future elderly experiencing a significant decline in their standard of living

- These studies also conclude that
  - o The inclusion of housing wealth in the analysis matters but does not change the picture significantly (explain why this is relevant)

- Because of the structure of our existing public pension programs, the prospect of declining living standards is largely a problem for people with moderate earnings and above
- Individual retirement savings do not fully substitute for non-participation in a workplace pension plan (Horner and McKinsey)

Against this background, I want to the ORPP proposal to address a number of design issues. Much of what I will say about the ORPP applies to a modest CPP expansion as well.

### **ORPP Design: What's To Like**

I will begin by noting what I see as three features of the ORPP proposal that are appropriate for dealing with the issue at hand..

- 1) **The decision not to rely on the voluntary initiative of employers and individuals** to address the central concern in the debate is warranted by the analytical work that has been done on the issue. It should be noted too that compared to other OECD countries, participation in third pillar pension arrangements in Canada is already fairly high where participation is voluntary. International experience does not warrant a hope of a major improvement in voluntary participation in RPPs. I will return to this question of voluntary participation in a few moments.
- 2) Subject to what I will say about the range of covered earnings, I think **the target benefit level of 15% of covered earnings is appropriate**. It minimizes risks of over-saving beyond the average earnings level, and leaves scope for employers and employees to address concerns specific to industries and firms. Compared to the *status quo* it increases the political risk to retirement incomes, but does so in a constrained way. Combined with OAS, the earnings replacement function will still have a progressive tilt. Compared to other OECD countries, the resulting GRR would be close to but just below the OECD average GRR at AWS from pillars 1 and 2. The GRR would be several several pp below the OECD average GRR at 1.5 x AWS
- 3) **The notion that a new initiative should wrap around existing RPPs** that can provide comparable benefits also strikes me as appropriate. There is value in firms and industries addressing their specific pension and retirement needs if they are able to do so. I am also mindful of the fact that in many cases the benefits provided by RPPs are greater than those provided by the CPP and the proposed ORPP – e.g. ancillary benefits and annual rates of benefit accrual. I would note too that the decision to have the ORPP exempt members of RPPs that provide comparable benefits is a departure from the CPP as we know it.

If the wrap around approach is adopted there is an obvious need for an effective protocol for people moving into and out of employment covered by the ORPP. The ease or difficulty of dealing with moves in and out of covered employment will depend on the benefits design that is ultimately adopted for the ORPP.

## **A Major Problem**

Despite these virtues in the ORPP proposal, the proposal as it now stands includes three incompatible features:

- 1) The ORPP will be fully funded;
- 2) It will have a fixed rate of contributions; and,
- 3) It will have predictable benefits.

Unfortunately, this combination of features conflicts with a basic axiom of pension plans which is: the more certainty that is placed on the benefit side of a pension plan the more uncertainty there will be on the contribution rate side and vice versa. Predictable benefits and predictable contributions are both desirable. But you can't have both.

Clearly something will have to give in the proposal.

This is not just an ORPP issue. It also applies to a modest CPP expansion. I will add too that the analytical work that has been done on the CPP in recent years implies that the investment portfolio that will back new CPP benefit promises will have a high allocation to equities.

I will return to this question as one of four design issues that I will address.

## **Four Design Issues**

There are literally hundreds of design issues that have to be addressed in formulating the ORPP and/or an expanded CPP. I will address four issues that I regard as among the most basic design issues.

### **1) The range of covered earnings:**

The central issue in the current debate is a problem faced by people with moderate earnings and above. People with earnings up to one half average wages and salaries are already able to replace about three-quarters of their gross pre-retirement earnings through OAS, GIS and the CPP as they currently exist.

Lifetime economic well being is likely to be reduced for people with low lifetime earnings if they are compelling to give up more pre-retirement consumption for a retirement benefit that will be largely offset by lower GIS benefits and increased PIT payments. Covering low earnings is likely to create forced over-saving for retirement.

The Province has indicated its preference for covering all earnings above the existing YBE which is about 7% of existing AWS and declining. I find the Province's case for this unconvincing.

I acknowledge that this issue could be addressed through changes to the GIS and the PIT

### **2) The degree of compulsion involved in participation:**

The real issue here is whether to adopt a mandatory or auto-enrollment approach.

The case for compulsion is strongest under two circumstances:

- 1) the benefit design is largely DB and adverse selection is a threat; and/or
- 2) the costs of non-participation to individuals and society is high.

The relevance of the first consideration needs to be assessed in light of the decision that is made on benefit design. The closer the benefit design comes to the DC end of the spectrum the weaker is the case for compulsion and the stronger is the case for auto-enrolment.

Opting out of participation in the ORPP entails some risks for individuals, households and for society. Otherwise the current debate would not exist. But, the experience to date with auto-enrollment suggests that opting-out is not widespread. Moreover, what is at risk for individuals and households is limited by the other elements of the RIS that are now in place.

Compulsion is a more decisive way to address the key issue in the debate. But, it is hard to see that the success of the reform initiative depends on it.

### **3) The degree of certainty in the benefit promise.**

From the perspective of plan members, providing a degree of predictability of benefits is highly desirable. But, as I noted before, benefit predictability can only be established along with some degree of contribution rate uncertainty. Moreover, there is a real risk that the contribution rate uncertainty will emerge in the context of difficult economic times when increased pension contribution will have unwelcome side effects.

Given the commitment to a fully funded reform initiative and the relationship between certainty of benefits and contributions, the plausible realm of choice is somewhere in the target benefits to DC range. My personal biases lie on the target benefit side of that choice. But, I would have to see some modelling that would satisfy me that a financially credible and understandable version of a target benefits plan could be created.

Moreover, while I would not want to see a pension system as a whole that was purely DC, the tranche that is at stake in the current debate on pension reform is far less than the whole system. If the choice of benefit design was at the DC end of the spectrum of choice, the certainty of the overall sources of retirement income would not be altered significantly – especially after taking account of the interactions with other components of the RIS and the PIT.

### **4) The rate at which benefits are phased-in.**

As a practical matter this issue only comes into play if there is a DB or target benefit component to the reform option that is chosen.

To date virtually all proponents of reform have said or implied that new benefits would be phased in over 47 years and would be fully funded. To the extent that this assumption is explained, it is usually cast in terms of insuring intergenerational fairness by avoiding an intergenerational transfer of wealth from the currently younger to older generations.

If we take a pension reform initiative in isolation from all other transactions in society, I accept the reasoning on this point.

But, a pension reform that transfers wealth to the current elderly population is not unfair if it is coupled with tax financed initiatives that transfer wealth in the opposite direction. Examples of initiatives that fit that bill are education, environmental clean-up and infrastructure investments.

Canada's pension history is more in line with the notion of exchanges of wealth in both directions.

### **Concluding Comments**

Impetus for the current debate is well founded

No crisis but we can do much better

The ORPP is heading in the right direction but, as currently proposed, it includes features that incompatible. It is important for governments to take a fresh look at the design issues for the ORPP and/or a modest CPP expansion.

Unfortunately, governments are getting no encouragement from private stakeholders to take a fresh look at issues.

If governments are going to produce long lasting reforms, I think they will have to exercise greater thought leadership than they have to date.

Also, as I noted at the beginning of my presentation, there are a number of issues that deserve more attention than they are getting. Of those issues, the only one with respect to which substantial stakeholder involvement can be expected is the RPPs issues.

This is a very different debate then the Canadian debate of the 1970s and 1980s, and from debates in other OECD countries.

- Focus on future & earnings replacement
- Somewhat out of sync with Esping-Anderson characterization of liberal Anglo approach to social policy