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The Future of Pensions in Canada

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Pozzebon, Silvana, "The Future of Pensions in Canada" (2004). *Wharton Pension Research Council Working Papers*. 406.

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The published version of this Working Paper may be found in the 2005 publication: *Reinventing the Retirement Paradigm*.

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The Future of Pensions in Canada

Abstract

Canada's multi-pillar retirement income system includes a public pension pillar with both a poverty reduction program for the elderly funded out of general tax revenues, and a pay-as-you-go earnings-related income replacement program. Reforms implemented to partially fund the latter have probably increased the financial sustainability of Canada's public pension scheme, at least for the medium term. A second, relatively large, pillar of the nation's retirement income system consists of voluntarily provided employersponsored pensions. As employers adapted to the changing context of the last decade or so, two tendencies gradually became discernable: a slow decline in registered pension plan coverage, and a complementary shift from defined benefit to defined contribution pension arrangements, many of which allow employees to make investment decisions. Recent large unfunded pension liabilities among the former, coupled with the inherent riskiness of savings arrangements of the latter type, suggest growing retirement income insecurity for working Canadians.

Disciplines

Economics

Comments

The published version of this Working Paper may be found in the 2005 publication: *Reinventing the Retirement Paradigm*.

Reinventing the Retirement Paradigm

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OXFORD
UNIVERSITY PRESS

OXFORD
UNIVERSITY PRESS

Great Clarendon Street, Oxford OX2 6DP

Oxford University Press is a department of the University of Oxford.
It furthers the University's objective of excellence in research, scholarship,
and education by publishing worldwide in

Oxford New York

Auckland Cape Town Dar es Salaam Hong Kong Karachi
Kuala Lumpur Madrid Melbourne Mexico City Nairobi
New Delhi Shanghai Taipei Toronto

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Published in the United States
by Oxford University Press Inc., New York

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First published 2005

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British Library Cataloguing in Publication Data
Data available

Library of Congress Cataloging in Publication Data
Data available

Typeset by SPI Publisher Services, Pondicherry, India
Printed in Great Britain
on acid-free paper by
Biddles Ltd., King's Lynn, Norfolk

ISBN 0-19-928460-1

Chapter 13

The Future of Pensions in Canada

Silvana Pozzebon

The Canadian public pension system has been characterized as one of the best in the world. Over time, it has succeeded in decreasing poverty among the elderly by the institution of a series of targeted, flat-rate benefits which redistribute income to pensioners. Reforms in 1997 are widely held to have increased the financial sustainability of the first pillar pay-as-you-go earnings-related element in the public retirement income scheme. To bolster it against the pressures of an aging population, measures have been implemented to partially fund the plan. As a consequence, there appears to be a general sense of increased confidence, at least among the Canadian population, in the future of public pensions. The second pillar of the Canadian retirement income system consists of voluntarily provided occupational pensions, also known as private pension plans. Until recent media attention raised questions about the financial viability of many of these plans, particularly those of the defined benefit (DB) variety, most plan members took their occupational pension promises for granted. Yet with 84 percent of registered, employer-sponsored pension plan membership in 2000 covered by plans of the DB type in Canada, there is increasing cause for concern (Statistics Canada 2003*a*).

This paper assesses the resilience of these two key components of the Canadian retirement income system. The public pension scheme is reviewed first, as it has been the subject of various studies in the last few years, including several of a comparative nature (e.g. Disney and Johnson 2001). Attention is then focused on occupational pensions. This second pillar of the retirement income system has been less studied, yet it is currently facing numerous challenges in Canada. The retirement system's third pillar consists of private savings. Only private retirement savings vehicles that receive tax treatment comparable to occupational pension plans will be discussed in this paper. We argue that future challenges to both the public and private pension pillars of the Canadian retirement system will require regulatory reform in the medium term.

The Public Pension System in Canada

The Components. Canada's state pension scheme consists of two main pillars.¹ The first, the *Old Age Security* (OAS) program, includes three subcomponents: *OAS pension*, *Guaranteed Income Supplement*, and *Spouse's Allowance*. The OAS pension is a flat benefit available to those aged 65 and over with at least 10 years of residency. To receive a full pension, which represents approximately 14 percent of average earnings, forty years of residency after the age of 18 are required; the OAS pension is reduced proportionally for each year of nonresidency. Originally a universal pension, the OAS pension became a targeted benefit with the introduction of a 15 percent benefit 'clawback' in 1989 for higher income individuals. The benefit reduction applied to those with net incomes above C\$56,968 in 2001; once net income reaches C\$92,435, no OAS benefit is received.² The OAS pension is taxable and indexed quarterly to the Consumer Price Index (CPI).

The other two subcomponents of the OAS program, the *Guaranteed Income Supplement* (GIS) and the *Spouse's Allowance* are means-tested flat-rate benefits. The GIS targets low-income OAS recipients while their spouses (or widow/ers) with a minimum of 10 years of residency are eligible for a Spouse's Allowance. Both are nontaxable, and like the OAS pension, indexed quarterly to the CPI and financed out of general revenues. Benefits for recipients who receive maximum benefits from these two income supplements represent 31 percent of average earnings for a single person and 50 percent for a couple (World Economic Forum Pension Readiness Initiative 2004b, henceforth WEFPRI)

The second major pillar of Canada's state pension is a compulsory, pay-as-you-go earnings-related scheme. Except for the residents of Quebec, who contribute to the provincially administered Quebec Pension Plan (QPP), employed residents of the rest of Canada are covered by the federally administered Canada Pension Plan (CPP). Contributions between plans are fully portable and the two plans offer similar benefits under its four major transfer programs—retirement benefits, survivor benefits, disability benefits and death benefits.³

CPP retirement benefits are set at approximately 25 percent of average pensionable earnings over the contributory period, adjusted for the mean increase in maximum pensionable earnings during the five years before retirement.⁴ A person's contributory period spans the years between his eighteenth and sixtyfifth birthday (or the retirement date if retirement occurs between age 60 and 64). Some periods of low or no income can be dropped from the contributory period including up to 15 percent of the months when earnings were lowest. The normal retirement age under the CPP is 65, though benefits can be obtained as early as age 60 or as late at 70; a 6 percent annual reduction (increase) in benefits applies for those who

opt to receive a pension before (after) age 65. Retirement benefits accounted for 70.5 percent of total benefits paid out in July 2003 by the CPP and QPP combined (author's calculations using Table 13-1, Chawla and Wannell 2004). The lion's share of the remaining payouts was attributed to survivor benefits (15 percent) and disability benefits (11 percent).

As the pay-as-you-go pillar of the public scheme matured since its inception in 1966, the C/QPP share of total transfer payments to seniors increased relative to that of the OAS program. In 2001, C/QPP benefits accounted for 48 percent of total government transfers to families receiving C/QPP whose major income recipient was 65 and over, while the OAS share was 43 percent the comparable figures for 1981 were 62 percent for OAS and 30 percent for C/QPP (Chawla and Wannell 2004).

The CPP plan is financed essentially by contributions split evenly between employees and employers. Combined premiums increased slowly at a rate of 0.2 percent annually from 1986 to 1996 when they reached 5.6 percent of maximum contributory earnings. As a result of demographic changes and benefit improvements, CPP transfer payments exceeded contributions by the early 1990s. To respond to the crisis, a reform in 1997 implemented a rapid increase in contributions to the 2003 level of 9.9 percent where they are projected to remain for some years.⁵ Premiums have been set high enough to permit the accumulation of surpluses until 2021 (MacNaughton 2004).

Under the 1997 reform, the management of CPP surpluses was relegated to the CPP Investment Board. Created in December of 1977, the CPP Investment Board is an independently governed and managed Crown corporation. It was set up to oversee the investment of CPP reserve assets 'to maximize return without undue risk' in a diversified portfolio of securities including stocks, real estate, bonds, and private equities (MacNaughton 2004). For some five years now, the CPP Investment Board has been actively investing funds that are segregated from general government revenue. Professional investment managers have been employed to assist the CPP Investment Board in managing the private equity components of the reserve fund. Though independent, the CPP Investment Board is held to high standards of accountability; it is subject to external audits and has a wide-reaching disclosure policy. In September 2003, CPP reserve assets totaled C\$64.4 billion (about 2.9 years of benefits)⁶ and they are projected to reach some C\$160 billion over the next ten years (MacNaughton 2004).

How Resilient is Canada's Public Pension System? As is true for many developed countries, Canada's population is aging rapidly. Those 65 and over accounted for eight percent of the population in 1971, 13 percent in 2001, with the percentage projected to rise to 15 in 2011, 19 in 2021, and 21 by 2026 (Duchesne 2004). While Canada's situation may not

currently be as 'critical' as that of some European Union countries, such as Italy or Spain whose population age structures already exhibit an inverted pyramidal form, declining fertility rates (from 3.7 in 1950 to 1.6 in 2000), rising life expectancies, and the looming retirement of the baby boom generation is expected to produce a labor shortage over the 2020s in Canada (WEFPRI 2004*a, b*).

Dependency ratios, defined as the ratio of the inactive population over 55 years of age to the labor force 15 years and older, are projected to almost double between 2000 and 2030 in Canada from 0.31 to 0.60 respectively (WEFPRI 2004*b*). These figures suggest an important rise in public pension plan expenditures in the future.

The evidence indicates that Canada's public retirement scheme has successfully reduced poverty among the elderly and income inequality among pensioners to date (cf. Hoffman and Dahlby 2001). These results are in part attributed to the highly progressive nature of the public pension system, as it favors low income earners. Some would advocate an even more progressive system (as the 1996 debate over the rejected Seniors Benefit Program suggests; see Battle 2003), while others, such as the Association of Canadian Pension Management (ACPM) (2000), characterize Canada's retirement income system as already unfair for higher income workers. The ACPM goes further, stating that poverty-level measures used to assess the adequacy of minimum government transfer payments for the elderly (OAS and less important supplemental assistant programs from the provinces) are too generous.

The Chief Actuary of Canada appears optimistic that changes made to partially fund the CPP will ensure its long-term viability, but there is room for pessimism here as well. For example, higher contribution rates may be required if the CPP Investment Fund does not attain its projected rate of return or if other actuarial assumptions, which underlie the long-term maintenance of the 9.9 percent premium, are not met. Additionally, the management of public pension reserves has typically been fraught with problems related to governance, investment policy, reporting, and disclosure, among others (Pension Research Council 2003). In fairness, it should be noted that the creation of the CPP Investment Board has been welcomed by leading experts as a positive experiment in how reserves from partially funded pay-as-you-go systems can be insulated from political interference⁷ (Pension Research Council 2003; MacNaughton 2004).

In view of Canada's already high tax rates and sizable public debt, there is also some cause for concern that future generations will bear a disproportionate tax burden to support rising public pension expenditures (financed both from general tax revenue and payroll taxes on earnings). Yet high tax rates can act as a disincentive for employees, reducing labor productivity that can, in turn, slow economic growth (WEFPRI 2004*a*). Moreover, the effects of higher pension costs must be considered in the

context of rising expenditures required to support Canada's already ailing public health care system.

To sustain economic growth needed to maintain living standards as the population ages, two broad levers are available: increasing productivity growth and increasing labor supply (WEFPRI 2004a). Like most developed countries, Canada has experienced labor productivity growth since World War II, though its pattern of growth during the last three decades appears to have been more consistent than that of other Organization for Economic Cooperation and Development (OECD) nations (WEFPRI 2004a). The increasing service orientation of the economies of developed countries like Canada makes significant future growth in labor productivity unlikely, however.

A second, more publicized, solution to alleviate the economic consequences of aging populations in rich countries is to increase labor supply. Three possibilities exist: induce greater labor force participation among seniors, do the same for other demographic groups (e.g. women or young people) with low workforce active rates; and increase immigration. It is believed that targeting efforts to increase labor force activity of those age 55+ will have an important impact in Canada, because the gap in the labor force participation rate for this age group is largest when compared with the average participation rates of the five OECD countries with the highest workforce activity (WEFPRI 2004b). In fact, the median retirement age in Canada was sixty-five in 1975, which then fell slowly until 1986 and then more sharply to 60.6 in 2002 (Duchesne 2004; Statistics Canada 2003b). Data also show that 43 percent of retirees were under sixty years of age during the five-year period from 1997 to 2001. Factors contributing to the early retirement trend were the lowering of the minimum age requirements from sixty-five to sixty for Q/CPP eligibility, other early retirement incentives introduced in corporate pension plans as a response to downsizing, and restructuring efforts during the last two decades.

Expanding labor force attachment among the elderly poses several challenges, among which are the need to make structural adjustments to pension programs (delaying early retirement eligibility is one obvious option); and tax laws which often act to decrease pension wealth for those who delay retirement in Canada. Though gradual withdrawal from the labor force may offer an interesting alternative for seniors who would like both more income and time to pursue leisure activities, the current system penalizes those who opt for phased retirement (Smolkin 2003). The quest for labor market flexibility in the new economy has begun to generate an unprecedented number of atypical employment opportunities (part-time, contractual, on call, seasonal, etc.) that may prove increasingly attractive to seniors in the future. This is particularly likely as the elderly now face longer lifespans in better health than in the past. Encouragingly perhaps, the labor force participation of Canadians age 65+ rose faster

than the overall growth of the same age group in the population recently (20 percent vs 11 percent from 1996–2001), and the average senior still on the job is aging (Duchesne 2004).

Employers also have a role to play by offering agreeable work environments to attract and retain older employees. Yet the high stress levels and increasingly heavy work loads that characterize the Canadian health and educational sectors are often said to have driven many of these workers, typically covered by good pension plans, to early retirement. Of course, if employers respond to high labor costs in developed countries such as Canada by outsourcing jobs to less developed nations, the projected labor shortage may never develop. An optimistic scenario would anticipate that the capital invested by Canada's funded private occupational pensions and partially funded public system (for example, the CPP Investment Board) would sustain aggregate consumption and output levels.

When all is said and done, one can conclude that Canada's public pension system currently meets income adequacy standards for lower income individuals and poor seniors. The move towards partial funding of the public pension scheme has likely increased the financial sustainability of its earnings-related component, the CPP, for the medium term. But the impact of future challenges and the ability of the system to adapt remain uncertain. The example of the QPP, whose population base is aging faster than that of the rest of Canada, is perhaps indicative. A recently released Working Paper by the Régie des Rentes du Québec (2003*b*) which administers the plan, includes a proposal to modify the calculation of the QPP benefit so that, in the future, eligible individuals who have worked fewer than forty years between age 18 and retirement (e.g. many of those who retire early) will receive lower benefits than under the current system. In fairness, the QPP Working Paper also proposes other provisions to encourage later retirement, such as allowing those who work after age 65 to accumulate benefits up to the age 70 at a rate of 0.7 percent per month of work, rather than at the current 0.5 percent.

Private Pensions in Canada

The Components. The second major pillar of the Canadian retirement income system consists of occupational pensions that are voluntarily provided by employers and some unions. Canada belongs to a group of developed nations where such private plans play a relatively important role in providing income for the elderly (Disney and Johnson 2001). Thus private pension payments to elderly Canadians amounted to 29 percent of their total income (in 1999; Statistics Canada 2003*a*). Evidence also suggests that pensioners age 60–64 receive a higher percentage of their income from private plans than do older pensioners (Hoffman and Dahlby 2001).

Under Canadian law, *registered pension plans* (RPP) are the most common type of employer-sponsored plans. These are subject to minimum standards prescribed by federal and provincial pension legislation. Contributions for both employers and employees are tax-exempt and subject to annual limits.⁸ In 2000, the percentage of paid workers covered by RPPs was 40.6 (Statistics Canada 2003a).⁹ Of the 5.4 million RPP participants in that same year, 54.3 percent worked in the public sector. The vast majority of Canadian RPP members have historically belonged to DB plans, with virtually all others in defined contribution (DC) plans of the money-purchase type. DB plans accounted for 84 percent of RPP membership in 2000; the proportion of overall RPP participants in final earnings plans was sixty; 73 percent of RPP members are in contributory plans. While virtually all public sector employees belong to contributory plans, only half (51 percent) of private sector workers do. Contribution rates are set at five or more percent of earnings for 72 percent of workers in such plans. Most Canadian jurisdictions now set vesting provisions at two years of membership or service.

Despite the historical bias toward DB plans, an increasingly popular form of occupational pensions in Canada is *group registered retirement savings plans* (group RRSPs). These are similar to registered DC plans mentioned above, in that contributions made by workers and investment returns receive tax-deferred treatment. By contrast, group RRSPs typically offer a wider range of investment choices, and employer contributions to these plans are treated as nondeductible employee earnings. Group RRSPs are essentially 'pooled' individual registered retirement savings plans (RRSPs) (see below) to which employers typically 'facilitate' access by underwriting administrative charges and deducting employee contributions directly from payroll. Group RRSPs are not subject to pension legislation, so that, unlike RPPs, employers are not required to contribute to them and lump sum withdrawals are permitted unless the plan specifies otherwise.

Briefly, individual RRSPs are voluntary retirement savings vehicles available to those with work income. Canada's income tax law since 1991 accords tax advantages to employee RRSPs contributions similar to those granted RPPs. As a consequence, workers not covered by RPPs (or the self-employed who are ineligible for RPP participation) can save up to 18 percent of earnings in a tax-sheltered individual RRSP to the maximum allowable (C\$14,500 in 2003). Additionally, employees for whom the pension adjustment (a calculated value of annual pension credits accumulated in their RPP) is lower than the tax-exempt limit set for RRSPs, may elect to contribute to an RRSP, or a group RRSP if one is offered, up to the allowable limit. Investment returns on funds accumulated in RRSPs are also not taxable. RRSP savings can be withdrawn at any time¹⁰ but, unless used to buy a home or to finance full-time education, taxes are withheld when funds are removed.

Unfortunately, no official statistics are collected for group RRSPs. Using annual data reported by *Benefits Canada*, probably the best-known publication for employee benefit professionals in Canada, it is estimated that assets held in group RRSPs have grown 178 percent during the last decade, from C\$9.4 billion in 1993 to C\$26.1 billion in 2003 (Benefits Canada 1993; Sharratt 2003). As a relative measure of the importance of group RRSPs, consider that in 2003 they accounted for 47 percent of all administered assets for the DC plan market, which includes both plans covered and not covered by pension legislation (Sharratt 2003).

A number of changes have affected the configuration of the Canadian private pension system, at least since the early 1990s. Official statistics are suggestive and anecdotal evidence from professional publications and the wider media provide strong hints that at least two trends are discernable. The first is a decline in the relative importance of pension plans covered by pension legislation (i.e. RPPs) in favor of savings vehicles, such as group RRSPs, which are not covered by these laws. A second trend, which complements the first, is a shift from DB plans, which have traditionally been the focus of most pension legislation, to those of the DC type. Growth in the latter segment is probably most pronounced outside the pension regulatory framework.

Pension plan coverage data is perhaps most revealing of the decreasing role of RPPs. Coverage of paid workers by a RPP fell slowly from 1991 when it was 45.4 percent to 40.6 percent in 1998, where it stabilized to 2000 (Statistics Canada 2003a). Several reasons may explain this decrease: structural shifts in employment patterns from sectors such as manufacturing to services and the related decline in unionization; shrinking public sector employment during most of the 1990s; important job growth during this same decade among the self-employed who are ineligible for RPP membership; and high pension administrative and financial costs in a context of increasing global competition (see Pozzebon 2002 for an overview).

While official statistics are suggestive, other evidence supporting the move from DB to DC plans is more anecdotal. Statistics Canada data does show that the proportion of total RPP plan membership in DB plans fell 9 percent between 1984 to 2000 (from 93 to 84) while that of DC plans rose by almost the equivalent amount (8.6 percent) (Pozzebon 2002; Statistics Canada 2003a). No official statistics support the allegation, and as the discussion above on group RRSPs indicates, growth in DC plans has not been confined to those covered by pension laws. A quick scan of the contents of professional journals in the benefits area over the last decade, such as *Benefits Canada*, further suggests that change is afoot. Unfortunately, it is difficult to discern from the information currently available how much, if any, of the DB to DC shift involves conversions to plans covered by pension legislation or can be attributed to the creation of new plans both within and outside the regulatory framework.

The loss of popularity of DB plans may have been fuelled by many of the same reasons noted above for RPPs (Pozzebon 2002). These include a fall in employment among more highly unionized industries like manufacturing and the public sector where DB plans have been prevalent. The market boom of the 1990s, coupled with easier access to financial information and opportunities to self-direct one's investments through the Internet, also contributed to making DC plans more attractive. And, younger workers who no longer expect long-term employment relationships probably appreciate the greater portability of DC plans relative to their less flexible DB counterparts. Employers too may be drawn to DC plans which are less complex to administer and have more predictable costs than DB pension plans.

How Resilient is Canada's Private Pension System? Many have argued that the slow decline in RPP coverage should be a matter of concern to those interested in retirement security. If the purpose of pension legislation is to protect plan beneficiaries and the soundness of pension funds, then one might surmise that workers would be better off with plans operating in a regulatory framework. Plans outside this protective umbrella, like group RRSPs, may result in lower levels of retirement savings if, for example, employers fail to contribute to them; or they make only sporadic, low, or stock-option-only contributions; or if employees are permitted to withdraw funds and make their own investment decisions.

Though group RRSPs are induced to some extent by tax incentives, there are also many other types of pension agreements outside the regulatory framework that offer an even less certain promise. The case of higher income earners is illustrative here. Due to Canada's much criticized low limits for tax-advantaged RPP contributions, it has become more difficult over time for higher-income earners (earning approximately twice the average wage) to set aside retirement savings sufficient to maintain living standards in old age. The maximum amount of pension entitlement per year of service that could be earned under RPPs remained frozen at C\$1722.22 from 1977 to 2003; the amount rises to C\$2000 in 2005, after which it will be indexed to increases in the average Canadian wage. As a consequence of these limits, some employers have provided a supplementary employee retirement plan or stock option plan. The extent to which such plans are pre-funded is unknown, and in the wake of the Enron scandal, it is legitimate to question the security of pension arrangements built on company stock. These factors must further be considered in the context of Canada's progressive public pension system which emphasizes the role of private pension income for higher earners.

The DB to DC shift may be worrisome, in that DB plans are viewed by many as synonymous with retirement security. They offer fixed pension

benefits payable on a regular basis and employees assume no responsibility for investment or saving decisions. But recent events have increasingly threatened the notion of security traditionally associated with private DB plans in Canada, as elsewhere. For instance, various high profile cases have demonstrated the fragility of DB pension plans in situations of corporate insolvencies (or near-insolvencies), which incidentally have been linked to large unfunded pension liabilities. The Air Canada and Stelco cases are two examples from a long list of established firms that have been adversely affected by competitive pressures over the last decade. Moreover, Ontario is the only Canadian jurisdiction that has established a pension insurance fund that secures partial benefits (to a maximum of C\$1000 per month) in the case of a DB plan insolvency. Set up in 1980 and funded by employer contributions, the Ontario Pension Benefits Guarantee Fund is currently under scrutiny. With only some C\$230 million in reserves, questions about its sustainability are being raised should it be called upon to help bail out Stelco's C\$1.25 billion pension shortfall (Livingston 2004; Reguly 2004).

Another related consideration is that the market downturn that followed the boom of the 1990s produced substantial DB plan unfunded liabilities. No Canada-wide estimates appear to be available, but a study of the nation's 104 companies on the SandP/TSX index with DB plan assets over C\$10 million indicates that 78 percent of these firms had pension shortfalls in 2002 (Church 2003*a*). Another report by the Dominion Bond Rating Service found 84 percent of the 263 Canadian DB plans studied had deficits at the end of 2002, with close to one-quarter of the plans being less than 70 percent funded (McFarland 2003). Using a larger sample of 1040 Canadian DB pension plans, a joint study by three consultancy companies—Mercer, Towers Perrin and Watson Wyatt—concluded that funding levels were generally about 85 percent (Church 2003*b*). These figures approximate those of the Régie des rentes du Québec (2003*a*) which supervises that province's private pension plans. It estimates that, as of December 31, 2002, some 70 percent of DB plans under its jurisdiction were underfunded, but assets covered more than 80 percent of obligations in the majority of cases. Finally, a recent estimate places the collective balance sheet deterioration of Canadian DB plans at 30 percent for the three-year period ending in 2002 (Ambachtsheer 2004).

Sizable pension asset shortfalls have brought to light 'fuzzy' embedded risks in DB plans, and they have also focused attention on problematic pension accounting, investment practices, and governance issues (Ambachtsheer 2003, 2004). For instance, a generally accepted accounting and actuarial practice, smoothing techniques for the calculation of pension assets and liabilities, has served to 'camouflage' the unfunded status of many private Canadian pension plans. Accounting standards bodies all over the world have recently undertaken initiatives to review these practices (see Chapter 10). Though the market upturn in 2003 may draw attention

away from the issue, the events of the last few years have highlighted the need for more transparency and communication so employees better understand the risks associated with DB plans and investors in general (many of whom are investing pension assets) can better evaluate the financial health of firms.

The booming markets of the 1990s resulted in more risky behavior among pension fund managers, many of whom increased equity exposure. As a consequence, several pension funds accumulated surpluses that were used to justify contribution holidays, and sometimes, to improve benefits. But the subsequent financial instability of many funds raises questions about pension fund governance practices. The response of the Canadian pension community was exemplified in a 2003 release of draft pension governance guidelines and a draft self-assessment questionnaire by the recently created *Canadian Association of Pension Supervisory Authorities* (CAPSA 2003). It may be anticipated that the promotion of better governance practices would help address issues arising from the inherent conflict between the increasingly short-term financial horizon of many firms, and the longer view required for the effective management of pension plans. How successful this effort will be remains an open question, particularly since the application of these principles appears to be voluntary.

What about the DC promise? While many workers embraced DC plans during the 1990s when financial markets were doing well, the negative returns from the 2000 period have brought home a harsher reality. There is growing awareness of the vulnerability of employees with DC pension plans; they may simply not accumulate enough retirement saving, especially if plans allow them control over participation, contribution, and investment decisions. By now, few would argue that the average employee has the savvy to construct an adequate investment portfolio focused on long term goals. The fact that many DC retirement savings vehicles are not covered by pension legislation and supervision in Canada adds to concerns.

Some have sought to address the problems raised by allowing employees to select investment options in retirement savings arrangements. For instance, the *Joint Forum of Financial Market Regulators*, a Canadian industry taskforce, has recently proposed guidelines for capital accumulation plans (defined as DC plans and other investment vehicles where employees are entitled to make investment decisions; JFFMR 2001). The stated purpose of the guidelines is to harmonize protection of the many different types of investment products across varying regulatory regimes (securities, insurance or pensions) so that members of capital accumulation plans have the information and assistance needed to make investment decisions. While these efforts are well-intentioned, they must be considered in light of the Canadian context where the nature of the pension sponsor's fiduciary duty remains unclear. Even if the Joint Forum's efforts are successful, they could prove more useful in bolstering protection for employers than employees.

Sponsors who adopt guidelines may be better armed against legal actions that could be brought against them by retiring employees unhappy with pension plan returns (Smolkin and Satov 2004).

Whether the provision of financial education will be effective in helping employees with capital accumulation plans make better investment decisions is far from clear. One of the least 'radical' solutions might be a return to something resembling the more cautious, early DC pension market approach, of offering a very limited number of investment bundles with different risk levels. Such an approach would be doubly interesting if it served to reduce the management fees for DC plans offering investment options. Estimates indicate that the median fee on mutual fund products targeted to individual investors was 2.4 percent in Canada (in 2000), some 1.4 percent higher than the median fee for pooled funds¹¹ offering institutional products to corporate investors (Ripsman 2000).

Looking ahead, the question arises as to whether the decline in RRP and DB plans will persist. What many employers perceive as burdensome pension legislation which targets DB plans especially may discourage some from continuing to offer these plans. This is particularly true for firms that operate in different provinces, and hence, must obey separate regional pension regulations; firms with employees in more than one province sponsor some 23 percent of Canada's pension plans (Rubin 2004). In an effort to promote greater statutory uniformity across Canada, the CAPSA has circulated proposed regulatory principles for a model pension law (CAPSA 2004). This model law is derived from current 'best practices' intended to serve as examples when jurisdictions amend their pension statutes.

This first consultative step toward greater harmony and simplification of pension legislation is intended to conserve RPPs. Yet some of the proposals inspired by Quebec's pension law—immediate vesting and the establishment of a pension committee¹² to act as administrator of the plan—may be interpreted by some sponsors as an added burden. Exempting small plans from the pension committee provision may, on the other hand, generate a more favorable response from other employers.

Even if greater legislative harmony is achieved, the administrative and financial burdens of DB plans make it unlikely that many employers will establish new DB plans, given the highly competitive global economy. The need for flexibility in employment relations will grow in the future in the context of the projected labor shortage. Turnover reduction efforts will probably be focused on a core group of employees whose services employers expect to retain at most for a handful of years. And it is hard to imagine that small and medium sized employers, particularly those that increasingly serve as lower-cost subcontractors for large firms, will be able to offer expensive and administratively cumbersome DB plans.

The shaky financial situation of Canadian DB plans may provide further motivation for some firms to terminate them altogether, though other

employers may opt to switch to a DC plan which will retain pension assets under the purview of pension regulation. Tax incentives for employers may also mean that not all new retirement savings arrangements will be made outside the pension regulatory framework. Moreover, DB plans are likely to persist for employees of Canada's large public sector where they are strongly entrenched.

Evidently, the private pension industry in Canada is at a crossroads. This far, change has been relatively gradual, as employers have adapted to environmental pressures by repositioning themselves in or around the old pension paradigm. These adjustments have tended to increase retirement income insecurity for employees, generally speaking, whether they had DB or DC pensions, but especially so when employees were permitted to make investment decisions. Responses so far have been piecemeal. Pension law harmonization efforts and recommendations to improve pension plan governance may prove effective, or they may just be wishful thinking. Of course given the poor performance of many investment professionals over the last few years, it seems doubtful that providing better investment education to employees will increase their economic security in retirement.

Conclusion

A multi-pillar approach with both funded and unfunded components is believed to provide a solid foundation for retirement income, due to the opportunities that such a system offers to balance long-term risks (Holzmann 1999). In Canada, the public pension scheme has both an unfunded component and a funded element, the CPP Investment Fund. The latter was adopted as a measure to improve public pension retirement security. The public system also embodies a balance between poverty reduction (the OAS program) and retirement income support (Q/CPP). The private pension system is generally considered the funded component of Canada's retirement system. It has proved successful in providing income replacement, particularly for those with higher incomes, who receive lower replacement rates from the OAS program due to the progressive nature of the public pension system.

Some might conclude from this overview that Canada's retirement system stands on reasonably solid ground at present. Nonetheless, it faces many challenges in the future. In particular, the private sector component appears to have weakened substantially during the last decade. The gradual shift from DB to DC, with a parallel move away from retirement saving arrangements covered by pension regulation, portend increasing insecurity for tomorrow's retirees.

To the extent that this shifting paradigm raises future retirees' dependence on the public component of the system, it may destabilize a system

already susceptible to demographic transition. As a result, more determined efforts to improve Canada's voluntary occupational pension system are needed, along with reforms to the Q/CPP. For instance, methods to encourage delayed or phased retirement could be a good starting point, along with a systematic overhaul of tax policy toward retirement saving. Additional review of pension governance rules and the plan sponsor liability environment would also be in order. In sum, strengthening the multi-pillar foundation of Canadian retirement income will require concerted and wide-ranging efforts.

Endnotes

1. The description of the public pension system draws especially on Hoffman and Dahlby (2001); WFPRI (2004*b*) and Chawla and Wannell (2004).
2. The exchange rate in March 2004 was C\$1.32 = US\$1.00.
3. To simplify the presentation, the discussion below focuses only on the CPP and retirement benefits.
4. Before 1998, a three-year average was used. The move to a four-year average that year and a five-year one in 1999 was part of the benefit reductions implemented by the 1997 reform described below. See Table 3.4 in Hoffman and Dahlby (2001) for a summary of other changes.
5. In 2003, contributory earnings equaled C\$36,400.
6. Author's estimate. Chawla and Wannell (2004) report that benefits paid under the CPP in July 2003 were C\$1.86 billion. Multiplying the monthly figure by twelve yields estimated annual benefits of C\$22.32 billion. C\$64.4 billion in the CPP divided by C\$22.32 equals 2.9.
7. The CPP Investment Fund was modeled on the Caisse de dépôt et placement du Québec which manages QPP funds in addition to those of other public and private sector depositors. But results for 2002 show that the Caisse experienced a 9.6 percent decrease in net assets (C\$8.6 billion) which represents its largest loss since its creation in 1966 (Sanford 2003). Much media attention has been focused on the Caisse's poor performance which is in part attributed to questionable investment decisions and lavish spending excesses for new corporate headquarters. Better market conditions and a major 'restructuring' of the fund has seen substantial improvement in the Caisse's performance in 2003 when it posted weighted average returns of 15.2 percent on overall funds held (Sharratt 2004).
8. The limits on employee contributions in 2003 were C\$15,500 for DC plans and the maximum annual pension accrual for DB plans was C\$1722.22.
9. Statistics throughout the paragraph are from this same source and for 2000.
10. Withdrawals are not permitted for locked-in RRSPs to which employees transfer their accrued RPP pension savings upon termination of RPP membership.
11. The median pooled fund fee of 1 percent assumes a 0.5 percent recordkeeping fee in addition to a 0.49 percent investment management fee.
12. At least two members of the committee must be designated by plan members, one to represent active participants and the other nonactive members.

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