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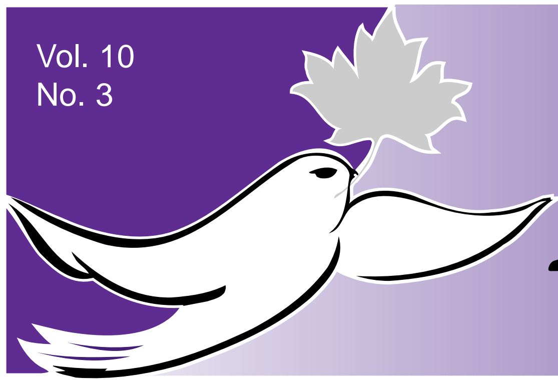

Expression

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NEWSLETTER OF THE NATIONAL ADVISORY COUNCIL ON AGING

Member's Editorial

Canada's Retirement Income System: Myths and Realities

The financial security of Canadian seniors has improved over the past 25 years, thanks to the development of a publicly-supported retirement income system. This system, however, is complex, comprising many different programs, with varying benefit levels, eligibility criteria and funding sources. The retirement income system is designed to protect seniors from poverty by providing a basic minimum income and to help replace income lost after retirement. It is composed of three levels.

At the first level are the Old Age Security (OAS) and Guaranteed Income Supplement (GIS) Programs. Every Canadian aged 65+ who meets the minimum residency requirement is eligible for OAS. The GIS is intended only for people aged 65+ who are in difficult financial

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circumstances.
Both OAS and GIS are funded through general government revenues.

The Canada/Quebec Pension Plan (CPP/QPP) constitutes the second tier. Only seniors who contributed to these plans during their working years and their surviving or divorced spouses or children are entitled to receive benefits. CPP/QPP is funded through contributions from employees and employers.

The third level consists of occupational pension plans, which are available to workers whose employers have established these plans, and Registered Retirement Savings Plans (RRSPs), which allow self-employed people and other individuals to set aside savings for their retirement.

As the number and proportion of seniors in the population increases, the costs of these programs will rise. The complexity of the retirement income system and the challenges of an aging population have provided fertile ground for the emergence of several misconceptions. What the National Advisory Council on Aging (NACA) found in delving into these myths is that many are unfounded. Facts simply don't support some of the more pervasive ones which largely revolve around the continued need of seniors for public pension programs and their long-term viability.

Dispelling myths about Canada's retirement income system is important. In the 1995 Budget, the federal government announced its intention to reform the retirement income system and proposed certain principles to guide this reform. NACA hopes that, armed with facts and a better understanding of how the retirement income system works, Canadians of all ages will be able to respond knowledgeably to the proposals that will be put forward by the federal government.

Hortense Duclos,
NACA member

Thirteen common myths

Myth No. 1: Poverty among seniors is no longer a problem

Fact: Poverty among seniors has declined over the last 25 years, but it remains high, especially for seniors who live on their own. In 1969, 41.4% of *families headed by a senior* had incomes below Statistics Canada's 'low income cut-offs' (which are accepted as poverty lines), while this figure was 9.4% in 1993. Unfortunately, *for seniors who live on their own*, the poverty rate remains high: it fell from 69.1% to 51.1% between 1969 and 1993. Among these, women are the poorest: in 1993, 55.8% were poor compared to 38.3% of men.[1]

Today, public pensions still do not guarantee an income equal to the poverty line. In 1995, OAS and the maximum GIS for a *single* person amount to $10,264. If a pensioner receives the maximum CPP/QPP retirement benefit, total public benefits come to $14,543. The poverty line for a single person living in a metropolitan centre of 500,000 or larger is $16,808. For a *senior couple* (both spouses 65 or older), the maximum benefits from OAS and GIS total $16,642 in 1995—$4,369 short of $21,011, the poverty line for two people living in a city of 500,000 or more.

Myth No. 2: Seniors are now better off than the rest of the population

Fact: In general, seniors are less well-off than the rest of the population. The average income of families headed by a senior was $40,572 in 1993, compared to $55,738 for *families* led by people under 65. For *single* seniors, the average income was $17,951, compared to $25,435 for non senior single Canadians. Only 26.1% of families headed by seniors had incomes of $50,000 or more in 1993, compared to 46.2% of all families.[2]

Myth No. 3: Seniors get generous tax breaks through the tax system

Fact: Seniors do receive some tax breaks, but the largest breaks go to seniors with modest incomes. Until recently, all seniors were entitled to claim an age credit when filing their income tax returns. In 1993, it was worth up to $918 in combined federal and provincial income tax savings. But the 1994 federal budget announced that this age credit will now be income-tested. The maximum credit in 1995, still $918, is available only to senior taxfilers with net incomes under $25,921 a declining credit goes to seniors with incomes between $25,921 and $49,100, while those with incomes above $49,100 are no longer eligible. Moreover, the age credit has been only partially indexed to the cost of living since 1986. It would have been worth $1,034 in tax savings in 1995 if it had remained fully indexed. Although the age credit will cost Ottawa and the provinces an estimated $2.2 billion in 1995-96, inflation is gradually eroding the value of the age credit. Seniors are also entitled to claim an income tax credit against the first $1,000 of pension income, which reduces their federal and provincial income tax bill by up to $264 on average. In 1995-96, the pension income credit will cost Ottawa and the provinces an estimated $465 million. But this tax break applies only to private pension income from employer sponsored pension plans, annuities and payments from a Registered Retirement Income Fund (RRIF). Many seniors have little or no income from these sources; only 49% of seniors who filed tax returns in 1992, for example, claimed the pension income credit.[3]

Myth No. 4: Women retiring in the future will be much better off because they will have pensions in their own right

Fact: The majority of women retiring in the future will indeed have spent most of their adult lives in the paid workforce, but they are likely to have a financially precarious retirement. While they will be entitled to CPP/QPP benefits in their own names, those benefits are equivalent to only 25% of their lifetime average earnings up to the average wage. The maximum CPP/QPP retirement benefit in 1995 is $8,558 per year, but few receive the maximum. The average CPP/QPP retirement benefit for women was only $3,288 a year as of August 1995, compared to $5,724 for men. Moreover, because of the sectors of the economy where they work and their generally low earnings, most women in the paid workforce do not have employer pensions and most do not contribute to Registered Retirement Savings Plans (RRSPs). In 1993, 42% of female paid workers were covered by an employer-sponsored pension plan, compared to 47% of male workers.[4] Only 21% of women who filed tax returns contributed to a RRSP in 1992, compared with 30% of men, and women contributed on average $2,444 as opposed to $3,399 for men.[5]

Myth No. 5: The government can no longer afford the rising costs of public pension programs like OAS and CPP/QPP

Fact: It is true that the aging of the population is driving up expenditures on OAS and the CPP/QPP, and will continue to do so well into the next century as the baby boomers enter old age. But whether Canada can afford rising public pension costs is a separate and quite contentious question.

It is important to remember that the government collects income taxes on OAS and, therefore, recoups part of the program's cost. Ottawa will recover an estimated $2.0 billion of the $16.5 billion it will pay out on OAS in 1995-96, and the provinces will collect an estimated $1.1 billion in provincial income taxes. The clawback on OAS

will bring in another $400 million, for a total federal recovery of $2.4 billion or 14% of gross OAS payments.

The federal government already has taken steps to limit future increases in expenditures on seniors benefits. The clawback of OAS will reduce the old age pensions of increasing numbers of middle-income seniors in the years to come because the income threshold for the clawback (which is only partially indexed to inflation) is falling steadily in value. Income-testing has cut the cost of the age credit, and partial indexation of the income tax system is steadily reducing the cost of tax benefits for seniors.

Measured as a percentage of the Gross Domestic Product (GDP), OAS expenditures have risen from 1.3%, when the program began in 1952, to 2.7% in 1995. But even assuming a low 1.5% real rate of economic growth in future, the OAS-to-GDP ratio will rise to only 2.8% by 2030 and then will decline steadily thereafter, falling back to its 1995 level by 2060. If GDP increases more (e.g., in the 3 to 4% range), then the OAS-to-GDP ratio will actually decline in future because economic growth will outpace OAS growth.

While OAS is funded by the general tax revenues collected by the federal government, the CPP/QPP is not. It is funded entirely by employer and employee contributions. The only real cost to government is the income tax credit for CPP/QPP contributions, which cost Ottawa and the provinces an estimated $1.4 billion in 1992. However, this cost is more than offset by the estimated $4.3 billion that the two levels of government collected in 1992 by taxing CPP/QPP payments. Since the CPP is not part of federal spending, questions of affordability' relate to whether or not employers and employees will be willing to pay increased contributions to the plan to offset the decline in the number of contributors relative to beneficiaries.

In 1995, employees must contribute 2.7% of earnings, up to a yearly maximum of $862, matched by a 2.7% contribution from their employers; the self-employed must pay the full 5.4%, up to $1,724. However, employees and the self-employed can claim a tax credit to help offset the cost of their contributions to the CPP/QPP. In 1995, the maximum CPP/QPP federal tax credit for employees is $147 and the maximum average provincial income tax savings is $80, for a total maximum tax credit of $227. In 1995, the maximum federal/provincial tax credit for self-employed Canadians' CPP/QPP contributions is $454. These tax benefits reduce the maximum CPP/QPP contribution to $635 for employees and $1,270 for the self-employed.

By the year 2030, it is projected that employee contributions will have risen to 5.8% of covered earnings.[6] This would amount to an estimated maximum $3,077 for workers with average earnings or more (in constant 1995 dollars), with a matching contribution from employers; the self-employed would have to pay 11.6% of their earnings up to the average wage, up to $6,154. In 2030, the tax credit for CPP/QPP contributions will reduce the maximum contribution to an estimated $2,266 for employees and $4,532 for the self-employed.

From the beginning of the CPP/QPP in 1966, it was understood that contribution rates eventually would have to rise to keep the plans financially viable in light of increased expenditures on Canada's aging population. The federal and provincial governments met late this autumn, according to their schedule of regular five-year reviews, to discuss future contribution rates for the CPP/QPP. In the future, there is no doubt that employees, employers and the self-employed will have to pay considerably more to maintain the CPP/QPP.

Myth No. 6: High payroll taxes required to fund the CPP/QPP puts Canada at a disadvantage compared with other countries

Fact: Canada enjoys an advantage relative to other countries in terms of the costs of pension programs. Pension contributions in other countries are actually substantially *higher* than those in Canada—both in terms of total revenues and in relation to employee compensation. A 1988 report from the Organization for Economic Co-operation and Development (OECD) estimated that pension contributions amounted to 8% of employee compensation in Canada, compared with 11.1% in the United States, 14.7% in Japan, 24.7% in Belgium,

34.8% in Austria, 36.6% in France and 39.4% in the Netherlands.[7]

Myth No. 7: The CPP/QPP is going bankrupt

Fact: The CPP/QPP is not funded in a way that makes it possible to go bankrupt. Many people do not understand how the CPP/QPP is funded and apparently believe there is a fund which will run out of money well before they get to retirement. However, unlike private employer-sponsored pension plans, the CPP/QPP does not have a fund from which pension benefits are paid. Instead, the CPP/QPP is a 'pay-as-you-go' plan. Contributions made by employees, the self-employed and employers pay for the pensions of those who are retired. As contributions come in from the current work-force, they are paid out in benefits to the current retirees.

Based on experience and actuarial calculations, the federal and provincial governments set contribution rates to provide the promised benefits for those who are retired. Like all social insurance programs, the CPP/QPP is backed by the taxing power of the government. For this reason, it is generally considered unnecessary to create a fund from which to pay the benefits.

A long-term financing plan for the CPP, which takes account of population aging, was established by agreement between the federal government and the provinces in 1985. Under this agreement, a 25-year schedule of contribution rates was set out in the *Canada Pension Plan Act* to keep the plan financially viable. It was agreed that contribution rates would be reviewed regularly every five years and adjusted, if necessary, to take account of current expenditures. At each five-year review, contribution rates would be extended by a further five years. Contribution rates have been established up to and including the year 2016. The agreement also provides that CPP contribution rates will be set to provide a contingency fund equal to about two years of benefits over time. (As manager of its own plan, Quebec has been able to act unilaterally in making adjustments to the QPP. On the whole, changes made to one plan have been eventually made to the other, so as to maintain substantial parallelism between the CPP and QPP.) Given this regular adjustment of CPP/QPP contribution rates, it is meaningless to describe the CPP/QPP as 'bankrupt.'

Myth No. 8: The CPP/QPP has billions of dollars in unfunded liabilities

Fact: The benefits promised to future retirees ('unfunded' liabilities) are guaranteed by the government's capacity to adjust rates of contribution to the CPP/QPP. Private occupational pension plans are required by law to have a fund from which pensions will be paid, so that there will be money to pay the promised benefits, regardless of what happens to the employer. Actuaries calculate what contributions will be required to fund the benefits, making assumptions about such factors as the demographic composition of the employer's work-force, the potential number of employees who will reach retirement, the length of time for which pensions will have to be paid, the rate of return that will be earned by the pension fund investments and the future rate of inflation. The promised benefits are the 'liabilities' of the pension plan. If liabilities have accrued and the fund is not adequate to pay them— for example, because the actuarial assumptions proved inaccurate or not enough contributions were made to the plan— the pension plan has 'unfunded liabilities'. A plan with 'unfunded liabilities' would not have enough money to pay the benefits if the employer went under.

By definition, a pay-as-you-go plan like the CPP/QPP does not have a fund. Current pensions are funded by current contributions, which in turn are backed by the taxing power of the government. As

the Royal Commission on the Status of Pensions in Ontario said in its 1980 report, "Sometimes the unfunded actuarial liability of the CPP, calculated as it would be for a private pension plan, is pointed to as an indication of the precarious position of the CPP... However, to relate this liability to the soundness of the Canada Pension Plan, which is premised on continuance in perpetuity, is meaningless. Like the fear of bankruptcy, it indicates an imperfect understanding of the nature of a social insurance program."[8]

Myth No. 9: The CPP/QPP won't be there when the baby-boom generation and its children retire

Fact: There is no CPP/QPP fund that is 'running out' and therefore will not be there when current contributors retire. The existing schedule of contribution rates, established for the next 25 years, ensures the CPP 'will be there' when those now in their 20s, 30s and 40s retire from paid employment.

Of course, governments could decide to abolish the CPP, but this would be a political decision with serious political consequences. Even if the federal government were to make such a proposal, it would (like all changes to the CPP) require the consent of two-thirds of the provinces having two-thirds of the population. It seems highly unlikely that the federal and provincial governments would agree to take such a step, especially since the CPP/QPP is superior in design to private pensions and individual savings plans. The CPP/QPP covers the entire work-force, including the self-employed and part-time workers; is fully indexed; provides disability, survivor, children and death benefits, in addition to retirement pensions; and is vested and portable. Occupational pension plans and RRSPs fail to meet these standards.

Myth No. 10: Now that people are living longer, we can expect them to work longer

Fact: Canadians are living longer, but retiring earlier. The life expectancy of a 65-year old man is now 15.4 years, compared with only 13.0 years in the 1920s. A woman the same age can now expect to live another 19.6 years, compared with 13.6 years in the 1920s.[9] But most Canadians now retire prior to age 65. In 1994, the average age of retirement was 61. Statistics Canada reports that the recession of the early 1990s contributed to the increase in the proportion of those who retired before age 65. Between 1989 and 1994, there was a 30% increase in the number of people reporting they had retired early because they had lost their jobs and were unable to find other employment.[10]

Finances are probably the key factor in the retirement decision. The higher the household income, the lower the retirement age. And there are significant differences between women and men when it comes to the age of retirement. Women most often cite health and family responsibilities as reasons for retiring early. Most married women apparently retire at the same age as their husbands— partly because married couples prefer to retire together, but also because wives may have to care for aging husbands. Given that women generally marry men who are older than they are, women are more likely than men to retire prior to age 65. As evidence, 65% of women who started receiving a CPP retirement benefit in August 1995 were under 65, compared with 57% of men.

Myth No. 11: There's less need for public pensions now that most people have RRSPs

Fact: RRSPs are largely the preserve of Canadians with above-average incomes. Although 77% of Canadians who filed tax returns in 1991 were entitled to contribute to RRSPs, only 31 % actually made a contribution.[11] The higher the income, the more likely a person is to have a RRSP. In 1992, the proportion of taxfilers who contributed to RRSPs ranged from 3% for those with incomes under $10,000 to 73% for those with incomes above $250,000. Close to 64% of those with incomes above $50,000 — the top 10% of taxfilers — put money aside in RRSPs.

Not surprisingly, the higher their income, the more money people are able to put into their RRSPs. While the average RRSP contribution in 1992 was $3,057, the amount ranged from $1,027 for taxfilers with incomes under $10,000 to

$11,764 for those with incomes over $250,000; the top 10% of taxfilers averaged $5,183.

Women are less likely than men to contribute to RRSPs (See Myth No. 4 above). Also, while people without any employer sponsored pension might be expected to contribute to RRSPs, only 27% of men and 22% of women in this situation make use of this retirement savings vehicle.

Myth No. 12: Most people will be able to count on private pension from their employer when they retire

Fact: A minority of workers belong to a private pension plan and their proportion has decreased over the years. At last count (1993), only 35% of the labour force belonged to a private pension plan (also known as occupational pension plan or employer pension plan). In fact, not all labour force participants can belong to private pension plans: the self-employed are not eligible for membership in private pension plans, and must, therefore, rely upon RRSPs; nor are the unemployed covered. But among Canadians who are theoretically eligible, the paid workers, 44.6% worked for employers that provided private pension plans in 1993. This figure shows a smaller coverage than in previous years. It was 47.7% in 1980 and 45.4% in 1991.[12]

Employment in sectors of the economy where many men work, such as manufacturing, construction and transportation, has been declining. The percentage of men with paid jobs who are covered by private pension plans dropped from 54.2% in 1980 to 46.8% in 1993. At the same time, coverage of female employees increased from 36.2% of all paid workers in 1980 to 41.9% in 1993. This reflects recent changes in government pension standards legislation that require part-time workers— many of whom are women— to be allowed to join pension plans where they are offered for full-time workers. Another factor is increased female employment during the 1980s in the public sector, where coverage of occupational pension plans is high. However, declining employment in the public sector, as a result of ongoing and planned federal and provincial government cutbacks, may well result in reduced pension coverage for women workers in the future.

Over the past 10 years, many employers with 'defined benefit' pension plans, which promise an employee a benefit related to earnings and years of service, have been converting them to group RRSPs or 'money purchase' plans. These don't guarantee any specific benefit at retirement but their worth depends on the amount of contributions accumulated and the return on their investment. Almost 10% of employees in occupational pension plans in 1994 belonged to money purchase plans, compared with only 5% in 1984.

Even if employees are fortunate enough to belong to a private pension plan, that source of income typically declines in value over the course of their retirement. Of the 4,775,543 members of defined benefit pension plans in 1992, only 14.1 % enjoyed the security of fully-indexed benefits. Another 29.6% were in private pension plans that provided for some form of automatic adjustment of benefits but less than full protection from inflation. But the majority of members, 56.3%, belonged to plans that make no provision for inflation protection.

Myth No. 13: With our changing economy, individuals will be able to provide for their own retirement

Fact: Because economic restructuring has led to higher unemployment and the growth of low-paid jobs with few benefits, many people will continue to need government support in retirement. Economic restructuring has already led to a decline in certain sectors of the economy, such as manufacturing, which has resulted in reduced coverage of occupational pension plans for male workers. Although coverage of women workers has increased, this trend may be reversed as cutbacks at all levels of government reduce jobs in the public sector.

Even Canadians who have RRSPs are not required to keep them until they retire. During the recent recession, increasing numbers of people under 65

used their RRSP savings as a source of emergency cash. The number of individuals under 65 who reported RRSP withdrawals on their 1991 tax returns increased by 22% from 1990, and the total amount withdrawn rose by more than 27%.[13]

Ontario, which experienced extensive job losses in 1991, had not only the largest increase in the number of persons making withdrawals, but also the highest average withdrawals. While some individuals may have drawn on their RRSP savings before age 65 because of early retirement, more than half of those making withdrawals were under 45 and likely not ready for retirement.

These developments may accelerate given trends projected for the labour force in the future. The Economic Council of Canada, among others, has pointed to increased polarization of the labour force into 'good jobs' and 'bad jobs', with more and more people employed in non-standard employment, such as involuntary part-time work, contracting and employment agency jobs. These jobs are unlikely to provide occupational pension plans, and unstable employment may make it difficult for many such workers to set aside sufficient savings in RRSPs. The likely result will be continued or increased reliance on public pension programs—old age pensions and the CPP/QPP—for most of the retirement income of most of the work-force in the future.

Notes

1 Statistics Canada. *Income distributions by size in Canada* 1993. Cat. no. 13-207. Ottawa: 1994.
2 *Ibid.*
3 Revenue Canada. *Taxation statistics 1994 edition*. Ottawa: 1994.
4 Data from Pensions Section, Labour Division, Statistics Canada.
5 Revenue Canada, *op. cit.*
6 Office of the Superintendent of Financial Institutions. *Canada Pension Plan fifteenth actuarial report*. Ottawa: 1995.
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