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PUBLIC PENSION PLANS AND THE LABOUR MARKET: THE CASE OF THE QUÉBEC PENSION PLAN

Philippe Le Goff
Economics Division

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INTRODUCTION

In a speech delivered in Montréal in April 2004, Henri-Paul Rousseau, CEO of the Caisse de dépôt et de placement du Québec, summarized the challenge facing public and private pension fund managers and investors in general:

> Back then, people left school at 15 to get a job, retired at 70, and died at 75 – a total of 55 years in the labour force and 20 years out. Today, on the other hand, people are in school until they are 25, work until they are 55, then retire and live until they are 85, which makes 30 years in the labour force and 55 years out![(1)]

To address this situation, which jeopardizes their stability and their ability to carry out their function, pension funds currently have no choice but to generate higher returns. Since the stock market meltdown in 2001-2002, however, the fundamentals of the financial markets have made it impossible to meet depositors' expectations. Returns on traditional instruments are slimmer than in the past, with lower real interest rates on bonds; and the risk premium on the stock markets has shrunk as well. Moreover, 60/40 diversification has lost some of its effectiveness, since the bond and stock markets are much more highly correlated. Consequently, pension funds have no other choice but to switch to substitutes such as hedge funds, private investments, derivative products and exotic investments, which enhance diversification by offering uncorrelated returns. But these investment strategies are much riskier and more complex, which some observers say is making the pension fund manager's job increasingly difficult.

(1) Quoted in René Vézina, "La dictature démographique," *Journal Les Affaires* (http://www.lesaffaires.com/fr/EnAffaires/detail.asp?id=173435&id_section=472) (translation).

In response to low returns, more and more businesses are considering the possibility of reducing pension benefits so that they can fulfil their obligations. Defined benefit plans,(2) which guarantee a certain level of income on retirement, will not disappear, but they will become less common, and those that remain will probably be less generous. Some observers also say that sooner or later, public plans will have to examine the contributions/benefits ratio in light of new assumptions concerning market returns.

Hence, the 2003 public consultations on the future of the Régime des rentes du Québec (RRQ – the Québec Pension Plan)(3) took into account not only the well-known demographic context but also a new realism concerning financial markets' capacity to remedy the actuarial deficits caused by demographic shifts.

This paper describes the key proposals in the discussion paper that guided the public consultations and how the social partners and observers reacted to those proposals. The first part provides an overview of the Canadian pension system's structure and the roles played by the Canada Pension Plan (CPP) and its nearly identical Quebec counterpart, the RRQ.(4) The second part focuses on some of the proposals in the discussion paper, specifically those concerning greater flexibility in retirement prerequisites and the revision of actuarial adjustment factors. The third and final part describes the social partners' main responses to the proposals of the Régie des rentes du Québec (the Régie – Quebec Pension Board) and briefly analyzes how effective the proposals concerning raising the official retirement age are likely to be.

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(2) *Defined benefit plans* are pension plans that specify either the benefits to be received by participants or the method for determining those benefits (based on factors such as the participant's age, salary and years of service). *Defined contribution plans* are pension plans in which the employer's contributions are fixed, usually as a percentage of compensation, and allocated to specific individuals.

(3) Since the 1998 reform (discussed later in this paper), the RRQ is required to hold public consultations every six years to analyze its situation and, if necessary, update the plan's terms and conditions.

(4) The CPP is the public pension plan to which all workers in Canada outside Quebec contribute. The CPP and the RRQ are equivalent plans. This equivalence is important for labour mobility and competitiveness. Though not identical, the two plans have the same contribution rates, the same insurable earnings and the same income replacement rate. The RRQ provides more generous survivor benefits for spouses under 65. The RRQ's eligibility criteria for disability benefits are also more flexible for participants between 60 and 64.

THE CANADIAN PENSION SYSTEM

A. The Levels

Canada's retirement income security system, recognized as one of the best in the world, is officially composed of three levels, though more and more experts are considering adding a fourth level, late-career part-time work.

The first level consists of the Old Age Security (OAS) pension, the Guaranteed Income Supplement (GIS) and the Spouse's Allowance, which are taxpayer-funded assistance programs administered by the federal government. These programs were introduced to support seniors with very low incomes.

The second level consists of the CPP and RRQ (public social insurance plans). These two plans provide basic universal financial protection in the event of retirement, death or disability. In contrast to the assistance programs, CPP and RRQ benefits are based on the participant's contributions. With regard to retirement, the plans are intended to ensure some continuity of income after retirement. The benefits replace 25% of the worker's career average earnings.

Together, the public pension plans (OAS and CPP or RRQ) replace about 40% of the income of a paid employee earning $37,000 a year (or 20% of the income of a paid employee earning $75,000 a year, and so on). For 70% replacement (the level required to avoid a decline in living standard on retirement), workers earning more than $20,000 a year need to have private retirement savings plans.

The third level comprises private pension plans: supplementary pension plans sponsored by employers on a voluntary basis, and registered retirement savings plans (RRSPs).

B. The 1998 Reform

In 1998, major changes were made to the CPP and RRQ. They were adjusted to make them affordable for future generations and sustainable in the face of an aging population, increasing longevity, and the retirement of the baby-boom generation.

This update involved the following changes:[5]

- Increasing the level of funding for the CPP to build a much larger reserve fund. It will grow in value from about two years of benefits to about five years of benefits.

- Ensuring the plans' sustainability by gradually raising the contribution rate to 9.9% in 2003 and then holding it steady from 2004 on.

- Freezing the year's basic exemption at $3,500.

- Adopting a more aggressive investment policy so that the new funds can be invested in a diversified portfolio of securities. A CPP Investment Board was established to diversify the investment of CPP funds and maximize the amounts available to pay for future benefits.[6]

ADAPTING PUBLIC PENSION PLANS TO LABOUR MARKET DYNAMICS

A. Proposals of the Régie des rentes du Québec

The main goal of the 1998 reform was to ensure the long-term financial health of the CPP and the RRQ, and actuarial studies indicate that the goal was achieved.[7] However, while the *official* age range for retirement remains unchanged – 60 for early retirement, 65 for regular retirement, and 70 for late retirement – the *actual* average retirement age continues to fall. In Quebec, it was 60 in 2000, compared with 61.2 in 1990 and 64.6 in 1970. In the rest of Canada, it was 61.5 in 2000, compared with 62.5 in 1990 and 65.1 in 1970.

In 2003, the Régie conducted the public consultations mentioned earlier. The proposals in the discussion paper produced to guide the debate were intended to adjust the RRQ so that it would be able to respond appropriately to labour market issues and new family situations while maintaining a sound financial basis. Notably, the Régie proposed raising the actual retirement age of Quebec workers. If the proposals are adopted, they could result in a significant change in the relationship between the contributions paid in by participants and the benefits paid out by the plan.

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(5) *Securing the Canada Pension Plan. Agreement on Proposed Changes to the CPP*, February 1997 (http://www.cpp-rpc.ca/sec/secure.pdf).

(6) This new policy does not affect the RRQ, whose funds are managed by the Caisse de dépôt et de placement du Québec. At the time, the RRQ had already adopted a similar investment policy.

(7) Office of the Chief Actuary, Office of the Superintendent of Financial Institutions, *Nineteenth Actuarial Report supplementing the Actuarial Report on the Canada Pension Plan as at 31 December 2000*, Ottawa, 14 June 2002.

The main objectives underlying the discussion paper's proposals on the transition from work to retirement are as follows:

- maintain flexibility in the age of eligibility for retirement and improve flexibility in retirement prerequisites;
- treat all workers equitably despite different career profiles;
- make it more worthwhile to stay in the labour force by linking contributions and benefits more closely.

Both in Quebec and elsewhere in Canada, employers' and workers' attitudes toward retirement are changing. Employers are concerned about the difficulty of recruiting skilled labour and the prospect of mass retirement of their most experienced workers. As a result, a majority of employers now tend toward a negative opinion of early retirement programs.(8) They are planning to introduce programs that encourage gradual (rather than early) retirement and are prepared to change the way their work is organized in order to retain their older employees.

For workers, even though early retirement is a widely shared goal, as indicated by the latest statistics on actual retirement age, the reality of personal finances in most cases could force them to stay in the labour force longer than before. These financial constraints will become even tighter with the trend toward atypical work and the increasing prevalence of defined contribution plans in the world of private pension plans. The fact that many people regard their paid job as a means of social involvement and identity should also be kept in mind.

More generally, this increasingly evident convergence of needs and interests on the part of employers and workers is occurring at a time of continuing growth in the service sector and the knowledge economy, which is creating conditions that favour the employment of older workers. The following proposals put forward by the Régie are relevant and necessary to promote the common interest:

- ***Allow workers to receive RRQ pension benefits at age 60 and still keep their jobs*** – Currently, people have to stop working to receive a pension. This change could be a strong incentive for workers aged 60 to 64 to stay in their jobs and remain active in the labour force.

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(8) CROP (marketing research/opinion polls), *Conciliation travail-famille, équité salariale, vieillissement de la main-d'œuvre et régimes de retraite. Sondage d'opinion auprès des membres du Conseil du patronat du Québec*, November 2001 (http://www.cpq.qc.ca/files/PDF/Sondages/01novplusieurs_sujets.pdf).

- ***Make entitlements easier to calculate –*** A participant's entitlements would be based on his or her lifetime earnings. Thus, the annual entitlement would be equal to 25% of all insurable earnings divided by 40 years, up to the maximum amount payable. The entitlement would increase, up to the maximum amount payable, if a worker has contributed to the plan for more than 40 years. Compared with the present plan, the use of a constant denominator would increase the entitlements of people who stay in the labour force for longer periods and reduce the entitlements of those who spend less time in the workforce.

- ***Require beneficiaries to continue contributing if they keep working after their pension starts –*** People who re-enter the workforce after they start receiving pension benefits would have to contribute to the plan while they receive their pension. The additional contributions would increase the pension that is payable, as long as the maximum is not reached.

- ***Revise the actuarial adjustment factors –*** Since 1984, flexible retirement has made it possible for people to start receiving a pension at any time between the ages of 60 and 70. An actuarial adjustment factor applies when retirement starts before or after age 65. Recent research by the Régie has shown that the current actuarial adjustment factor penalizes workers who start receiving their pension after age 65. The Régie believes that in order to correct the situation, the increase in entitlements after 65 should be raised from 0.5% per month to 0.7%. For example, someone whose pension starts at 70 instead of 65 would receive a 42% increase instead of the current 30%.

B. Views and Reactions of the Social Partners

Public pension plans' flexibility with regard to the transition from work to retirement and the proposed changes in the actuarial adjustment factors are in fact designed to raise the labour force participation rate of older workers. The social partners (employers and unions) have a major role to play in achieving the Régie's goals.

1. Employers

The Régie's goals are generally shared by Quebec's employers.(9) This is evident both in businesses' increasing openness to changes in the organization of work to keep workers on the job and in the development of coaching and job-shadowing programs. On the other hand, the employers warn against any attempt to oblige businesses to keep staff on against their will, since productivity is the top priority.

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(9) Conseil du patronat du Québec, *Adapter le Régime de rentes aux nouvelles réalités du Québec : les préoccupations du Conseil du patronat du Québec*, Brief by the Conseil du patronat du Québec submitted to the Commission des affaires sociales, February 2004 (http://www.cpq.qc.ca/files/pdf/memoires/0402regierentes.pdf).

The employers hope that the Régie's proposals will lead to an appreciable increase in the overall labour supply, but they have some doubts. Consequently, they recommend that the Régie keep a close eye on the short-term and medium-term impact of its proposals. The employers also raise two noteworthy issues concerning the RRQ's alignment with the labour market.

First, they point out that in 2002, only 10.5% of new RRQ beneficiaries received the maximum pension. They therefore maintain that the 40-year contribution period required to receive the maximum pension[10] is not consistent with Quebeckers' labour force activity profile. In fact, the requirement would be less than 40 years (full-time equivalent) for the majority of workers in Canada. This statement is supported by Statistics Canada data, which show that the average duration of workers' labour force activity in Quebec and in other parts of Canada is less than 40 years and has been declining for a number of years. This criticism by the employers is surprising, though, since the RRQ's goal is in fact to encourage workers to keep working longer by providing an incentive to stay in the labour force.

Second, the employers are concerned to maintain intergenerational equity within the RRQ, noting that workers who have just retired or will do so in the next few years will enjoy a higher return on their contributions than younger workers, who have been contributing at a rate of 9.9% since 2002 and will be retiring in 30 or 40 years. They suggest that the Régie should plan for an upward adjustment of the maximum pension for the post-baby-boom generation to ensure greater intergenerational fairness and more support for the system among younger workers.

2. Unions

Like employers, unions welcome the proposals for improved flexibility in the transition from work to retirement, especially the possibility of continuing to work while receiving a pension at age 60.

The unions' main criticism concerns the way in which entitlements are calculated; they regard the formula proposed by the Régie as inequitable. In their view, it would be virtually

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(10) When the RRQ was established in 1965, a participant could qualify for the maximum benefit after 10 years of contributions. The RRQ will reach maturity in 2010, and the maximum benefit will be obtained after 40 years of contributions (between 36 and 44 years, depending on whether benefit payments begin at age 60 or age 70) if the worker's total income is greater than or equal to the average income according to Statistics Canada.

impossible to obtain the maximum pension at age 60. To do so, a worker would have to have started contributing at age 20, with an income greater than or equal to the maximum eligible earnings. The unions consider this unacceptable, pointing out that very few workers can hope to earn as much as or more than the maximum eligible amount (about $40,000) at the age of 20. What is more, as the Régie itself acknowledges, workers' careers are more likely to be interrupted in the future (maternity and paternity leave, further education leave, occasional unemployment).

Hence, the unions are highly critical of the Régie's thinly veiled attempt to tie the maximum pension to extended labour force activity. They would prefer to see extended labour force activity encouraged through the introduction of measures such as more flexible work hours.

The unions also doubt that the proposed actuarial adjustments, punitive before 65 and attractive after, can really ensure greater flexibility in the transition from work to retirement. They see them as a downward levelling of pension benefits that will force some workers to keep working longer than planned because they cannot afford to retire.

THE TIMING OF RETIREMENT, THE RETIREMENT INCOME SECURITY SYSTEM, AND THE TAX REGIME

The decision when to retire is based on a wide range of personal factors (spouse's retirement, motivation to work, health, age, etc.) and financial considerations (personal wealth, private pension, expected income, etc.), including RRQ/CPP benefits. In 2001, those benefits accounted for 16% of the income of recipient households. To be effective, then, the reform proposed by the Régie must not be carried out in a vacuum.

In May 2004, the C.D. Howe Institute published a study by Yvan Guillemette in which the author simulated the effects that the Régie's proposals would have on the income of individuals, taking into account the RRQ's interaction with other government transfers to individuals (OAS, GIS, etc.) and taxation.(11) The purpose of the simulation was to determine how significant the income changes caused by the Régie's proposals would be and how they might affect a worker's decision when to retire. The simulation was based on a number of assumptions and was conducted for three typical individuals with different wealth and income profiles. It led to the following conclusions:

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(11) Yvan Guillemette, *Follow Quebec's Lead: Removing Disincentives To Work After 60 by Reforming the CPP/QPP*, C.D. Howe Institute – Commentary 199, Toronto, May 2004 (http://www.cdhowe.org/pdf/commentary_199.pdf).

1. Overall, the Régie's proposals would encourage workers to remain at work longer and would make the RRQ fairer.

2. Remaining at work would be least advantageous for low-income workers, as the financial improvements provided by the RRQ would be wiped out by the income tax system.

3. The incentives for lower-income workers to continue working after 65 would also be erased by a reduction in GIS benefits.

4. For people with an income and wealth profile typical of the average worker, the Régie's proposals, in combination with the rest of the retirement income security system, would have a significant positive impact on the incentive to keep working. This finding is a point in favour of the Régie's proposals.

5. For high-income workers with greater personal wealth, RRQ benefits make up a smaller proportion of total retirement income; as a result, the additional incentives proposed by the Régie would make little difference in retirement decisions.

Guillemette notes that the Régie's proposals will have the greatest impact on decisions to continue working in the case of people whose earnings have been at or near the maximum insurable level throughout their careers. For those workers, the Régie's proposals will reduce the proportion of income replaced by pension benefits between 60 and 63 and increase the incentive to remain at work.

The most attractive of the Régie's proposals, according to Guillemette, is the suggestion that everyone could receive RRQ benefits while continuing to work. The idea, first put forward a few years ago by several analysts,(12) is particularly well suited to the context of an aging workforce and addresses the need, shared by businesses and workers, to promote a gradual transition from work to retirement. However, the effects that the proposal might have on the RRQ's cash flows and financial stability are unclear and should be carefully studied before any decision is taken.

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(12) William Robson, *Aging Populations and the Workforce: Challenges for Employers, and a BNAC Statement*, British-North American Committee, Winnipeg, 2001 (http://www.cdhowe.org/pdf/BNAC_Aging_Populations.pdf).

CONCLUSION

The Régie's proposals[13] for increasing the labour force participation of older workers are largely based on measures introduced or planned by many Western countries grappling with the issue of aging workforces. The Régie's proposals can be described as more modest, though, since they are suasive rather than coercive. In contrast to the United States and some European countries, the issue of raising the normal retirement age is not yet on the agenda in Canada.[14] It should be noted that compared with many countries, Canada has a fairly sound pension system that is well equipped to deal with the demographic challenge. Nevertheless, some adjustments are needed to restore it to its original lustre. In that regard, the Régie's proposals are a proactive response to recent comments by the Organisation for Economic Co-operation and Development (OECD) to the effect that the major challenge facing Canada in the area of pension plans is raising the actual retirement age to strike a better balance between the duration of people's working lives and the duration of retirement. It remains to be seen whether the proposals go far enough to produce the desired results.

Even though the proposals have generally been well received, observers maintain that in order effectively to attain their objectives, they cannot be implemented in a vacuum – that is, without considering the other components of the Canadian retirement income security system. If the C.D. Howe Institute's simulations are correct, a comprehensive reform of the system would probably have a better chance of achieving the results hoped for by the Régie. The federal and provincial governments would do well to work together with the CPP to formulate a consistent, comprehensive policy to keep older workers in the labour market. Other provinces are also grappling, albeit somewhat less urgently, with the problem that Quebec is facing.

It is also vital that any current or future proposal ensure that the CPP and the RRQ remain equivalent, for the sake of labour mobility and competitiveness. In fact, it is in order to ease the pressures that could lead to a difference in contribution rates between the two plans that the Régie is proposing an overall decrease in benefit payouts. The RRQ is in an unfavourable financial position compared with the CPP because of its more generous disability pension criteria for participants aged 60 to 64 and because Quebec is aging faster than the rest of Canada.

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(13) This paper does not cover all of the proposals in the discussion paper on the RRQ's future; in particular, the proposals concerning disability benefits and death benefits are not discussed here.

(14) The issue is discussed in Philippe Le Goff, *Raising the Normal Retirement Age: A Socio-Economic Policy Option or an Imperative for Canada?* PRB 03-11E, Parliamentary Information and Research Service, Library of Parliament, 10 September 2003 (http://lpintrabp.parl.gc.ca/lopimages2/prbpubs/pdf/bp1000/prb0311-e.pdf).

In view of the current financial health of public pension funds, the small proportion of income replaced by RRQ/CPP benefits, and expected changes in private pension plans, the Régie's modest approach is probably the right one. Its proposals may at least serve as a wake-up call in the sense that future generations of workers will have to resign themselves to working longer or expecting less money in retirement for as long as the baby boom's population bulge lasts. More coercive measures, such as raising the normal retirement age, might be considered too radical at this time.