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Old Wine in New Bottles: Privatizing Old Age Pensions

Pension reform is on the agenda again. During the 1993 election campaign, the Reform Party proposed taxing back 100 percent of Old Age Security (OAS) benefits in households with net incomes above $50,000 per year. The *Globe and Mail* (November 15, 1993) has been urging privatization of public pensions (yet again). Even traditional advocates of a strong social safety net, such as Ken Battle, are proposing to fold OAS into an expanded version of the income-tested Guaranteed Income Supplement (GIS).[1] And recently, Tom Courchene and the C.D. Howe Institute have carried this logic a step further suggesting that the Canada and Quebec Pension Plans (C/QPP) be folded into a 'super GIS.'[2]

In reality, both goals already have been realized. Under current legislation, the C/QPP will remain in force, but the first tier of the Canadian pension system, OAS, is scheduled for eventual elimination. The cut-off at which the OAS clawback takes effect, initially set at $50,000, is indexed to inflation only in excess of three percent. This means the cut-off gradually will work its way down the income distribution until benefits are paid only to low-income seniors.

The decline of OAS represents a substantial withdrawal by government from the pension industry. Since the 1960s, OAS has played a double role in Canada's retirement system. Together with GIS, it provides income assistance to low-income seniors. However, OAS also represents the first tier of a three-tier retirement income system. When the C/QPP was created, it aimed to replace about 25 percent of the wages of the average worker when he or she retired. This figure is far below the 60-70 percent replacement rate considered necessary for an adequate retirement pension. The assumption in 1965, however, was that the OAS would provide an additional 15 percent of the average wage. Hence, for the average worker, the public pensions system (OAS and C/QPP) would provide a pension equal to about 40 percent of average wages. For almost three decades, workers have constructed their retirement plans on this assumption.

The clawback changed all this. As it works its way down the income scale, average earners will lose the OAS pension. This was a brilliant piece of retrenchment 'packaging' by the Conservative government. Had cuts of equal magnitude

to the C/QPP been announced, the resulting outcry no doubt would have forced a hasty retreat. The clawback achieved the same result, reducing public pension benefits by more than a third, with virtually no resistance.

For young workers now entering the labour market, OAS is history. How will they respond?

To reach traditional retirement income goals, new labour force entrants will have to increase their private savings for retirement. This means more and better occupational pensions (RPPs) or more contributions to individual retirement savings plans (RRSPs). Under current tax arrangements, the result surely will be perverse.

Both RPPs and RRSPs now receive huge tax subsidies from government since contributions and plan earnings are tax-deductible. Because contribution levels and marginal tax rates rise with earnings, the subsidies disproportionately benefit high-income earners. As Caledon reports, the average tax subsidy from the RRSP deduction was just $233 for the small group of taxfilers with incomes under $10,000 with RRSPs in 1991 and almost $5,000 for RRSP contributors in the $250,000 and over group.[3]

Because of the distributional effects of tax deductions, any growth in the RPPs and RRSPs has the effect of raising tax expenditures (and hence the debt) in order to support high-income retirees, the very thing the clawback set out to eliminate. Indeed, what the Conservative government took away from middle- and upper-income earners with one hand (the clawback), it returned with the other by raising contribution levels for RRSPs.

Both Battle and Courchene offer a partial solution for the perversity problem; convert RPP and RRSP tax deductions to tax credits. This would be a step forward. Under a tax credit system, the taxpayer's marginal rate would be ignored.[4] A $3,000 contribution to an RRSP then would trigger the same dollar tax savings, regardless of income level.

Converting the tax deductions to a tax credit is only a partial solution, however, since the credit would offset OAS losses only for employees covered by occupational plans and contributors to RRSPs. A more complete solution would be to follow Australia's lead and make RPP contributions mandatory, an approach much discussed in the Great Pension Debate of the early 1980s. Once in place, one might even consider folding the C/QPP into a 'super-GIS' along the lines suggested by Tom Courchene. Privatization then would be complete. Henceforth, government would administer old age assistance for the poor elderly and retirement pensions would be left to the market.

Unlike the *Globe and Mail* or Tom Courchene, Ken Battle does not envision full privatization (he would retain the C/QPP). At the end of the day, however, all such proposals must answer the same question: Why privatize at all?

For all three, one of the chief aims of restructuring the pension system around the needs of low-income seniors is to reduce the public costs of supporting Canada's rapidly aging population. Unfortunately, things are not so simple. The fallacy is to assume that reducing public costs lowers the total cost of supporting the retired. If pension spending as a percent of GDP must double to provide the elderly of 2030 with the same relative

living standards as today, it matters little how it is paid for.[5] It will be financed either by rising taxes (for public pensions) or by rising dividends paid into the funds on which private pension funds depend. In either case, the share of GDP going to the retired rises and the share available to the working age population declines.

What matters for future generations is not the share of GDP going to the elderly but the level of GDP available to support workers, their aging parents and their children. This is the crux of the debate: The case for privatization hinges entirely on its presumed effects on productivity and the rate of economic growth. Here the disputes are complex. The case for privatization rests almost entirely on theoretical arguments derived from neo-classical economics concerning a presumed trade-off between welfare state spending on the one hand, and productivity and competitiveness, on the other. However, the empirical evidence tends to be ambiguous (no effect) and the exceptions go against the case for privatization.[6]

For the *Globe and Mail,* a main advantage of directing pension savings into the private sector is to increase the amount of capital available for private investment. But even if the advantage of investing pension contributions in the private sector is real, there is no reason to privatize the administration of contributions and benefits with the attendant losses of economies of scale. Just as the Bank of Canada now auctions off its debt, it also could auction off the capital accumulated in public pension plans to private investors.

My aim here is not to resolve this old debate over private versus public insurance, but merely to point out that – at the end of the day – this is what the debate is about. Assuming current retirement practices remain intact, it is inevitable that a rising share of GDP will be required to support the baby boom generation when it retires. Rearranging the public/private mix makes a difference only if the new mix raises the level of GDP available to support it.

None of this is new, simply old wine in new bottles. These issues were thoroughly thrashed out during the Great Pension Debate of the late 1970s and early 1980s. Meanwhile, the OAS clawback should be recognized for what it is. In the short run, the clawback was a tax on the social income of high-income seniors in aid of debt reduction. The short-term gains to'the government treasury and the same distributional effects could have been achieved with a clawback (higher taxes) on income from all sources. However, the long-term goal was more ambitious – to reduce the role of government in providing retirement pensions for average wage earners.

The pressures on governments to follow this path are real. High unemployment, the declining wages of young workers and new family forms have changed the distribution of economic risks that were considered 'normal' when the present welfare state was constructed in the 1950s and 1960s. The long-term pressures of an aging population on the government treasury cannot be ignored. But while exporting responsibility for an aging society to the private sector may solve the government's problem, it does nothing to solve society's problem.

The main reason even 'progressive' policy analysts have taken up the case for privatization is the belief that high government debt and growing tax resistance have impaired permanently the revenue-generating capacity of governments. As a result, the only way to provide badly-needed improvements to assistance programs for low-income seniors (and young people) is to cut social insurance programs for average wage earners. If

average workers are unwilling to provide the tax base required to finance programs like pensions, education and health care, there is little choice but to target existing revenues toward those in need and to leave average wage earners to find their 'welfare' in the market.

The Liberal government is about to 'consult' the Canadian public for its views on these matters. The challenge is to ensure that Canadians understand the nature of the question being asked.

John Myles

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Notes

1. Battle, K. (1993). *Thinking the Unthinkable: A Targetted, Not Universal, Old Age Pension.* Ottawa: Caledon Institute of Social Policy, October.

2. Courchene, T. (1994). *Social Canada in the Millennium: Reform Imperatives and Restructuring Principles.* Toronto: C.D. Howe Institute.

3. Caledon Institute of Social Policy. (1994). "RRSP Series." *Fast Facts.* Ottawa, February.

4. Higher-income earners would still get higher subsidies because of higher contributions. This effect could be practically offset with the Ontario Fair Tax Commission's proposal to limit the maximum benefit eligible for tax assistance, now 2.5 times the average industrial wage, to 1.5 times the average wage.

5. For a concise discussion of this point, see *The Economist,* August 13, 1994, p. 21.

6. For a review of evidence, see Esping-Andersen, G. "Welfare States and The Economy." In N. Smelser and R. Swedburg (eds). (1994). *Handbook of Economic Sociology.* Princeton: Princeton University Press.

Reply to John Myles

John Myles' article *Old Wine in New Bottles: Privatizing Old Age Pensions* responds in part to a commentary I wrote in October 1993 entitled *Thinking the Unthinkable: A Targetted, Not Universal, Old Age Pension.*

The gist of my proposal is captured by the title of the commentary, but I will repeat here my main arguments for readers who did not see the original and will add another pension reform proposal that was not discussed in the commentary. I also want to respond briefly to a couple of John's points.

I argued that the federal government should fold Old Age Security, the Guaranteed Income Supplement, the Spouse's Allowance and the age and pension credits into a single income-tested program geared to low- and modest-income Canadians 60 and older – a 'super-GIS' or guaranteed income plan for the aged, if you will. I claimed several advantages for my proposal over the current system.

First, it would do away with the devious clawback on Old Age Security which, because it was designed with a partially-indexed threshold, will deceive many middle-income Canadians into believing that they will have an old age pension to look forward to when they reach 65, when in reality they will end up with only a partial benefit or none at all. Try explaining to a lay person that what appears to be a rising income threshold for the clawback in reality is a falling threshold – the old nominal versus real distinction – and you'll appreciate my concern: People may understand at some inchoate level that it takes more dollars to equal a dollar 20 years ago, but they still will complain about how much more a new car costs now than when they were young. Nor is the term 'threshold' or the concept it denotes commonplace or easily explained.

My proposal would fully index both benefits under the super-GIS and its income threshold, so Canadians would know up front how the program really operates and whether they will qualify: no more social policy by stealth. Incidentally, it will be all too easy for the Liberals and future federal governments simply to leave the clawbacked OAS in place, and even more tempting to make a small 'technical change' in how it is calculated in order to accelerate its fall into highly lucrative middle-income territory (the current clawback takes back 15 cents of OAS for every dollar of income above the threshold: Jack that up to 20 or 25 cents and you can recover a lot more benefits a lot faster without seniors knowing the difference).

Second, my proposal would resolve the Spouse's Allowance problem, which is the fact that the program discriminates against low-income people between 60 and 64 years of age who were never married: They do not qualify for benefits, and instead likely rely on welfare which not only stigmatizes (unlike the Spouse's Allowance) but also pays less. Several Charter challenges against the Spouse's Allowance are slowly winding their way through the courts, another part of the Spouse's Allowance problem. My proposed super-GIS would serve all low- and modest-income Canadians aged 60 and older, regardless of marital status or any other characteristic (except for income).

Third and perhaps most importantly, I am concerned about the capacity of the public pension system to sustain its present level of income support for poor and modest-income seniors in future. I see a deadly combination of an aging population, high rates of marriage breakdown and an insecure labour market that could produce substantial growth in the number of low-income elderly and near-elderly women and men as baby boomers reach old age. My proposal is intended not only to ensure an income safety net for older

Canadians in future, but hopefully to raise that net to provide a better basic guarantee level for the retirement income system.

In 1951, during the height of the baby boom, only 7.8 percent of the Canadian population was made up of men and women 65 and older. By 1991, when the baby boomers were lamenting having reached 'the big four-0,' the elderly had increased their share of the population to 11.6 percent. Recent projections from Statistics Canada estimate the aged will climb to 18.6 percent of Canadians in 2021 and 23.2 percent by 2036, when the baby boomers of the 1940s and early 1950s – who will live longer on average than previous generations of the elderly – will become the seniors boom of the early decades of the 21st century.

Marriage breakdown typically brings a substantial reduction in income for mothers and their children. For many women, this loss will carry forward to their retirement years. Women continue to fare less well than men in the earnings-related parts of the pension system, both public and private. They average lower *C/QPP* benefits because they have lower average lifetime earnings; women are still overrepresented in low-paid jobs, still more likely to work part-time and still more likely than men to interrupt their careers to care for children. Although women's occupational pension plan coverage has improved over the years, it is still low and lower than men's: At last count (1992), 41.0 percent of the male workforce belonged to an employer-sponsored pension plan as opposed to only 35.3 percent of the female labour force. And women are less likely than men to contribute to an RRSP.

The majority of jobs created in recent years have been of the 'non-standard' type – part-time, self-employed, often insecure and typically offering little if anything in the way of employer-sponsored pension plans and other benefits. Nor can we count on RRSPs to fill the breach for the majority of Canadians: Only one taxfiler in four contributed to an RRSP at last count (1992). Relatively few individuals with below-average incomes can afford to put money aside in RRSPs, and when they do the amounts are small on average.

This bitter demographic-cum-labour market brew not only could reverse the significant progress that Canada has made against poverty among the aged over the past generation, but also could swell the size of the poverty population overall. It certainly will exert enormous pressure on the public pension system, upon which millions of seniors will depend in future for most or all of their retirement income. The steady and significant growth in spending on public pensions is a constant, non-cyclical pressure on social spending overall, which – contrary to popular mythology – has risen significantly over the years both in absolute terms and as a percentage of GDP, government spending and government revenue.

In 1991, there were 3.2 million elderly Canadians. Total spending on Old Age Security, the Guaranteed Income Supplement, the Spouse's Allowance, and the Canada and Quebec Pension Plans increased by 87 percent in real terms between 1980-81 ($19.8 billion) and 1992-93 ($37 billion), and by 5.6 percent a year in real terms on average.

Statistics Canada projects the number of elderly Canadians at 8.6 million by 2036. I estimate that Old Age Security payments in 2036 will amount to around $38 billion (in 1993 dollars) as opposed to the $15 billion for 1993. This is a staggering expenditure.

Granted, net expenditures on the public pension system are significantly less than gross

payouts. Federal and provincial income taxes recover about one-quarter of Old Age Security and Canada Pension Plan payments (which are taxed, unlike the Guaranteed Income Supplement and Spouse's Allowance); as well, the clawback on Old Age Security benefits will catch increasing numbers of middle-income seniors as its partially indexed threshold falls steadily over time. The Caledon Institute's 1993 study *Federal Social Programs: Setting the Record Straight* estimates that the income threshold for the clawback on Old Age Security will have fallen from $50,000 in 1989 to $23,000 by 2020 (in constant 1989 dollars) and will recover the entire old age pension from seniors with incomes above $49,000. Nonetheless, the relentless growth in the elderly will exert intensifying pressure on pensions, health care and social services. Until the government starts report-ing its social expenditures in net dollars, the cost of public pensions will continue to look even worse than it really is.

John Myles puts me in the same camp as Tom Courchene and the C.D. Howe Institute regarding old age pensions, which is fair enough on this point since Tom cites and repeats my proposal for a super-GIS in his recent book *(Social Canada in the Millennium).* However, I don't regard my ideas on pension reform as putting me in the privatization camp, as some readers of John's piece might infer, and I reject any move to collapse the *C/QPP* into a super-GIS.

Not only do I want to retain the social insurance tier of the retirement income system, but I want to strengthen its role by increasing the earnings-replacement capacity of the Canada/Quebec Pension Plan to serve better the needs of lower- and middle-income pensioners. I don't think a straight doubling of that rate from 25 to 50 percent of average earnings – the stock proposal of *C/QPP* expansionists – is politically feasible in terms of the future contribution rate increases it would require. However, a COFIRENTES-style expansion, which would double C/QPP retirement benefits for those earning half of average lifetime earnings and increase by 50 percent the maximum benefit payable, is desirable and feasible, especially if we also raised the earnings band on which con tributions are levied. I strongly oppose any attempt to income-test the C/QPP, which would be disastrous to the political health of that admirable program because it would sever the visible link between current contributions and future benefits: That aspect of the genius of social insurance is not *passe,* even at a time when it is fashionable to proclaim that the social programs we inherited from our parents and grandparents are out of step with the realities of the 1990s.

Myles also notes my long-standing, windmill-tilting proposal to convert the costly and regressive tax deductions for Registered Pension Plans and RRSPs – I estimate their total net cost to the federal and provincial governments at $23 billion in 1991, which dwarfs public pension programs like Old Age Security and the C/QPP – to credits, which both would save taxpayers' money and make the system of tax assistance for retirement savings more fair. I even would accept as a second-best alternative substantially reducing the maximum level of tax assistance for RPPs and RRSPs, even if it continued as a deduction, since this still would preserve the level of tax assistance currently available to low- and middle-income earners; when I was Director of the National Council of Welfare, we proposed that the maximum tax assistance for RPPs and RRSPs be reduced to 1.5 times the average wage. I have other and far better uses for the tax savings my proposal would remove from upper-income pension plan members, such as boosting child benefits for poor families. The point is not to remove entirely tax assistance for private pensions, which would be penny-wise-and-pound-foolish, but to reduce the tax expenditure required and to put an end to its highly regressive form.

I understand John's central point about "the fallacy [of assuming] that reducing public costs reduces the total cost of supporting the retired" but I cannot agree that "If pension spending as a percent of GDP must double to provide the elderly of 2030 with the same relative living standards as today, it matters little how it is paid for." I think it matters a lot how it is paid for. In abstract economic terms, a buck may be a buck whether it is public or private money, but in political terms, it does make an important difference how we finance our pension system. Taxes (including payroll taxes) will have to go up to pay for the higher demands on the public parts of the pension system as well as health and social services in future – which, as I argued above and in my commentary, will be heavy indeed because of trends in the labour market and population aging – and will have to rise even more if we want to expand the C/QPP and improve the guarantee level for my proposed super-GIS. Therefore, it is essential that we reduce public spending through Old Age Security and the tax system on well-off taxpayers and seniors. As Caledon said in *Green Light, Red Flag: Caledon Statement on the Social Security Review,* Canada no longer can afford welfare for the wealthy.

John Myles ends his commentary by stating that "the long-term goal [of the clawback on Old Age Security] was to reduce the role of government in providing retirement pensions for average wage earners." This fear is well warranted, since I project the income threshold for the clawback on Old Age Security will have fallen from $50,000 in 1989 to $23,000 by 2020 (in constant 1989 dollars) and will recover the entire old age pension from seniors with incomes above $49,000. I also share John's concern about the future of the public pension system overall (including its crucial social insurances) in light of the proposals from some quarters to raise the retirement age (surely a retrograde step) and well-publicized (and unwarranted) fear-mongering about our capacity to sustain the C/QPP. However, I regard the Liberals' move in the 1993 budget to income-test the age credit as a step in the direction that I propose towards a super-GIS. But I want to make it clear that my proposals for a super-GIS and expanded C/QPP would strengthen, not weaken, the pension system's capacity to serve the needs of lower- and middle-income Canadians.

My original commentary said that there would have to be great care given to the design of a super-GIS, how it would interact with other existing pension plans, and its cost in light of projections about the future number and incomes of Canadians 60 and older. Where should we set the threshold for maximum benefits and the income level above which partial benefits will end (i.e., the disappearing point, which is determined by the combination of the benefit and its reduction rate)? These design decisions will determine how targeted the super-GIS will be and how much it will cost. There are tough trade-offs between the objectives of maximizing benefits for lower-income recipients and (if so desired) maintaining some partial support for middle-income seniors. My proposal for a super-GIS requires more work on alternative design options.

We will need a new social contract with Canadians to make major changes to the retirement income system, including those that I have proposed. Just as the C/QPP was phased in over a number of years and its contribution rates are being very slowly raised over many years, so also would the transformation of the current system of OAS/GIS/SPA/age credit/pension income credit to a super-GIS have to be gradually implemented so as not to harm older Canadians who should not be expected to play the pension game by a new set of rules.

Finally, I could not agree more with John Myles' concluding comment about the need to consult the public about pension reform and his statement "that Canadians should understand the real nature of the question being asked," though I think several questions are required. Perhaps more than any area of public policy, pension reform is fruitful ground for misinformation, misguided fears and simplistic solutions.

John Myles and I invite readers to join the debate over pension reform – one of the key social policy issues of the not-too-distant future that will not go away, no matter what governments might wish.

Ken Battle

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