

REFORMING THE CANADIAN RETIREMENT SYSTEM: INVESTING SOCIAL SECURITY ASSETS IN EQUITIES

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Executive Summary

Canada, like the United States, has developed a retirement income system that relies on both public and employer-sponsored plans to provide a reasonable level of old-age income. Canada's public programs largely focus on assuring a basic old-age income and provide quite modest benefits to higher-income workers. Canada's employer plans provide significant top-ups for middle- and upper-income workers. Powerful demographic and economic forces, however, have emerged over the past quarter century that have challenged the long-term solvency of both public and employer plans. Canada, in response, has had to reform both public and private retirement income programs.

The sharp recession of the early 1980s exposed serious shortcomings in employer defined benefit pension plans. To protect plan participants, Canada enacted reforms that required stepped-up funding should a plan have insufficient assets to satisfy its obligations in the event it should terminate. The economic boom that lasted from the mid-1980s through the end of the century did wonders for the health of these plans. But the sharp financial downturn of the early 2000s created large deficits that put the funding reforms to the test. The new requirements succeeded in improving the finances of employer plans. But they did so by forcing employers to make sharply higher contributions precisely when times were tough and cash scarce. This perverse and unpredictable funding pattern has led many employers to terminate or curtail their defined benefit plans.

With respect to public pensions, Canada has faced a long-term financial challenge due to an aging population. In 1997, the nation responded by deciding to pre-fund its earnings-related public pension program — the Canada Pension Plan (CPP) — and investing a major portion of the accumulated assets in equities. The goal was to set a contribution and benefit that would be the same for each generation, using equities to minimize the cost of the program. The primary concern over the use of equities is political — will this mixture of politics and economics result in a loss of investment returns or, more troubling, in a loss of democratic control of politicians and government officials? To alleviate such concerns, Canada set up an elaborate governance system designed to make the CPP Investment Board professional and independent. Thus far, the CPP governance system is generally viewed as achieving these objectives.

Creating the Retirement Income System

Canada enacted its first national old-age income program, fittingly called Old Age Pensions, in 1927. This program was designed to assume a portion of the social welfare burdens that were overwhelming provincial and local governments. Benefits, as a consequence, were means-tested and low. The program paid long-term residents, age 70 and over, a bit more than 20 percent of average earnings so long as their total income was less than about a third of average

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earnings. Canada's diverse provinces had been given jurisdiction over social welfare by the British North America Act of 1867 — the "basic law" of the Canadian federation. So Old Age Pensions was administered by the provinces and jointly funded, with the federal government initially paying half the cost, and later three-fourths.¹

In 1951, Canada replaced Old Age Pensions with a new program called Old Age Security. This program was entirely federally-run, which a new constitutional amendment allowed. Like Old Age Pensions, it provided benefits to long-term residents age 70 and over and was funded out of general government revenues. Benefits were about 15 percent of average earnings — comparable to the federal government's 75 percent contribution to the Old Age Pensions benefit. The provinces were free to top-up benefits as they saw fit, and most did. The key change was that benefits in the new program were demogrants — flat payments granted without a means test to all elderly long-term residents. Old Age Security remains to this day the first tier in the Canadian retirement income system. And while OAS benefits have never been automatically linked to wages, the demogrant has remained at about 15 percent of average earnings. Canada, as other industrial nations, also had a tradition of employer-provided pensions stretching back to the nineteenth century. As in other Anglo-Saxon nations, these plans grew rapidly after the Second World War, with coverage jumping from less than 15 percent of wage and salary workers in the 1930s to 40 percent by 1970.

Over the course of the long post-war prosperity, Canada, like other industrial nations, found its retirement income system increasingly deficient.

Working-age adults and their children were moving to the suburbs, buying houses and cars, and expanding their economic horizons. But the elderly were left behind, with nearly 45 percent classified as poor in the early 1960s. Canadian workers, though enjoying steadily rising incomes, also faced a precipitous decline in living standards over the rapidly increasing number of years they would spend in retirement.²

The Expansion of the Canadian System

The Canadian response came in a series of initiatives enacted in the latter half of the 1960s. The primary goal was to lift the elderly out of poverty, with a secondary objective of spreading income more evenly across the lifespan. Between 1965 and 1969, Canada:

- Reduced the age of eligibility for Old Age Security from 70 to 65.
- Introduced a new earnings-related social insurance program, the Canada/Quebec Pension Plan (C/QPP). The program was funded by a payroll tax and provided a pension that replaced 25 percent of earnings, up to the national average, at age 65.³
- Introduced the income-tested Guaranteed Income Supplement, which guaranteed elderly individuals an income of about 33 percent of average earnings and couples about 52 percent of average earnings. Policymakers expected the program to become irrelevant with the maturation of the C/QPP.⁴

A SERIES OF GLOBAL BRIEFS

This brief is the fifth in a series that profiles national retirement income systems and their response to the impending demographic transition. These systems are an outgrowth of industrialization and the transfer of a nation's workforce from family and communal production to organized wage employment. The transition created an enormously productive economy. But wage workers face increasingly uncertain employment prospects as they age, and eventually a complete loss of earnings. Only rarely can a worker's savings offset this loss of wages. So governments, employers, and unions responded by organizing formal retirement income systems.

The maturation of these systems over the past half-century has made retirement a generally secure and well-defined stage of life. Thanks to extended longevity and ever-earlier withdrawals from the workforce, retirements now last about twenty years, on average, and have emerged as one of the great blessings provided by modern industrial society. But declining fertility and rising longevity have placed this blessing at risk.

Each nation's retirement income system has emerged out of its particular history and ideological commitments. Each nation's response to the current challenge reflects its existing institutional set-up and its economic prospects, social commitments, and ability to reform large and complex institutions.

This series presents brief descriptions of the emergence of national retirement income systems, recent reforms and evaluation of these reform initiatives.

- Broadened access and improved the security of employer pension benefits by imposing vesting, funding, and fiduciary requirements.⁵

In the expanded Canadian system, a full-career worker who consistently earned the average wage and retired at age 65 would get a government pension that replaced 40 percent of pre-retirement earnings — 15 percent from Old Age Security and 25 percent from the C/QPP. "Average earner" households with a non-working spouse would get an additional OAS demogrant, bringing their combined income up to 55 percent of pre-retirement earnings. The Guaranteed Income Supplement program assured older cohorts, low-wage workers, and those who did not qualify for a full C/QPP benefit incomes nearly as large — about a third of average earnings for individuals and about half of average earnings for couples. The Canadian public system, as John Myles put it, "functioned approximately like a universal flat benefit system"⁶ (see Figure 1).

The expanded Canadian system would largely achieve its main objective of reducing old-age poverty. As the C/QPP program matured and an increasing share of the elderly received benefits from the plan, the elderly poverty rate, as measured in Canada, would fall from 44 percent in 1961 to 19 percent in 1997. The maturation of the C/QPP did not eliminate poverty or the need for GIS benefits, as originally envisaged. A third of the elderly population got GIS benefits in 2001, down from half in 1985, with older widows, in particular, especially dependent on

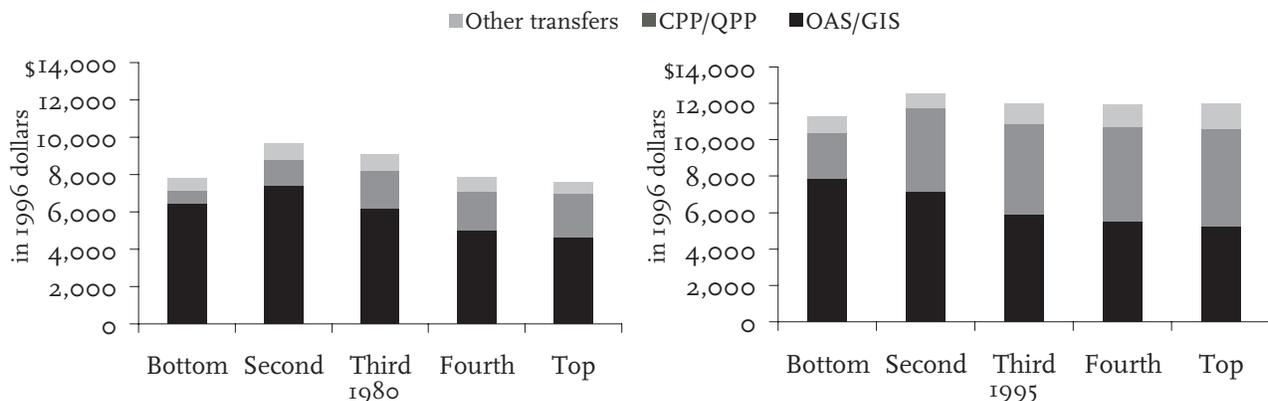
GIS supplements and remaining somewhat below the official poverty line.⁷

Canada's public old-age income programs were designed to provide a foundation for individuals' retirement income; they were not intended as the sole support for the bulk of the population. The maintenance of pre-retirement living standards was the responsibility of private efforts, especially employer retirement plans. The reforms enacted in 1965-66 nevertheless enhanced the coverage and security of employer plans. As in the United States, these plans would contribute to the major expansion of old age incomes at the end of the twentieth century, especially for middle- and high-wage workers (See Figure 2).⁸

The Reformed Canadian System

After 1980, powerful demographic and economic forces challenged the solvency of retirement income programs throughout the industrial world. Rapid population aging would significantly stress the public OAS, GIS, and C/QPP pay-as-you-go programs, beginning about 2010. Increased volatility in product, financial, and labor markets, along with population aging, would undermine the solvency of employer defined benefit pension plans. Canada responded to these pressures by introducing employer plan reforms similar to those seen in other industrial nations. Its response to the solvency problem in its public programs, however, was far more unique.

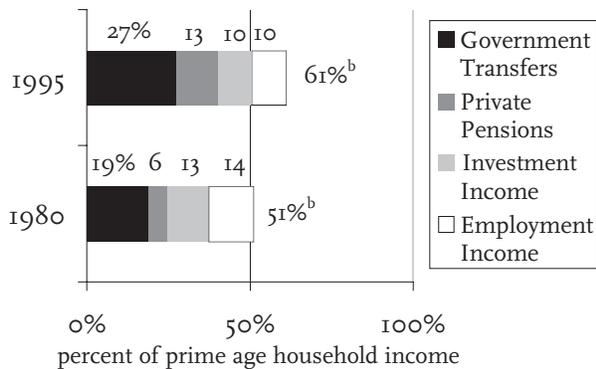
FIGURE 1. GOVERNMENT RETIREMENT INCOME BENEFITS BY INCOME QUINTILES, 1980 AND 1995



Source: Myles (2000).

*Note: Household income, sorted into income quintiles based on household income given in 1996 dollars and adjusted by family size.

FIGURE 2. SOURCES OF INCOME OF ELDERLY CANADIAN HOUSEHOLDS, 1980 AND 1995^a



Source: Myles (2000).

a. Average income of households headed by someone 65 or older, relative to average income of households headed by someone 24-54 (Baldwin and Laliberte, 1999).

b. The sum of the income components differs from the total because figures have been rounded.

Shoring up the Solvency of Employer Pension Plans

The solvency of employer defined benefit pension plans was hardly a new concern. Most plans were actually insolvent when the Pension Benefit Acts were introduced in the mid-1960s. Defined benefit plans, unique among major financial institutions, generally begin life totally insolvent. They give workers credit toward future pensions based on their past service with the firm before the first dollar has been deposited in the pension fund. And most Canadian plans were young, having been created or significantly expanded after the Second World War.

The new regulations addressed the solvency problem by adopting the "best practice" funding rules used by pension actuaries. They measured the size of the deficit by asking the amount of additional assets the plan would need, given the expected returns on those assets, to pay future benefits. The shortfall was the difference between the value of pension fund assets and the value of projected benefit obligations, discounted to the present using the expected return on those assets. The Pension Benefit Acts then required any initial "past service" deficit to be amortized, or extinguished, within a thirty year period.

A fundamental problem with this approach, especially in the more volatile economy that emerged after

1980, is that employer plans typically invested a substantial portion of their assets in equities. Equities have a greater expected return than bonds, but carry more risk. So even in plans that are currently solvent, the value of pension fund assets will likely fall below the present value of benefit obligations at various points in time. The assumption implicit in the actuarial funding approach is that the sponsor functions as the plan's financial guarantor. When "risk happens," the sponsor increases its contributions to bring the plan back into balance. And when asset returns are high, the sponsor recoups these added expenditures by reducing its contributions.

The sharp recessions of the early 1980s illustrated the limitation of this approach. Equity prices fell sharply. The expected return on equities also fell, raising the present value of future benefit obligations. But rather than backstop their plans, many sponsors themselves went bankrupt.⁹ The liabilities of a terminated plan are different from those of an ongoing plan. Benefits are based on earnings at the time of the termination, which are lower than earnings projected at retirement, or separation from the firm at some later date. Without the sponsor as a financial guarantor, however, the plan must satisfy these obligations by purchasing annuities from an insurance company. Insurance companies are legally required to fund annuities with low-risk bonds, which carry an interest rate well below the expected return on equities. So while pension benefits in a terminated plan are less than those in an ongoing plan, the amount of assets needed to fund each dollar of benefits is greater.

To protect worker benefits in the event a plan terminates, Canada enacted the Pension Benefit Standards Act in 1987 that introduced a second solvency measure. It asked whether the plan had sufficient assets to satisfy its termination liability — the value of future pensions based on current wages, discounted to the present using the interest rate on low-risk bonds. If there was a significant deficit, the sponsor had to pay it down within five years. Sponsors were thus required to value their plans on both an on-going and termination basis, calculate the required contribution using both approaches, and fund the plan at whichever level was greater.

Shoring up the Solvency of Public Plans

Canada's primary solvency problem lay in its public programs, which were funded on a pay-as-you-go basis. With the maturation of the C/QPP, older Canadians now relied more on government benefits and less on labor income than in 1980.

And the number of working age adults for each person age 65 or over was projected to fall from 6.6 in 1970 to 2.4 in 2030 (see Figure 3). Thus the burden on each working-age adult would rise dramatically. The C/QPP, for example, took only 2.4 percent of earnings (split evenly between workers and employers) when the program was introduced. It required 5.6 percent in 1996. But to pay promised benefits in 2030, the tax rate would need to be nearly three times the 1996 level.

Like other industrial nations, Canada responded to the impending demographic transition by reducing benefits and raising contributions. But because the Canadian program focused on poverty reduction, the cuts were small.¹⁰ Canada's primary response to the challenge of population aging was the decision, in 1997, to prefund the C/QPP and invest the accumulated assets in equities. The reform was sparked by the government actuary's 1995 report on the program, which projected a sharp rise in benefit payments in the coming century. To fund these benefits on a pay-as-you-go basis, contributions would need to rise from the current 5.6 percent of covered earnings to 14.2 percent by 2030.¹¹

There was significant opposition, however, to pushing the payroll tax that high in 2030. The primary objection was inter-generational fairness. In response to the prospect of such a sharp increase in the tax rate, a consensus had developed around the notion that each generation should contribute much the same share of earnings to support the C/QPP and get, in return, a benefit that replaced much the same earnings in retirement.¹²

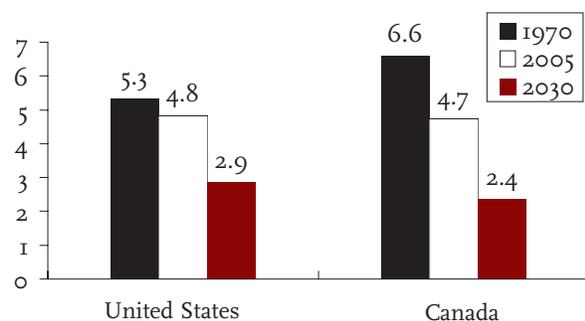
The key reform of the C/QPP program enacted in 1997 thus involved a rapid rise in contributions to its projected uniform long-term rate. The rapid rise was designed to build-up the C/QPP trust fund in the near term, with income on trust fund assets augmenting contributions to pay benefits in the out-years. And to increase trust fund income and reduce

the long-term contribution rate, the C/QPP would invest trust fund assets in equities.¹³

The decision to invest C/QPP assets in equities, with their greater expected return but also greater risk, was strongly influenced by the contrasting experience of the QPP and CPP trust funds. Both plans had accumulated assets, equal to about two years of benefit payments, as a buffer against cash flow shortfalls. Each plan also pursued a policy of "social investment" — investing trust fund assets to achieve "socially desirable" objectives in addition to traditional financial goals. And both notions of "socially desirable" reflected the influence of the Canadian provinces in national pension policy. The CPP invested its assets in non-marketable provincial bonds with a yield equal to that on federal debt. As the federal government paid a lower interest rate than the provinces, and as the bonds were not marketable, the CPP was subsidizing the provincial governments. Quebec adopted a more active social investment policy, with the QPP directed to buy equities and fund projects thought to advance the economic development of the province. Such active "social investment" strategies also tend to produce sub-par risk-adjusted returns. But the three decades in which the C/QPP programs had been in existence had been a boom period for equities. And the QPP over time had moved away from social investing toward a policy that emphasized standard risk-adjusted return optimization. The QPP thus clearly out-performed the CPP. With this experience in the advantages of equity investments in social insurance programs, the 1997 reform decided to invest CPP assets in equities.¹⁴

The 1997 CPP reform, however, rejected social investment. It defined the sole objective of the CPP Investment Board (CPPIB) as acting in the best interests of plan participants — both active and retired — under the governing notion that each generation should contribute much the same share of earnings and get much the same benefits. That investment decisions are made solely in the best interests of plan participants is the fiduciary standard that the (U.S.) Employee Retirement Income Security Act and the Canadian Pension Benefit Acts require of employer defined benefit plans. To pursue such a policy at the CPP, the 1997 legislation created the CPPIB, a quasi-independent agency explicitly modeled on the "institutional investor" governance system that ERISA and the Pension Benefits Acts mandate for publicly regulated employer plans. In addition to defining participants as the sole beneficiaries of the plan, this governance system requires the CPPIB to "exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances"

FIGURE 3. RATIO OF WORKING AGE (AGE 20 TO 64) TO RETIREMENT AGE (AGE 65+) POPULATION



Source: Author's calculations based on United Nations Secretariat (2004).

when handling plan assets and to provide periodic performance reports to assure accountability.¹⁵

The 1997 legislation defined an elaborate set of procedures designed to make the CPP Investment Board as independent from the government as possible. To name the members of the Investment Board, the participating provincial governments, as "stewards" of the program, would each select one member of the nominating committee. That committee would draw up a list of candidates that excluded government officials and included investment professionals. The federal Minister of Finance, in consultation with the provincial Ministers of Finance, would then select the Investment Board members. To assure efficiency, transparency, and public accountability, the Board was required to conduct periodic internal performance reviews, issue quarterly and annual financial reports, organize biennial town meetings in each province, and undergo a thorough triennial review.¹⁶

The CPP Investment Board has embraced the institutional investor model. "As a long-term investor, with substantial annual cash inflows for the next twenty years," it intends to "build a broad-based portfolio" that includes not just investments in stocks and bonds, but also in merchant banking, real estate, infrastructure projects, and venture capital, private equity, and buyout funds.¹⁷ The Investment Board also intends to become active in corporate governance under the notion that "the thoughtful voting of our proxies can constructively influence corporate performance and have a positive impact on the value of our portfolio."¹⁸

"TO SECURE EMPLOYER PENSIONS, CANADA
TIGHTENED FUNDING RULES."

Will the Reform Succeed?

In response to the solvency problems that emerged in both employer and government plans after 1980, Canada imposed new funding requirements to safeguard accrued pension benefits should the sponsor go bankrupt and built up its social insurance trust fund and invested those assets in equities.

Shore up the Solvency of Employer Plans

From the enactment of the employer plan reforms in 1987 through the end of the century, very few plans terminated with insufficient assets. A booming stock market and high returns on capital generally produced comfortable surpluses when plans were valued on either an ongoing or termination basis. Employer

plans were so well funded that 1) many sponsors took extended funding holidays and 2) the government restricted the ability of sponsors to make tax-deductible contributions to plans with "excess surplus" — defined as plans with pension fund assets greater than 110 percent of plan liabilities.

But the financial downturn at the beginning of the new century quickly pulled them into the red. At year-end 2000, the plans of companies listed on the Toronto Stock Exchange had assets equal to about 115 percent of plan liabilities. But by May of 2003, assets barely covered 80 percent of plan liabilities. The new funding rules now generally became binding, requiring sponsors to extinguish termination-valuation deficits within five years.¹⁹

The increased contributions, required by the new regulations, were largely responsible for lifting the overall funded ratio — the ratio of assets to liabilities — above 85 percent by year-end 2003. The recovery in stock prices had raised the value of pension fund assets. But this positive effect on plan finances was largely offset by declines in the discount rates used to value plan liabilities — both the

expected return on trust fund assets, used to value liabilities on an "ongoing" basis, and the yield on low-risk corporate bonds, used to value liabilities on a termination basis.²⁰

A major shortcoming of the 1987 reform, however, was the perverse funding pattern it imposed over the business cycle. During upswings, both the ongoing and termination valuations gave employer plans a clean bill of health and funding requirements were low. The restrictions on funding plans with "excess surplus" exacerbated this tendency to reduce contributions when times were good. But in economic downturns, when sponsors were financially stressed, the new rules forced a sharp spike in contributions.

The demand for stepped-up pension contributions in the downturn of the early 2000s accelerated the shift by employers out of defined benefit plans. Such plans had covered a steadily declining share of the work force. But the fall off was milder than in the United States, with employer defined benefit plans still covering 35 percent of wage and salary workers in 2003, compared to 40 percent in 1980. But a 2004 survey of 68 large firms, conducted by Watson Wyatt and The Conference Board, found that 30 percent had either eliminated a defined benefit plan, converted one to a defined contribution format, or were planning to do so. And of the companies with underfunded plans, nearly 60 percent had taken a contribution holiday during the previous four years. Of

these, less than a quarter had wanted to contribute but was prevented by government funding restrictions. The great majority had happily gone on a contribution holiday — implicitly accepting the solvency measurements taken at the height of the boom as the best indication of the long-term health of their plans.²¹

The experience exposed serious shortcomings in the regulation of employer plans. The primary tool for identifying problems — the funded ratio — turned out to be flawed. Whether calculated on an ongoing or termination basis, it considers only the current value of assets and liabilities. It ignores the substantial risks involved in funding long-term pension obligations with equities, a highly unstable structure. Also problematic is the use of stepped-up contributions as the response to a sudden deterioration in funded ratios. This is especially onerous now that most employer plans have matured, and have substantial asset accumulations, with investment returns accounting for about

two-thirds of benefit payments.²² The financial downturn at the turn of the century thus produced losses that dwarfed the employer's annual contribution. Forcing sponsors to quickly make up such losses became a burden that led many to terminate or curtail their plans.

Shore up the Solvency of Public Plans

Canada's response to the solvency problem in its public programs also involved the use of equities. It is too early to evaluate the success of this approach. The primary concerns, however, are the financial and political risks inherent in the new funding model.

The CPP is in a far better position than an employer defined benefit plan to manage financial risks. The funding program of an employer plan implicitly relies on the sponsor to guarantee solvency. But sponsors go bankrupt, especially in recessions, when large shortfalls tend to emerge. In Canada (but not the United States), sponsors can also walk away from an underfunded plan at any time. The regulations governing employer plan solvency thus only consider assets held in the pension fund and ignore the viability of the sponsor and any future contributions. Whether evaluated on an ongoing or termination basis, the basic question is whether pension fund assets are sufficient to pay promised benefits.

The solvency of the CPP and other social insurance programs, by contrast, is typically evaluated in

cash-flow terms. The fundamental solvency question is whether the current level of contributions is sufficient, given the financial structure of the program, to pay promised benefits. The CPP funding model, developed by the government actuary, projects a level contribution rate, set at 9.9 percent of covered earnings, exceeding benefit payments through 2020. The model makes various assumptions about future economic performance. Among the most critical are the projected 4.65 percent real return on equities, 3.55 percent return on bonds, and 4.1 percent total return on trust fund assets. If past experience is a reasonable guide, returns will vary dramatically from year to year and could even be negative for an extended period of time. Past experience might also be an imperfect guide, and the long-term return on equities might be lower in the future than it has been in the past. A final risk is that the plan's financial managers succumb to euphoria in booms and trepidation

in busts, buy high and sell low, and fail to capture the available long-

run returns. The success of the reform will depend on the CPP's ability to handle such risks.

The CPP is in a strong position for managing the first type of risk — fluctuations around the expected long-run rate of return. If the required triennial review identifies a funding shortfall, similar to that caused by the financial downturn at the turn of the century, the 1997 legislation included an automatic adjustment mechanism that restores solvency by freezing benefits and raising the contribution rate. The political system could enact a different response. But the stabilizer is a guarantee that the CPP's finances will not go off the rails.

The required adjustments, moreover, would not be as draconian as those required of employer plans in the early twenty-first century. As the government was presumed to continue indefinitely, the automatic stabilizer would restore balance over 100 years — a sharp contrast to the 5 years given to employer plans with termination valuation deficits. The CPP is also far less reliant on investment income than a mature employer plan, and thus less vulnerable to the risk in investment returns. Investment income is projected to contribute only 25 percent of CPP inflows, with total inflows 10 to 15 percent greater than projected outlays. In mature employer plans, by contrast, investment income is generally more than twice as large as employer contributions. Financial fluctuations should thus have a much more moderate effect on CPP solvency.

“TO SECURE PUBLIC PENSIONS, CANADA PRE-FUNDED FUTURE BENEFITS WITH EQUITIES.”

A permanent decline in asset returns is a more serious concern. To protect against this risk, the CPP funding model assumes a conservative 50-50 allocation of equities and bonds; a conservative 4.1 percent real return on trust fund assets; and a funding model that projects substantial cashflow surpluses and a rising ratio of assets to outlays. If investment returns do decline to the point where the actuarial review finds the 9.9 percent contribution rate inadequate, the automatic adjustment mechanism would push up contributions and cut back benefits. Only if real returns fall significantly below 4 percent would the CPP funding program face serious problems.²³

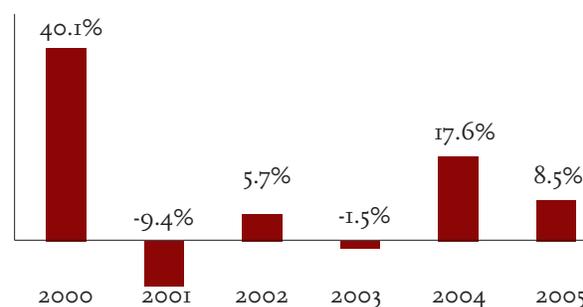
The CPP funding program also requires disciplined long-term investment management at the CPPIB. And thus far it has had such a policy. Even though investment returns have been extremely volatile over the early years of the reform (see Figure 4), the CPPIB has maintained a disciplined long-term outlook. The 2004 Annual Report explained that a "large part of the reversal in the CPP's investment fortunes ... was the result of our decision to continue to build the equity portfolio throughout the market collapse that began in the fall of 2000 and continued to the spring of 2003, one of the worst declines in a century. Many Canadians were concerned that we were on the wrong track and should invest in bonds, or hold cash and try to time the market bottom. Our decision to stay the course and buy shares in hundreds of Canadian and foreign companies resulted in equity gains of \$7.2 billion versus a \$4.1 billion loss a year earlier. For us, the stock market collapse was a buying opportunity in a long investment journey."

The use of equities to fund the CPP also creates a set of political risks. Researchers have identified four such risks in building up a social insurance trust fund. These risks are that a trust fund would:²⁴

- become a captive source of credit that would fund the government at below-market rates;²⁵
- invest in "socially desirable" projects and/or avoid "socially undesirable" projects;²⁶
- use its power as a major shareholder to promote "socially desirable" and/or avoid "socially undesirable" corporate decisions, such as those regarding plant closings or mergers and acquisitions; and
- prop up financial markets in a "crisis."

Most Canadian observers view the CPPIB as well protected from political influence that could lead to

FIGURE 4. INVESTMENT RETURNS FOR THE CANADA PENSION PLAN INVESTMENT BOARD



Source: CPPIB (2005).

*Note: If \$100 were invested at the beginning of 2000 and experienced these returns, its value would be \$169 at the end of 2005. This would be an internal rate of return of 8.7 percent per annum.

such outcomes. Because of the explicit "institutional investor" mandates included in the 1997 legislation, and the elaborate governance and reporting structures, the CPPIB is widely viewed as professional, independent, and accountable.²⁷

Some critics, however, contend that the government has too little influence on the CPP Investment Board. They worry that the "institutional investor" model unduly strengthens the hand of "capital" against competing, and weaker, "socially desirable" interests. Such critics have objected, for example, to CPP investments in Talisman Energy, a large Canadian oil and gas producer with operations in Sudan. Because Talisman funded the Sudanese government's widely criticized military campaigns, the U.S. government threatened to bar it from U.S. financial markets. Critics also object to CPP investments in buyout funds, which finance corporate restructurings that result in layoffs and plant closings. Members of Parliament have also called for "ethical" screens, which would restrict investments in tobacco companies and providers of other "socially undesirable" products.²⁸

Calls for a more "socially responsible" investment policy will no doubt continue. In time, this could result in a change in the CPP Investment Board's mandate. The acceptance of "social investment" as a policy objective could well advance Canada's larger public policy objectives. Such a change, however, would clearly jeopardize the CPP funding model and its contribution to retirement income security.

Conclusion

Canada responded to financial pressures over the past quarter century, with reforms to both private and public pension plans. With respect to employer plans, the new funding requirements cannot be viewed as successful, as they contributed to a significant contraction in the very plans they were designed to strengthen. This shift away from defined benefit plans means a withdrawal of employer contributions, investment management expertise, and inter-temporal risk-bearing from the retirement income system. While workers in defined contribution plans could offset the loss of employer contributions, they are unlikely to offset the loss of investment management and inter-temporal risk-bearing.

By contrast, Canada's public pension reform effort seems promising. Most observers agree that the CPP Investment Board has thus far managed trust fund assets in an independent, professional, and accountable fashion. And the use of equities to fund the CPP has allowed it to maintain benefits with a level contribution rate lower than it otherwise could. This is extremely important given the projected rapid rise in the cost of other public programs for the elderly. It has also allowed Canada to pre-fund retirement income benefits within the traditional defined benefit structure. As employers shift to defined contribution arrangements, the predictability of public benefits provides a secure retirement income floor. This helps workers plan their retirement and allows them to take more risk in their supplemental plans. For all these reasons, the Canadian system deserves careful attention.

Endnotes

- 1 The Old Age Pension program closely resembled the program enacted in the United Kingdom in 1908. See Sass (2004).
- 2 Osberg (2001).
- 3 Reflecting the importance of the provinces in Canadian pension policy, the program was organized as a joint federal-provincial initiative; provinces were allowed to opt out if they created a similar program, a path taken by Quebec; and all major changes required the approval of the federal government and two-thirds of the provinces with two-thirds of the population. Like other social insurance programs, the C/QPP program was "rushed to maturity." While introduced in 1966, workers who had consistently contributed from that date could retire on a full C/QPP pension at age 65 from 1976 onward.
- 4 The Guaranteed Income Supplement was income-tested rather than means-tested. Only income, rather than income and assets, was considered in calculating eligibility and benefit levels (Osberg, 2001).
- 5 Again reflecting the importance of the provinces in Canadian social welfare policy, the Pension Benefit Acts that imposed these regulations were enacted at the federal *and* provincial levels in 1965 and 1966.
- 6 The benefit for the policy model "average earner" was essentially the same as that provided by the U.S. Social Security program after its expansion in 1972 and the level targeted by the combined U.K. Basic State Pension and State Earnings Related Pension enacted in 1978. The GIS program, however, made the Canadian system more generous to lower-income groups; and the lack of benefit increments for workers earning more than the average wage made it less generous to upper-income groups (Myles, 2000); (Battle, 2003); (Osberg, 2001); and (Béland and Myles, 2005).
- 7 It is important to note that the Canadian poverty line is now significantly higher than the benchmark used in the United States. In 1994, the Canadian poverty line for a family of four in a medium sized city was C\$26,650 — 40 percent higher than the U.S. poverty line of C\$19,024 (converted to Canadian dollars on a purchasing parity basis). The Canadian poverty rate would thus be significantly lower if measured using the U.S. benchmark (Myles, 2000); (Osberg, 2001); (Battle, 2003); and (Sarney and Preneta, 2001/2002).
- 8 Baldwin and Laliberte (1999); and Myles (2000).
- 9 Unlike in the United States, Canadian employers are generally free to terminate their plan and walk away from any funding shortfall.
- 10 The benefit cuts primarily targeted the well-to-do, mainly through reductions in tax relief for the elderly and a limited clawback, or income-tested reduction, of OAS benefits. For details, see Myles (2000) and Battle (2003).
- 11 Federal, Provincial and Territorial Governments of Canada (1996a and 1996b).
- 12 Federal, Provincial and Territorial Governments of Canada (1996a and 1996b); and Pesando (2001).
- 13 CPP benefits were also reduced by a change in the indexing formula: The benefit calculation now indexed past wages to the present, with the "present" defined as average wages over the five years prior to retirement, rather than three. As a result, benefits are now sometimes estimated at 24 rather than 25 percent of indexed earnings. The reform also reduced future outlays by tightening access to CPP disability benefits. In addition to raising the contribution rate, the 1997 reform increased revenues by freezing the "exempt amount" of earnings not subject to tax. This exempt amount, which had been pegged at earnings up to 10 percent of average earnings, was now frozen at \$3,500.
- 14 Department of Finance Canada (1997); Béland and Myles (2005); and Béland (2006 forthcoming). A proper analysis of the choice between equities and bonds in a social insurance program would not focus narrowly on the experience of the CPP and QPP from the mid-1960s through the mid-1990s. But the political process rarely makes decisions based on proper analysis. Within the investment community, which is sophisticated about such issues and tends to be suspicious about government, the recognition that the QPP had essentially abandoned social investment and was professionally managed did reduce anxiety over the use of equities in the CPP (Communication from John Myles).
- 15 CPPIB (1997); and Slater (1997).
- 16 Department of Finance Canada (1997); and Slater (1997).

17 CPPIB (2003a).

18 CPPIB (2005).

19 Watson Wyatt Worldwide (2004).

20 Watson Wyatt Worldwide (2004).

21 Watson Wyatt Worldwide (2004).

22 The data described in the following example are for U.S. pension plans; results are likely similar for Canadian plans. In 1999, single employer defined benefit pension plans paid out \$91 billion in benefits and held \$1.65 trillion in assets. If U.S. plans were 30 percent overfunded, as was then the case in the plans of 100 very large firms surveyed by Milliman, the pension consultant, \$1.27 trillion was the "fully funded" level of assets. If 60 percent of those assets were invested in stocks with an expected real rate of return of 6.5 percent, and 40 percent in bonds yielding an expected 2.25 percent real return, expected investment income would be \$61 billion, or 67 percent of benefit payments (U.S. Department of Labor, 2004); and (Milliman, 2005).

23 Sarney and Preneta (2001/2002); Slater (1997); Ambachtsheer (1997); and Office of the Chief Actuary (2004).

24 The political risks of trust fund investment are described in Palacios (2002).

25 This was clearly the case at the CPP before 1997, as it only bought provincial government bonds paying a sub-market yield. This subsidized provincial borrowing allowed provincial governments to spend more than they otherwise would, weakened the finances of the CPP, and distorted the democratic budgeting process. To the extent that the policy increased government spending, it also reversed the contribution to national saving created by the funding program. Shifting CPP investments from provincial bonds to equities thus reduced the political risk that the CPP would function as a captive source of credit.

26 This was clearly the case in the initial QPP investment program.

27 John Myles (2005) reports that there is "a high level of 'trust' in government to actually treat the fund at arms length."

28 Social Investment Organization (2002); and Cooke (2003).

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About the Center

The Center for Retirement Research at Boston College was established in 1998 through a grant from the Social Security Administration. The Center's mission is to produce first-class research and forge a strong link between the academic community and decisionmakers in the public and private sectors around an issue of critical importance to the nation's future. To achieve this mission, the Center sponsors a wide variety of research projects, transmits new findings to a broad audience, trains new scholars, and broadens access to valuable data sources. Since its inception, the Center has established a reputation as an authoritative source of information on all major aspects of the retirement income debate.

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