

## Province of Nova Scotia Department of Finance

### MECHANISMS FOR ENHANCING THE RETIREMENT INCOME SYSTEM IN CANADA

The Government of Nova Scotia is working with other provinces and territories, and the Government of Canada, to consider opportunities for enhancing Canada's retirement income system. The overall goal is to increase savings from employment income of individuals (i.e. future retirees) who are not currently saving enough to obtain sufficient levels of replacement income to maintain their standard of living in retirement.

Finance Ministers have been informed by comprehensive research as well as proposals and comments submitted by numerous interest groups and individuals. Selective reports and research from various jurisdictions can be found at:

<http://www.gov.ns.ca/lwd/pensionreview/default.asp>

<http://www.fin.gc.ca/activty/pubs/pension/riar-narr-eng.asp>

<http://www.fin.gov.on.ca/en/consultations/pension/dec09report.html>

The Finance Ministers provided direction at their June 2010 meeting for continuing work in this area. They acknowledged the importance of financial literacy and the central role that the Canada Pension Plan (CPP) plays in our government supported retirement income system. Most Ministers have agreed to consider a modest, phased-in, and fully-funded enhancement to the CPP in order to increase coverage and adequacy. Ministers further agreed to continue to work on pension innovations that would allow financial institutions to offer broad based defined contribution pension plans to multiple employers, all employees, and to the self-employed. Results of further work on technical and implementation issues will be presented at the late Fall 2010 meeting. This paper seeks your views on these important issues. The Government of Nova Scotia wants to ensure that the perspectives of Nova Scotians are reflected in recommendations as they are developed.

#### **BACKGROUND**

##### *Retirement Income System – The Three Pillars*

Canada's Retirement Income System (RIS) has been described as being composed of three supporting pillars:

- Pillar One is comprised of publicly funded pension programs based on age that are financed from tax revenues and focus on the elimination of poverty. These programs are typically available to Canadian citizens and legal residents, based on criteria such as age and years of residence, with or without an income or means test. Pillar One consists of Old Age Security (OAS), the Guaranteed Income Supplement (GIS) and two smaller programs targeted at spouses and surviving spouses (aged 60-64) of OAS/GIS recipients.
- Pillar Two is made up of compulsory programs for the employed and self-employed that focus on providing minimum income protection in retirement by replacing a portion of pre-retirement earnings. These programs are funded by employer and employee contributions,

and investment earnings, and are available only to those who contribute. Pillar Two consists of the Canada Pension Plan and Quebec Pension Plans (CPP/QPP).

- Pillar Three consists of voluntary personal savings, including employer-sponsored occupational pension plans and tax-assisted individual retirement savings, and investment income such as from housing or business investment including selling these assets. Pillar Three includes registered pension plans (RPPs) provided voluntarily by employers and/or unions, group or individual registered retirement savings plans (RRSPs), and the new Tax Free Savings Accounts (TFSA).

### *Adequacy for the future*

The three pillars combined are intended to provide retirees with adequate income to approximate their pre-retirement living standards. Indications are that current retirees are receiving significant income replacement levels from this system but the situation for future retirees is less certain.

Research was done on what replacement rates of income would be needed in retirement to help maintain a similar standard of living. Because of the design of Pillars One and Two<sup>1</sup>, there is less earning replacement from these programs as income increases. At the low earning levels, few savings are needed as Pillars One and Two will replace most of the income but as income levels increase the need to save increases sharply over the modest/middle earning ranges and then grows more slowly over higher income levels. Currently the structure of the RIS system which has contribution limits on CPP, RPPs, RRSPs and TFSA means that as income becomes higher, households are less likely to meet targeted levels of savings within the RIS.

Research<sup>2</sup> prepared for the Ministers indicates that 31 per cent of Canadians are at risk of experiencing a drop in their consumption in retirement because they are not saving enough through retirement savings (RRPs and RRSPs). This figure masks where the problem is concentrated as 91 per cent of Canadian low-income households are saving enough but nearly 40 per cent of modest, middle and high income earners are not<sup>3</sup>. Because of the structure of the RRSP and RPPs high income earners would not be able to meet replacement targets within these programs but this groups is more likely to have other savings outside this system. Horner's work indicated those relying on savings only through RRSPs were more likely to fall short of the required savings rate. This is concerning as RPPs has been steadily declining. Currently, three out of four private sector workers are not covered by a workplace pension plan, and the self-employed are not permitted to be members of these plans.

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<sup>1</sup> OAS is a flat rate benefit, though reduced for those with high retirement income while the GIS is means tested. The CPP pension benefits only replace income to a certain maximum.

<sup>2</sup> Horner, K. (2009) "Retirement Saving by Canadian Households". Published work prepared for the Working Group on Retirement Income Adequacy. <http://www.fin.gc.ca/activty/pubs/pension/ref-bib/horner-eng.asp>

<sup>3</sup> Horner adjusted the household income ranges by family size and composition. For single persons and lone parent families, modest income is \$25,000 - \$60,000 and middle income is \$60,000 to \$100,000. For couples and two parent families, modest income is \$40,000 to \$100,000 and middle income is \$100,000 to \$166,700. This is in 2006 dollars.

### *The Nova Scotia Perspective*

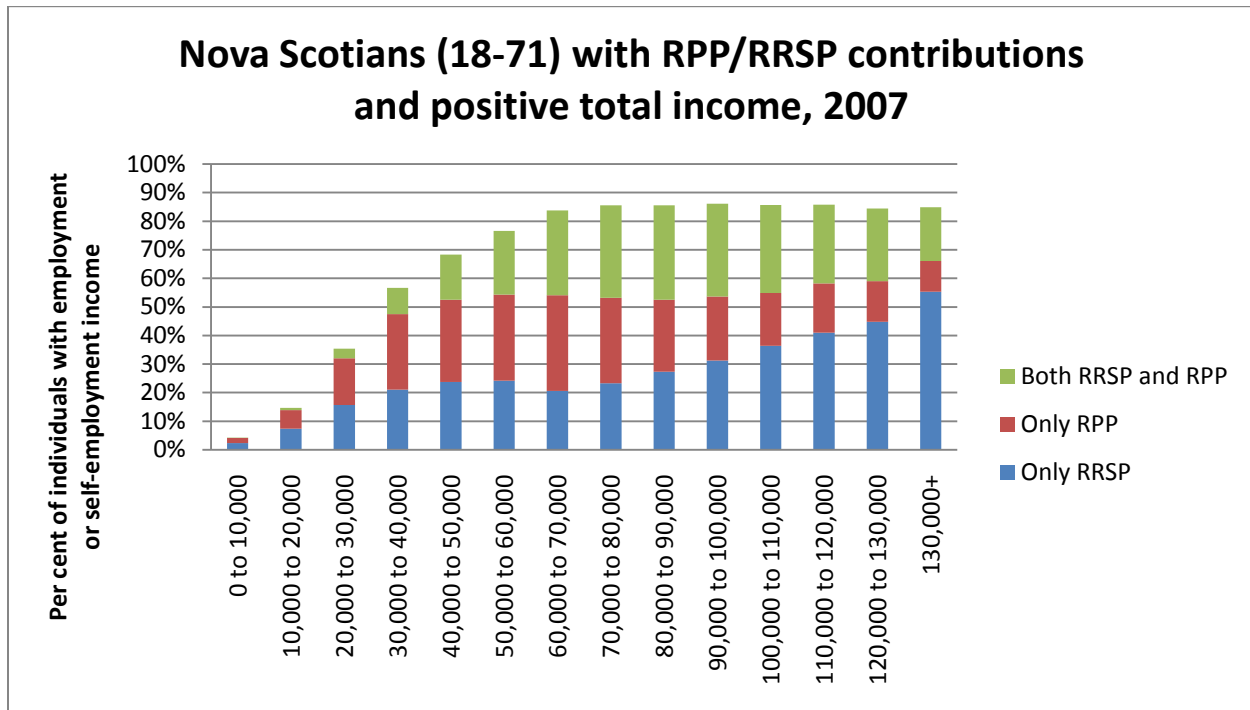
Information on the number of Nova Scotians contributing to RPPs and RRSPs provides some insight to this issue.

According to the figure *Nova Scotians (18-71) with RPP/RRSP contributions and positive total income, 2007* only 46 per cent of Nova Scotians who were employed<sup>4</sup> with positive total income made a contribution to a RPP and/or RRSP. This means that over half of employed Nova Scotians do not contribute to RPPs or RRSPs in any given year.

Participation increases with income before essentially levelling off at \$70,000 at approximately 85 per cent making contributions.

- At \$30,000 to \$40,000 of total income, 43 per cent did not make any contributions and 21 per cent made only RRSP contributions.
- At \$40,000 to \$50,000, it was 32 per cent did not make any contributions and 24 per cent made only RRSP contributions.
- At \$50,000 to \$60,000 it was 23 per cent who did not make any contributions and 24 per cent only contributed to RRSPs.

Just over 80 per cent of employed taxfilers (aged 18-71) had positive total income under \$60,000 with 34 percent having between \$30,000 and \$60,000 of total income.



<sup>4</sup> Includes self-employment

Source: Nova Scotia Department of Finance

The participation in RRP's and RRSP's would seem to suggest a significant number of Nova Scotians are not saving to support similar levels of consumption in retirement.

## **APPROACHES**

A range of possible approaches to enhancing Canada's RIS have been proposed by various stakeholders. After careful consideration of the research and suggestions, the Finance Ministers decided to concentrate on two approaches.

- Enhancement of the existing Canada Pension Plan – making modest, phased-in and fully funded changes to increase coverage and adequacy; and
- Pension Innovation - modernizing pension legislation so that there can be more flexibility in pension plans such as allowing financial institutions to offer broad-based defined contribution pension arrangements to multiple employers, all employees and to the self employed. This would require changes to federal taxation rules and federal, provincial and territorial collaboration on modification of pension standards.

Continuing work on technical and implementation issues will be reported to the Finance Ministers at their next meeting expected in late Fall 2010.

The two key proposals are further discussed below.

### **1. Enhancement<sup>5</sup> of the existing Canada Pension Plan – modest, phased-in and fully funded**

The Ministers have specified the changes to the CPP will be modest, phased-in and fully funded which means that the employers and employed individuals would pay the full-cost of the changes and these changes would be implemented over a number of years. As such the full increase to pension benefits may take approximately 40 years to be fully experienced by “new” retirees.

The CPP is a national, mandatory DB pension plan available to both employed and the self-employed. All employers, employees and the self-employed are required to pay combined contributions (currently 9.9 per cent) on employment income up to the Year's Maximum Pensionable Earnings (YMPE). The YMPE is set annually by the CPP based on that year's average wage in Canada (\$47,200 in 2010). Funds are invested by an independent, expert board of trustees.

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<sup>5</sup> Changes already approved generally will come into effect in 2012 and they will not affect anyone who is currently on CPP benefits or who will receive benefits prior to 2012. These changes will include removal of the work cessation test, an increase in the period that low or no earnings can “drop-out” of the calculation of CPP benefits, contribution requirements for CPP while receiving benefits and being employed, and pension adjustments for early and late CPP take-up.

The monthly retirement benefit is predetermined by formulae based on earnings history, years of service and age. Currently, a maximum pension (\$937.17 monthly in 2010) is payable if an individual earns the maximum pensionable earnings under the CPP over a 40 year period.

Two important elements of the CPP formula are:

1. The targeted earnings replacement rate- this is the percentage of pre-retirement earnings sought to be provided by a pension plan. It is currently at 25 per cent.
2. The maximum level of annual income that would be subject to contributions (YMPE)  
Currently this is \$47,200

Changes to the CPP could involve one or more of the following options: increasing the targeted replacement rate; increasing the YMPE; or some combination or variation of the two.

- The CPP could be expanded by increasing the targeted replacement rate which is currently at 25 per cent. A modest increase could be changing the replacement rate to 30 per cent, 35 per cent or some other amount. An increase in the replacement rate on career pensionable earnings would increase retirement benefits and contributions for *all* participants in the plan over time.
- The YMPE could be increased from \$47,200 to \$60,000, \$70,000 or some other figure with the replacement rate remaining the same. This would improve retirement benefits for those individuals who earn more than the average wage during their careers, so would not impact those earning less than \$47,200.
- Combination or variation of the two options could be pursued that would change the replacement rates for certain income levels to target income ranges that would be more likely to have insufficient replacement rates. Examples of such options could include:
  - Increase the YMPE but have a different replacement rate than the amount below the original YMPE (e.g., increase YMPE to \$60,000 but above the original YMPE have a 10 per cent replacement rate and below have the 25 per cent replacement rate or another specified rate );
  - At a specified amount increase the replacement rate (e.g., at \$30,000 increase the replacement rate to a higher replacement rate perhaps 30 per cent to the YMPE so the replacement rate would be 25 per cent to \$30,000, and 30 per cent to \$47,200 )
  - At a specified amount increase the replacement rate to the original YMPE and then have the original 25 per cent replacement rate to a “newer” YMPE (e.g., at \$35,000 increase the replacement rate to 35 per cent to \$47,200 then have it revert back to the 25 per cent replacement rate to a new YMPE of \$70,000).

Variations of the replacement rate and YMPE may leave the people at the lowest earning levels unaffected so that it does not change their qualification for the GIS which is an important source of retirement income at the lower levels of income.

### *Implications*

Changes to the CPP will affect both employers and the employed. Of the 452,800 people employed in Nova Scotia in 2009, 71.8 per cent were employed full-time; 14.8 per cent, part-time; and 13.4 per cent were self-employed. It was possible to develop estimates of the income ranges of full-time employees to develop a sense of the numbers of individuals who could be impacted by changes.

- In 2009, 66 per cent of full-time employees in Nova Scotia made \$46,750 or less, which is already under the 2010 YMPE of \$47,200.
- There were 67,100 part-time employees in Nova Scotia last year, the vast majority of whom make less than YMPE. Some of these may not be eligible for inclusion in the CPP as they may be under the age of 18 or over the age of 71 or make less than \$3,500 annually.
- Earning data were not available for the self-employed.

Changes to replacement rates without changing YMPE will affect all employers and individuals currently paying CPP. If suggested enhancements involved increasing the YMPE, in 2009 this would have affected approximately 34 per cent of full-time employees who earned above the YMPE plus any self-employed and part-timers earning above this amount

Any changes to the CPP would have employers and individuals paying contributions on earnings that had not previously been covered under the CPP and/or additional contributions to meet the higher replacement rates. These costs are not without implications to the firm, the employed individual or to the Nova Scotia economy. These changes can not be considered in isolation either, as CPP is one of a number of employment benefits (e.g., employment insurance, vacation, workers compensation, company pensions, etc.) that require contributions from the employers and/or employees. It is known that the contributions of some of these benefits will increase in the near future (i.e., employment insurance premiums). The increased labour cost to the employer may have an effect of causing the employer to substitute capital for labour. However the changes are expected to be modest and phased-in, moderating the effect. As well, such changes need to be considered in the context that the age structure of the Nova Scotia population will cause the future labour force to shrink which could have much more of an impact on wages than any CPP change.

It is difficult to determine the potential effects of proposed changes to pension plans on the private savings of individuals – if it would be an element of forced savings replacing current consumption, if there would be a substitution of previous savings not changing current consumption, or if there would be additional savings reducing personal consumption. Factors such as employment income, level of debt and life stage (e.g., accumulation of household assets, beginning a family) also impact savings.

## **2. Pension Innovation- Modernization of pension standards to improve flexibility in pension plan design**

The Ministers are interested in pension innovation that would allow financial institutions to offer broad based defined contribution pension arrangements to multiple employers, all employees, and to the self-employed. Such innovation will require changes to the federal tax rules, as well as federal-provincial- territorial collaboration on modifications to pension standards. All Canadian provinces (except Prince Edward Island) and the federal government have pension benefits standards laws that

set minimum standards for RPP investments, eligibility for benefits, funding requirements. These standards are comprised of rules that are detailed and prescriptive for the traditional Defined Benefit (DB) plan and are less well developed for other types of plans, such as Defined Contribution (DC) plans. Defined contribution plans have a specified contribution from the employer/employed worker but the future benefits can vary on the basis of investment earnings.

Pension plans have two fundamental characteristics that distinguish them from other retirement savings vehicles:

- The plan sponsor has a fiduciary or duty of trust to plan members to act only in the best interests of the plan members in all actions undertaken in relation to the plan and its fund; and
- Pension plan funds are 'locked-in' – i.e., subject to restrictions that ensure the money is used for a retirement pension.

Both characteristics preserve the intended purpose of pension plans, which is to provide income security for individuals when they are no longer expected to work. Some of the suggested proposals relate to the new world of work, where people move from province to province, and work for different employers throughout their careers, and thus want more portability in their pension plans. Suggested proposals for change include:

- Permit the regulator to approve, and issue guidelines for new plan designs;
  - Broaden the definition of plan administrator to permit an entity that is not an employer or a board of trustees to sponsor a plan (e.g., multi-employer groups, professional associations, corporations) subject to the requirement that the administrator or joint administrators, as the fiduciary for the plan members, must be in a position to make decisions in the best interests of members;
  - Broaden the definition of member to permit a worker who is not an employee to become a member (e.g., self-employed).
- For voluntary plans, enable the plan sponsor to:
    - Enrol members through automatic enrolment and assign a default investment portfolio, subject to the right to opt out; and
    - Annually increase a member's contribution rate to the maximum permitted under the plan, subject to the right to opt out.

## QUESTIONS

This paper describes two mechanisms for increasing retirement savings in Canada. Please provide your views on these two proposals, including comments on the more technical aspects.

What is the best option for the CPP proposal– to increase the replacement ratios, the YMPE or some combination or variation of the two? What do you feel are the merits of the various options? Do you have concerns with these options?

Would even a modest expansion of CPP have an impact on total earnings replacement opportunities to warrant a reconsideration of earnings replacement opportunities provided through RPP-RRSP limits?

Will proposed pension innovation changes affect employers' participation in employer sponsored pension plans? How will they effect employee participation? Will they assist the self-employed? What concerns are there for the proposals? Are there other innovations?

Are there tax implications to be considered in support of either of the options?

Are there broader economic or social implications for the options under consideration?

Please provide responses to the questions. At the same time, if you have other comments not addressed by these questions, please include them. Your responses will help us better identify and understand the implications of the ideas proposed.

**DEADLINE FOR COMMENTS: September 17, 2010**

**Please submit comments to:**  
**Department of Finance**  
**c/o Crown Agencies and Corporations**  
**Provincial Building, 1723 Hollis Street**  
**Halifax, NS B3J 1V9**  
**Email: [riaconsultations@gov.ns.ca](mailto:riaconsultations@gov.ns.ca)**  
**Contact: Susan Winfield**  
**Telephone: 902 424 8864**  
**Fax: 902 424 0635**

**Please note that the Department will be sharing comments it receives with others, and comments will not be kept on a confidential basis. Nova Scotia will be using the results of the consultation and comments received to help inform the ongoing discussions among federal, provincial and territorial Finance Ministers. Please be advised that given the nature of this process comments may be attributed to their source.**