

**BUSINESS COUNCIL ON NATIONAL ISSUES**

**ADEQUATE RETIREMENT INCOME  
- A CHALLENGE CANADIANS MUST FACE -**

**A Submission to  
The Parliamentary Task Force on Pension Reform**

**October 1983**

## **ADEQUATE RETIREMENT INCOME**

### **A CHALLENGE CANADIANS MUST FACE**

#### **Summary Statement**

Designing a system to provide adequate retirement income to Canadians is a challenge for governments, employers and employees alike. Too often the objectives of the various sectors have seemed irreconcilable, but the Business Council believes the responsibilities of government, the capacities of employers and the desires of Canadian workers can meet if we recognize that the challenge is twofold: we must ensure our elderly are supported by secure and adequate income in their retirement years and we must maintain a healthy and productive economy that will be able to sustain the pension system.

The Business Council believes that Canadians recognize the urgency of improving our retirement income system and offers the following comments and proposals.

1. Today's society must be prepared to put a larger proportion of today's income into savings if larger pensions are to be paid in the future;
2. A combination of public and private pension plans are needed to meet retirement income requirements; these plans should not be expected to provide 100% replacement of pre-retirement disposable income at all income levels;

## SUMMARY STATEMENT

Page B

3. Pension system reform should focus on continued growth in pension coverage through the availability of good program options in private occupational plans, not on the expansion of public plans;
4. Proposed improvements must be carefully costed and implemented to minimize adverse effects on employee standards of living and employer stability and competitiveness;
5. The Canada Pension Plan/Quebec Pension Plan (CPP/QPP) should be improved by bringing the Year's Maximum Pensionable Earnings (YMPE) up to the level of the Average Industrial Wage (AIW) as was originally intended;
6. Legislated improvements in occupational pension benefits should apply only to income up to the AIW. The legislated changes should not apply retroactively;
7. There should be early vesting and locking-in of pension benefits to allow a mobile employee to accumulate a satisfactory level of pension by retirement. For a terminating employee, the employer should provide at least 50% of this vested benefit, provided there is no mandatory inflation protection of the vested benefit;
8. Vested pension benefit credits should be portable with employees able to accumulate locked-in credits throughout their working lives;

## SUMMARY STATEMENT

Page C

9. A surviving spouse of a retiree should be provided the automatic option of the continuation of at least 60% of the pension payable when both were living;
10. The erosion of pensions by inflation is a valid concern. The full indexing of OAS/GIS and CPP/QPP provides substantially full inflation protection to low income pensioners. Middle and upper income groups receive significant protection from these plans also. In addition, many employers are improving pensions on an ad hoc basis and should continue this voluntary practise of adjusting them taking into account the rate of inflation, the needs of the pensioners, and the employer's financial capability. Extension of this approach should be encouraged and efforts should be continued to develop additional approaches to the problem. There should not be a mandatory system of inflation adjustments;
11. Government and pension plan suppliers should consider ways to encourage and assist employers, particularly smaller business, to institute plans for workers not otherwise covered. Mandating private plan coverage is neither desirable nor necessary;
12. Emphasis should be placed upon achieving uniformity among provinces in their individual pension reform initiatives, as problems will be compounded if different legislative paths are followed;

## SUMMARY STATEMENT

Page D

13. The problems of inadequate retirement income for today's elderly Canadians must be addressed by government by way of their social programs targeted at those whose requirements are not being met currently by the pension system.

The Business Council is convinced that the challenge of providing adequate retirement income for all Canadians can be met if governments and the private sector work diligently together to improve the coverage and administration of existing public and private pension plans, and to address remaining needs when they are identified.

## ADEQUATE RETIREMENT INCOME

### THE CHALLENGE

Throughout the course of this decade, Canadians will face a vitally important social policy issue - adequate retirement income. The decisions made during this period will not only affect our current needs and desires but also those of our future generations.

Inadequate retirement income for some Canadians is widely acknowledged to be an issue of national concern. It is important to every facet of our society because its effects are felt universally. Thus, the vast and sometimes fractious nature of this issue calls for collaboration between broadly disparate sectors of our national entity. At the same time, it should be recognized that a substantial part of the solution is occurring as the present system matures.

Whether it is government meeting its declared social responsibilities, business ensuring that a thriving free market system can support these goals, or the individual determining what lifestyle is desirable, there must be a concentrated effort to align expectations with reality. Defining and understanding the dimensions of this critical social issue must be the first step toward an adequate solution.

As a concerned participant in this vital debate, the Business Council on National Issues believes that it is in the national interest for the private and public sectors, working together in close co-operation, to address a solution to this important national concern.

ADDRESSING THE ISSUE OF RETIREMENT INCOME

The objective of pension reform is to ensure an adequate level of retirement income is available to as many Canadians as possible. A 100% replacement ratio of post-retirement to pre-retirement disposable income is not required at all income levels. Reform requires a review of the entire system - an analysis of need, an assessment of cost, a setting of priorities and a redesign of some of the retirement income delivery vehicles.

The Business Council participated in the research studies of the Business Committee on Pension Policy (BCPP). These studies encompassed an examination of the public pension system, the private employer sponsored system, the role of private saving and the interrelationships of all three at varying levels of age and income.

There is a role for government in providing retirement income. In Canada, we have accepted the concepts of transfer payments i.e. Old Age Security (OAS), Guaranteed Income Supplement (GIS), and the universal public occupational pension system (CPP/QPP).

The role of private occupational pension plans must be recognized along with their potential for growth to include more workers in a system which provides a wide range of benefits without direct government subsidization. In addition, there are shortcomings in existing plans which must be addressed.

Private savings must be encouraged and individuals must have the option to allocate earnings between spending on their present standard of living and saving for their future retirement at every level of income.

### **THE PRINCIPLES OF PENSION REFORM**

In our view, there are three fundamental principles which are prerequisites to pension reform:

- 1) a productive economy must be maintained;
- 2) the allocation of current earnings to retirement needs must increase;
- 3) legislated improvements in occupational plans should apply only to income up to a certain level and they should not be retroactive.

#### **1) A Productive Economy**

The ability of any society to properly sustain its retired members is a product of two things: the collective wealth of that society and the choices made in deploying that wealth. The issues of pension reform in Canada today clearly illustrate the importance of both elements.

A viable pension system is first and foremost a function of a strong and growing economy. Pension fund assets represent a major pool of capital. The BCPP Capital Markets Study states that the accumulation of pension assets (\$137 billion at the end of 1981, of which \$85 billion was invested through the capital markets) is occurring at an increasing

pace. While saving for pensions constituted only 12% of Canada's Gross Savings in the early 1960s, it constituted 23% during the last two years. Clearly, pension funds represent a large and growing pool of savings from which to finance the growth of the Canadian economy. The productive use of such funds throughout the economy can generate income to support the pension system.

Canada's economy is highly sensitive to our competitive position in world markets. We cannot have a strong and growing economy if our costs are out of line. Canada does not enjoy any competitive advantage that would permit substantial expansion in pension benefits without some offsetting adjustments in cost elsewhere. This leads to the second fundamental principle of pension reform.

## **2) Allocation of Income**

A prime requisite, as a second principle, is that the country as a whole, at all levels of society, must consciously agree to devote a greater share of current income to savings and investment for retirement if larger pensions are to be paid in the future.

Pension costs are well recognized by employers and pension reform will no doubt push them higher. It is important, therefore, to undertake a careful examination of the trade-offs between current and future needs. There must be a proper balance between income during employment and income in retirement.

It is critical that any implementation strategy for pension reform allow for a transition period. The ability to balance needs and desires between income in employment and income in retirement is fundamental to the pension issue, but adjusting to this balance will not be easy. As well, pension clauses already in place in collective agreements must be respected and dealt with in a manner that preserves the fundamental bargain. Employers and employees must have sufficient time to adjust to any substantial change.

### **3) Legislated Improvements in Occupational Plans**

A third principle is that legislated improvements in occupational pension benefits should apply only to the amount of an employee's income up to a specific level and they should not be retroactive.

There are two measures for assessing the appropriate level of income in retirement: (1) the relationship of income in retirement to income while working, and (2) the amount of income needed to provide an acceptable standard of living.

Under the present pension system, for an employee retiring now with earnings up to about  $3/4$  of the Average Industrial Wage (AIW), the retirement benefits from OAS, GIS and CPP/QPP will provide income in retirement that is about the same or higher than the income while working. This is implied in the Green Paper and demonstrated in the BCPP Cost Study - with the exception of some single households. At this level of earnings, continuation of the same net income into retirement seems appropriate. Certainly a pension system should not

be designed to provide any group with a higher income in retirement than while working. Further, at this earnings level, any increase in retirement income from an occupational pension plan would at present be offset by a 50% reduction in GIS. In this situation, it would be wrong to require an employee to contribute more out of his working income.

The Green Paper introduces the concept of Level of Income Maintenance, that is, the ratio of post-retirement to pre-retirement disposable income. This is a useful advance in assessing levels of retirement income and was followed in the BCPP Cost Study. In both of these documents, the definition of disposable income is quite complete in allowing for all sources of income and expenses. The Green Paper introduced this subject under the heading "Canadians Should Be Able to Avoid Serious Disruption of Their Pre-Retirement Living Standards Upon Retirement". However, the documents compare disposable income in the year preceding retirement and the year following retirement; in our view, they do not adequately recognize a significant reduction in living expenses that has generally occurred earlier -namely the expenses of raising and educating children.

The BCPP Cost Study examined "the extent to which current programs and savings will provide adequate income maintenance after retirement in the future". This study shows that there is no particular level of income which is a critical area of concern for pension reform at this time. However, the low income households have the least margin of income to provide an acceptable standard of living in retirement. For example, the net replacement rates could be affected by a reduced

CPP/QPP benefit because of little or no income in some years. Also, it would be appropriate to require less reliance on GIS as the earnings approach the AIW level. Thus the area of concern for pension reform at this time should be employment earnings up to the AIW. If available resources are allocated to this important income range, then improvements in benefits related to such earnings can be significantly greater than if part of the available funds is used for legislated benefits on higher amounts of income.

Therefore, the Business Council recommends that legislated improvements in pension benefits should apply to the amount of income up to the level of AIW. Of course such improvements will mean an increase in post-retirement income for employees at higher income levels arising from their income up to the AIW level. For amounts of income above the AIW, employers and employees should be free to design their occupational pension plan as part of a total compensation package satisfactory to each. A principle held by the Business Council is that legislated changes should not be retroactive. Pension benefits already accrued have been part of a total compensation package. It is unfair to increase the cost of these accrued benefits.

### **MEETING THE NEEDS OF TODAY'S ELDERLY RETIRED**

Poverty among today's retired seniors is an urgent problem that demands immediate action. It is essential that our elderly become the first priority in the allocation of funds available for income transfer purposes.

Most private sector occupational pension plans were initiated after the Second World War and it has only been in the last thirty years that private pension plans have come to widespread use. Both public and private pension plans introduced in recent decades and the amendments to them have yet to reach maturity and to provide full benefits to retiring employees.

The slow maturing of pension plans is illustrated by using the CPP/QPP as a model. The plan, which began in 1966, provides each pensioner with benefits far in excess of the individual's contributions. These pensioners have been and continue to be heavily subsidized by contributions from the current work force. The BCPP Cost Study points out that for an individual who has contributed since the inception of the Plan in 1966 and retired on January 1, 1983, the accumulated joint contributions made by himself and his employer provided about 16% of the pension benefits he received on retirement. Even so, only those who have retired in the last few years have been eligible for the full CPP/QPP benefit, and only two out of five retired seniors are now receiving income from the CPP/QPP.

Since today's retired seniors will not share in any benefits from pension improvements affecting the present work force, their problems are distinct from the question of occupational pension reform. Their needs must be addressed at the same time that the reforms are considered for present occupational pension plans. The Business Council believes poverty among current elderly can only be alleviated by government action.

The Business Council believes that the most effective and appropriate way to assist today's elderly poor is through public pension schemes targeted

to those most in need. The vehicle should be the GIS program and it should be adjusted now to meet the particular problems of the single elderly, many of whom are women. We support the statement of the Minister of National Health and Welfare which identifies this as a priority issue. We recognize and accept that the cost of this increase will be reflected in increased taxes.

Although the demands on the GIS program should diminish as existing plans and amendments mature, it will play a critical role for many years to come.

#### **THE PUBLIC OCCUPATIONAL PENSION SYSTEM**

The Business Council is committed to the view that reform should concentrate on the private sector occupational pension system, not on the public pension system, except in the case of GIS adjustments for today's elderly poor. CPP/QPP should not be expanded because such expansion would have the effect of reducing capital available for savings and investment. The CPP/QPP is by its very nature largely financed on a pay-as-you-go basis and as a result does not accumulate savings for investment comparable to private pension plans. Even on its current basis, given the present demographic structure, significant increases in CPP/QPP premiums will be required as early as 1986 to pay current benefits. To further expand the pension system by way of the CPP/QPP would only exacerbate the problem; current consumption would take place at the expense of investment and capital accumulation.

The investment earnings of pension funds moderate the cost of any pension system. This will be especially important in the Canadian context, given the changing demographic profile of this country. By the early part of the 21st century, Canada will have one of the "oldest" populations in the world; fewer workers will be supporting more retirees.

Expanding the public pension system on a "pay-as-you-go" basis would be economically undesirable; fully funding it would be equally undesirable. In a fully-funded private pension plan, contributions by the employer and employee are invested and the employee's pension at retirement is fully paid for by those contributions and the interest on them. If full funding were attempted in the CPP/QPP, the result would be the accumulation of an enormous pool of capital through sharply increased pay-roll taxes with immense social, economic and political implications for the investment decisions required.

The Federal Government Actuarial Report estimates that the rate of CPP contributions will have to be increased from 3.6% to 9% by 2030, just to meet obligations of our current benefit formula. The schedule of estimated increases in CPP/QPP contribution should be established. It should be incorporated into legislation so that the real cost is explicitly acknowledged and the information is available to all Canadians. This would facilitate governments making the necessary increases in rates of contribution without the political pressure to increase benefits.

The BCPP Cost Study estimates that if the CPP benefits formula were doubled, and Green Paper adjustments accepted, CPP/QPP costs would

approximate 20% of contributory earnings by the year 2030. These costs, when combined with OAS, GIS and health care for the elderly, would likely be unacceptable to future generations of Canadian workers supporting retirees. The United States and Sweden are recent examples of taxpayer resistance in other countries to high contribution rates.

However, certain adjustments should be made to public occupational pension systems to make them more realistic and equitable. The Business Council agrees that the Year's Maximum Pensionable Earnings (YMPE) should be raised quickly upward to the level of the AIW to meet the original intention of the plan. The YMPE is \$18,500 for 1983 while the AIW is about \$21,000, a difference of \$2,500.

The Business Council supported the recent addition to the CPP of the "drop-out" provision for the years spent caring for young children. This will significantly increase the retirement income of women who temporarily leave the work force to raise children. At the same time, we are opposed to full-time homemakers being eligible for coverage by the CPP/QPP. The objective of the CPP/QPP should continue to be an earnings-related pension plan.

#### **REFORM IN THE PRIVATE OCCUPATIONAL PENSION SYSTEM**

The Business Council strongly recommends that reform of the occupational pension system should be based on growth in private pension plans. The focus for reform should be on improved vesting, portability, and survivor's benefits.

## 1) Coverage

Pensions represent a major claim on the productive capability of the nation and receive legislated government support and tax incentives. The Business Council believes that a social system of such importance and magnitude should be broadly based and that private pension coverage should be available to as many employees as realistically practicable.

However, for some segments or individuals in society, it may be unwise, unnecessary or clearly impractical to require coverage under a private pension plan. Although it is frequently said that about half the Canadian work force is not covered by such plans, the significance of this statistic should be challenged. In this grouping are the low income workers whose income in retirement (from OAS, CPP/QPP and GIS) will reasonably replace working income. In addition, many in the grouping have not yet met eligibility requirements, have other savings programs designed to provide for their retirement, or have negotiated higher wage settlements in lieu of pension.

Many of those who are not yet covered are employed by small businesses. The cost to small business owners of providing pension benefits and the difficulty of administration are obstacles to providing their employees with pension coverage regardless of their willingness to do so. Simplified arrangements from pension plan suppliers are available and should be encouraged. Simplified regulation in this regard would be helpful. A practical alternative in some cases would be access to a locked-in Registered Retirement Savings Plan (RRSP) or a Registered Pension Account (RPA).

In order to achieve broader coverage of the working population, we recommend that the provinces legislate, as uniformly as possible, improvements in the key areas of vesting, portability, and survivors' benefits. As a result more people will come under pension umbrellas earlier and will not lose credits when they change jobs.

Also, eligibility under existing employment pension plans should be expanded so that part-time employees can join by age 25 with 2 years of service at a level of 700 hours of service per year. Part-time employees may be secondary wage earners in the household and we think their participation in the pension plan should be voluntary. We realize that part-time employment may be a growing part of the work force in the future. We appreciate that the subject of part-time employment is currently under discussion.

The Business Council believes that these reforms will bring about a significant increase in coverage and that mandating private plan coverage is neither desirable nor necessary.

The Green Paper in commenting on coverage notes that there has been little or no increase in coverage by employer-sponsored pension plans over the last several years. It is hardly surprising to find a levelling of private plan coverage in this period. The Anti Inflation Board operated between 1975 and 1978, limiting total compensation and thus discouraged pension plan growth. The small business sector is the main growth area for pension plans and by 1980 the top priority in this sector was survival. The trend to increase in coverage by employer-sponsored plans can be expected to resume when economic conditions make it feasible.

## 2) Vesting

Mobility of the work force is an essential component in the maintenance of a vibrant, efficient and productive economy, particularly in light of the rapid changes that new technology brings to the industrial and commercial environment. Mobility offers both the individual and the nation the opportunity to match human resources to the needs and desires of the marketplace, and for Canada, with its vast geographical area and regional differences, this is a particularly significant consideration.

The concept of vesting has an important effect on mobility. Vesting means the right of an employee, on termination of employment, to part or all of his or her accrued pension and it usually requires locking-in of the employee's contribution. Statutory vesting occurs when the employee meets the service and age conditions set out in pension benefits legislation.

Regrettably, in many instances employees lose their pension credits when they change jobs because they have not satisfied the vesting requirements of the pension plan and/or they have voluntarily withdrawn their contributions. As a result, a mobile employee may receive only a fraction of the pension which would have been earned had he or she remained continuously with one employer. This is often a significant personal penalty, which in equity should not have to be borne by those whose willingness to relocate is such an important ingredient to the country's future economic growth.

Although many occupational plans already provide for earlier vesting of pension benefits than what is currently required under provincial pension

legislation, the Business Council believes new legislation is required to ensure early vesting of benefits. We propose vesting and locking-in after five year's service or after one year's service if age plus years of service add up to at least 45, whichever is better for the employee. In the case of a terminating employee, at least one half of the cost of the vested benefit should be paid by the employer, provided there is no mandatory inflation protection of the vested benefit.

One of our principles of pension reform is that legislated improvements should apply only to income up to a certain level in order to give priority to greatest need in the use of available funds. We identified the critical area of concern as the part of each employee's income up to AIW. Therefore we recommend that the legislated early vesting should apply only to benefits related to this critical area. For pension benefits with respect to the part of the employee's income above the AIW, the Business Council recommends that legislated vesting requirements remain as at present. After assessing the cost, employers who are financially able may improve vesting on this section of income also.

The legislated changes should not apply retroactively to benefits already accrued. Employers who are financially able may choose to apply the new vesting standards retroactively in the interest of employee relations and simpler administration; some employers will not be able to afford to do so.

### 3) Portability

The intent of portability is to ensure that an employee retains the full benefit of the vested amount of pension when changing employment. It would provide for the transfer of his or her vested pension benefits to the plan of the new employer. The Business Council supports this concept as a means of providing continuous pension coverage to individuals throughout their working life.

An interest rate is needed in determining the transfer value of the vested benefit. This rate of interest should be prescribed, but the problem requires further study. It should be noted that the proposed earlier vesting and the 50% employer payment of the vested benefit are substantial improvements for a terminating employee.

There are however, some practical problems in the transfer of value of vested pensions into the plan of a new employer. In our view, such a transfer should only be allowed if the new employer is agreeable to the attributed transfer value and his pension plan makes suitable provision to accommodate the transfer. If, however, the new employer will not accept the transfer value, the employee should have the options of: (i) moving the value of his or her vested pension benefits into a RPA or a locked-in RRSP; or (ii) leaving the funds with the previous employer if the latter is agreeable.

#### **4) Survivor Benefits**

Of today's elderly poor, a significant portion are surviving spouses in situations where the occupational pension benefits ceased on the death of the retired employee. To avoid the occurrence of this type of situation in the future, a surviving spouse should be entitled to a pension of at least 60% of the pension payable when both were living unless waived in writing by both the employee and spouse. This benefit may be provided on an actuarially reduced basis. A waiver might be appropriate, for example, where both spouses have individually arranged for adequate retirement income, or where serious illness influences the decision.

#### **5) Inflation Protection**

The erosion of pensions by inflation is a valid concern. Obviously the most effective long term solution to the problem is to eliminate inflation.

In the short term, however, while considering ways to reduce the impact of inflation on the real value of pension payments we must also consider the employer's difficulties with the level and uncertainty of cost. Concerns over cost are well founded. As shown in the BCPP Cost Study, the various proposals for inflation protection are by far the most expensive features of the Green Paper pension reform proposals.

First it is important to identify the extent of inflation protection under the existing pension system. As stated in the BCPP brief, low income

pensioners whose retirement incomes are largely derived from government plans are fully inflation protected. The BCPP Cost Study shows the percentages of middle income households which, when the current pension system is mature, will achieve various levels of net income replacement in retirement, adjusted so that they are inflation protected through the retirement years. At the levels of income which the Business Council feels should be the primary concern of pension reform legislation, the problem of inflation protection is not as serious as is commonly thought.

Many employers, aware of the income problems of their retired employees, have improved their pensions principally by (i) increasing the basic benefit formula e.g. under defined benefit plans, moving up to a 2% benefit based on final average salary and (ii) making ad hoc adjustments to pensions being paid to retired employees. Mandating inflation protection on top of pensions already improved by the first method would be highly inequitable. A plan that has already a generous benefit level would then be required to add the most costly further protection against inflation.

The ad hoc approach has major positive features in meeting the problem of inflation protection. Perhaps most important, it gives protection to today's pensioners. A flexible approach is frequently used, giving the biggest improvements to those in greatest need.

The Business Council does not support mandatory inflation protection of pensions and is particularly opposed to the excess interest formulas of the Green Paper.

In theory, the excess interest approach defines a formula for inflation protection of pensions and identifies the source of funds to pay for it. In reality, the earnings of pension funds do not follow the pattern of the Green Paper formula. Pension fund liabilities and investments are long term and therefore the rates of investment return lag behind the changes in the rate of inflation. Even the guide rate recommended in the Green Paper does not reflect well the changing rate of inflation. Further it would not be possible for a pension fund to immunize the investment risk of a commitment to this guide rate.

On the other hand, indexing of private pension payments to the Consumer Price Index would present severe difficulties for the private sector. It would have an unknown, open-ended cost and is not a viable solution.

The Business Council believes that employers should continue the voluntary practise of improving pensions on an ad hoc basis. This means reviewing pensions-in-payment on a regular basis and adjusting them taking into account the rate of inflation, the needs of the pensioners and the employer's over-all financial capability. The practise of providing ad hoc adjustments should be encouraged by permitting advanced funding of the cost of the adjustments.

There could be adverse consequences to the mandating of inflation protection. It would force some employers to change their pension plan design to reduce the basic level of pension. Some employers who could not afford the increased cost might well terminate their plans; others who were contemplating introducing a plan might be deterred. Thus, it could have a

negative effect on pension coverage. Also, it could have a detrimental impact on labour relations. It should be noted that similar adverse consequences could result from retroactive application of pension reform legislation.

### UNIFORMITY OF LEGISLATION

It is fundamental to pension reform that the various jurisdictions of government work together to achieve substantial uniformity in pension legislation. The practical problems of implementing pension reforms will be compounded if the provinces choose different legislative paths. Confusion in administrative practises causes additional expense. Furthermore, many companies operate in a number of provinces and frequently move employees from province to province; naturally, they would prefer to offer the same pension coverage to all employees wherever located. In the interests of developing and maintaining a mobile labour force, pension considerations should not interfere with an employee's opportunities and decision to transfer.

The Business Council believes that consistency among the provinces in pension reform initiatives must be a major objective.