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BACKGROUNDER

THE PENSION PAPERS/FINANCIAL SERVICES

Cutting Through Pension Complexity:

Easy Steps Forward for the 2010 Federal Budget

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In this issue...

Ottawa could move now to make good retirement savings plans accessible to more Canadians, and liberalize the rules governing retirement income.

The Author of This Issue

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The Study in Brief

The recent galvanization of debate over pensions in Canada has created a valuable opportunity for reform. To capitalize on that opportunity, Canadians need to get past two obstacles: a misplaced emphasis on classic defined-benefit (DB) plans and individual schemes, such as defined-contribution (DC) plans and registered retirement saving plans (RRSPs), as essentially the only options for "third-pillar" retirement saving; and paralyzing complexities attending a root-and-branch revamp.

In its 2010 budget, the federal government can take some straightforward steps to break the DB-DC/RRSP mental deadlock, improve the unhappy circumstances of many DC plan participants and RRSP savers, and clear the field for larger, better third-pillar pensions. Among them:

- Providing more tax deferral room for DC/RRSP savers. Using the federal Public Service Plan as a benchmark suggests raising the contribution limit from 18 percent to 34 percent of earned income, and raising the maximum dollar amount proportionally, from $22,000 to $42,000.
- Raising the age at which people lose access to tax-deferred saving and must start decumulating from 71 to 73.
- Making the pension credit available to people receiving income from a Registered Retirement Income Fund (RRIF) or Life Income Fund (LIF) regardless of age, as it is to recipients of annuities from pension plans.
- Giving RRIF/LIF holders the same spousal income-splitting opportunities as recipients of annuities from pension plans.
- Alleviating the tax disadvantages of group RRSPs by letting sponsors and/or participants deduct some administrative expenses currently levied against plan assets from outside income, and by removing payroll levies from employer contributions.

Further changes to the *Income Tax Act* would (i) make retirement-related services more readily available to employees of small organizations and to the self-employed, and (ii) allow LIF-style payments from inside DC plans. Such changes would give more Canadians access to cost-effective risk pooling and funds management, and foster a more robust third-pillar retirement saving system.

About the Institute

Pensions, once considered dull, are now hot. After years of stress – evident in the complex regulation and litigation affecting pension plans and the erosion of defined-benefit (DB) plans in the private sector – the financial crisis has galvanized debate about reform. Canadians have an opportunity to harness that energy in aid of a constructive reworking of Canada's "third-pillar" pensions.[1]

Such reform, however, requires pushing past the mistaken view that classic DB plans and individual schemes such as registered retirement saving plans (RRSPs) are essentially the only options for the system. The complexity of root-and-branch reforms also risks deadlock or dissipation of effort.

Happily, near-term policy changes could move the system in a promising direction. The 2010 federal budget could contain some straightforward steps to promote more tax-deferred saving, make good retirement saving plans accessible to more Canadians, and liberalize the rules governing retirement income – all no-regrets steps toward larger, better third-pillar pensions.

Hung Up on a False Choice

One key source of stress on voluntary and occupational retirement saving in Canada is an unhelpful preoccupation with two familiar but flawed models: traditional single-employer DB plans on the one hand, and individual account plans such as defined-contribution (DC) pension plans and RRSPs on the other (Robson 2009).

The classic DB plan, which promises a given future payment based on salary and years of service, appeared to offer big guaranteed future annuities in return for small deductions from current pay. But a key assumption underlay this arrangement – that investing in assets, such as equities, that did not match plan liabilities offered higher returns that were increasingly certain over time. As many employees in such industries as steel, automobiles, and telecommunications discovered to their cost, however, such an outcome is by no means guaranteed.[2] Fair-value reporting has revealed the risks and higher costs of these arrangements, and coverage by DB plans is eroding in the private sector.[3]

Many people regret that development. They hold up classic DB plans as an ideal, partly because the alternative that usually comes to mind is the individual account – at worst, the RRSP – in which, left to their own devices, people risk saving the wrong amounts, taking on too much risk or the wrong kinds of risk, choosing the wrong accumulation and decumulation vehicles, and ending up pinched in old age.

These drawbacks of individual plans are real. But framing pension policy in terms of a false choice between classic DB plans and DC/RRSPs has stunted the development of fresh ideas. A scan of recent official reviews, a federal discussion paper, and pension-related initiatives reveals the extent to which DB plans preoccupy policymakers.[4] Their decline in

This paper draws on remarks on the occasion of the C.D. Howe Institute Benefactors Lecture, 2009 (Ambachtsheer 2009). I thank attendees at that Lecture, Steve Easson, Alex Laurin, and Ron Sanderson, members of the C.D. Howe Institute's Financial Services Research Initiative and the Pension Papers Advisory Group, and in particular Bob Baldwin, Ian Markham, James Pierlot, and Terri Troy, for comments. Responsibility for the recommendations and any errors is mine alone.

1 I use "third pillar" to refer to the voluntary and contractual saving that builds retirement income above the levels provided by the safety net "first pillar" – mainly Old Age Security and the Guaranteed Income Supplement – and the mandatory work-related "second pillar" – the Canada and Quebec Pension Plans (CPP/QPP).

2 Laidler and Robson (2007) discuss the "equity premium" controversy, and show how far from guaranteed these higher assumed returns actually were – a fact painfully highlighted by the market collapse in fall 2008.

3 Gougeon (2009) shows that, between 1991 and 2006, the number of private-sector employees in DB plans fell from 2.3 million (against total private-sector employment of 8.8 million) to 2.0 million (against total private-sector employment of 11.8 million). In contrast, over the same period, the number of public-sector employees in DB plans increased from 2.5 million to 2.6 million (against total public-sector employment of 2.9 and 3.3 million, respectively).

4 The mandate for Ontario's review (Ontario 2008) was explicitly to promote DB plans. The Alberta-British Columbia Joint Expert Panel on Pension Standards (JEPPS 2008) and Nova Scotia (2009) reviews are less tendentious, but they give DB-specific issues such as funding requirements and surplus ownership much more attention than participation in these plans as a share of all Canadians saving for retirement warrants. The federal discussion paper (Canada 2009b) devotes the bulk of its substantive discussion to DB plans, and the proposals arising from those consultations (Canada 2009a) are likewise skewed toward DB concerns. Recent provincial initiatives responding to pension-related distress (Ontario 2009, Quebec 2009) deal exclusively with DB issues.

the private sector is widely deplored, and their recent troubles have prompted accommodations in funding rules and some outright bailouts.

Policy toward DC/RRSPs is less supportive, worsening their problems and inhibiting their improvement.[5] For one thing, savers in DC/RRSPs get less generous tax deferral than do most DB participants. The *Income Tax Act* uses a "pension adjustment" to estimate how much saving people without DB plans need to do to accumulate the same wealth as people with them. Because this adjustment assumes relatively high returns and overlooks important provisions often found in public-sector plans, it tends to underestimate the required amounts of saving. The result: annual contribution limits for DC/RRSP savers are set relatively low.[6] For similar reasons, larger contributions for past service are possible in DB plans than in DC/RRSPs. When, as notably occurred recently, a DB plan's assets fall short of its liabilities, the act allows unlimited rebuilding, and regulators encourage it. In contrast, when assets in DC plans or RRSPs fall short of expectations, annual contribution limits make no accommodation.

Differences in the tax treatment of employer contributions, as well as many costs, hinder saving in DC/RRSPs more subtly. Employer contributions to group RRSPs are subject to employment insurance (EI) and CPP/QPP premiums, while employer contributions to sponsored plans (whether DB or DC) are not. RRSP savers also must absorb through their accumulation period many administrative costs and fees that are immediately deductible for sponsors[7] – and RRSP savers face higher fees to begin with, since, unlike pension funds, the holders of their investments are taxable businesses.

As for investment risk and costs, delegation of investment management to experts, for better or worse, is implicit in DB arrangements and explicit in pooled DC plans. In individualized DC plans and group RRSPs, however, sponsors have little ability to guide participants' asset choices. For costs, size matters – but federal and provincial regulations inhibit pooled DC plans that would offer economies of scale to employees at small firms or the self-employed.[8]

The contrast continues at retirement. The pension credit that reduces income tax for people, regardless of age, who receive income from a pension plan, is available to people who receive income from a Registered Retirement Income Fund or Life Income Fund (RRIF or LIF) only after age 65. Similarly, the minimum age at which the *Income Tax Act* permits splitting of income from tax-deferred saving between spouses is 65 for RRIF/LIF holders, but 55 for pension plan members. Vitally important, DB participants move smoothly to pensioner status, while many DC and all RRSP savers face a potentially risky and expensive transition to a separate annuity or decumulation vehicle such as a RRIF or LIF. After retirement, DB pensioners get unlimited tax-free reinvestment of surplus funds, while outdated formulas force RRIF and LIF holders to withdraw faster than makes sense given today's investment returns and life expectancies (Robson 2008b).

Overwhelmed by Complexity

Simply noting the policies that exacerbate the disadvantages of DC/RRSPs relative to DB plans highlights the fact that the apparent need to choose between these two models is artificial. Change the policies, and the range of options expands. Hybrid plans – neither DB nor DC/RRSP, but with attractive features of both – are possible and exist in other countries. Contributors to the C.D. Howe Institute Pension Papers series[9] and key passages in several official reviews have outlined schemes to

5 Pierlot (2008) elaborates on many of these points.

6 The pension adjustment also creates inequities among DB plans. It takes no account, for example, of inflation-indexing of benefits, which public-sector DB plans typically provide, but private-sector ones do not. It would be fairer if participants in DB plans without inflation protection and DC/RRSP savers alike, got additional tax-deferred saving room that they could use to bolster their retirement incomes against erosion by inflation.

7 In a sense, RRSP holders eventually are compensated because the tax they pay on withdrawn funds does not apply to funds they paid in fees. Most RRSP holders, however, likely would prefer a current deduction against their employment income.

8 Kyle (2009) cites proprietary data from Great-West Life Assurance that suggest all-in cost differences between large and small DC plans in Canada (pooled and segregated funds, both actively and passively managed) are similar to those Deloitte (2009) finds in US 401K plans – that is, around 200 basis points per dollar of assets for small plans, around 80 basis points for medium plans, and around 60 basis points for large plans.

9 Laidler and Robson (2007), Ambachtsheer (2008, 2009) and Pierlot (2008) all explore this territory.

promote and facilitate saving to achieve target payouts, nudge participants into cost-effective investments, and smooth the transition to user-friendly decumulation vehicles.

Going from outline to implementation, however, is not straightforward. Some Canadians undoubtedly should save more, but we know too little about how much people of different ages, income levels, and family situations actually do, or should, save.[10] We worry about risk profiles, but a heterogeneous population means we lack reliable prescriptions for better ones or tools with which to nudge people toward them. Key design features of potential revamps are both unclear and controversial; they span pooled plans run by existing private-sector providers, through government-mandated aggregator/payers, to additions to the CPP/QPP (Horner 2009). Notwithstanding early enthusiasm, most evident in British Columbia's commitment to a provincially led, universally accessible plan,[11] a coherent root-and-branch restructuring of Canada's third-pillar pensions is not an immediate prospect.

The Short List for the 2010 Federal Budget

The longer-term stresses exacerbated by the pension crisis are real, and the federal government's October 2009 proposals (Canada 2009a) signalled its willingness to act. But of the six sets of proposals, only one would relieve DC plans of some obligations that make no sense outside a DB context and allow LIF benefits to be paid from within DC plans; the other five focus on DB plans and their stresses, and RRSP savers got no attention at all. With the 2010 budget, however, Ottawa has an opportunity, mainly through changes to the *Income Tax Act*, to break the DB-DC/RRSP deadlock and move several important steps toward a richer, more robust system.

The first step is to provide more tax deferral room for DC/RRSP savers. Using the federal Public Service Plan as a benchmark suggests changes to two numbers: raising the current maximum percentage of earned income from 18 percent to 34 percent, and making a proportional change in the maximum dollar amount, from $22,000 to $42,000 (Laurin and Robson 2009, 3). Fiscal pressures might appear to make it hard to sell a one-year jump to these higher numbers. Yet among the October 2009 proposals was one to increase the maximum permitted overfunding of DB plans from 10 percent to 25 percent of liabilities. This would be an important improvement in the environment for these plans,[12] but it would have little impact on tax revenue in the short run because most DB plans currently have sizeable deficiencies. The number of DC/RRSP savers able to use an increase in contribution room would be limited at first – suggesting the need for a phased increase – but in the long run more generous limits would make for a fairer and better funded retirement-income system.

Although significant help for DC/RRSP savers to recover from setbacks would require a lifetime pension saving limit – as Pierlot (2008) suggests – two immediate steps would aid many. First, the age at which people lose access to tax-deferred saving and must start decumulating should rise from 71 to, say, 73. Second, once the holder is drawing income, the pension credit should apply regardless of age, and RRSP holders should have the same spousal income-splitting opportunities as registered plan members. Less salient, but still quickly achievable would be to alleviate the tax disadvantages of group RRSPs by letting sponsors and/or participants deduct some administrative expenses currently levied against plan assets from outside income, and by removing federal payroll taxes from employer contributions.

10 Baker and Milligan (2009) discuss the heterogeneity of incomes replaced in retirement, gaps in measures of income, and the difficulties relating incomes to consumption and economic wellbeing. Dodge et al. (forthcoming) highlight the differences in saving efforts required at different income levels and different points in life to hit a given replacement target.

11 The B.C. government has followed up its commitment in the last provincial election to a new plan with legislation to facilitate pooling, but no further concrete plans have emerged.

12 Banerjee and Robson (2008) advocated it to remove a bias toward underfunding plans.

But facilitating the growth of DC plans to scales that would give more Canadians access to cost-effective, expert funds management needs changes of a different sort to the *Income Tax Act*. Currently, to establish a multi-employer pension plan, a potentially disparate group of employers must come together and create a trusteed organization. Allowing third parties, such as financial institutions or purpose-built cooperatives, to administer such a plan would make retirement-related services more readily available to employees of small organizations and to the self-employed. A complementary change to the act could allow DC plans to cover the same types of income that create RRSP contribution room – among other things, such a change would give the self-employed access to third-party-administered plans. Also, changing the current requirement of an employer-employee relationship would create new opportunities for existing financial institutions or specialized providers to enrol employees of small businesses and the self-employed.

As noted already, the recent federal proposals envision allowing LIF-style payments from inside DC plans, instead of forcing participants to transfer outside them, as is now the case. The 2010 budget should implement this proposal. Indeed, it could go further. Since 1992, the *Income Tax Act* has forbidden DC plans to practise "self-annuitization" – that is, to offer guaranteed payments without maintaining a separate fund, so that participants again need not leave the plan or transfer to a separate fund to get the payments.[13] At the time, however, several plans that already offered such annuities were grandfathered, which suggests that examples do exist of appropriate safeguards against unsupported promises. Unless the tight timeline precludes drafting rules governing this type of annuity from a DC plan, the 2010 budget should permit them.

Turning to age-related restrictions on tax-effective reinvestment, RRSP savers could also benefit from relaxing the prohibitions against buying annuities with terms that exceed age 90 with non-locked-in funds and against buying term annuities of any kind with locked-in funds. As well, although the 2009 federal budget's one-year 25 percent reduction in mandatory withdrawals from RRIFs and LIFs acknowledged that the rules can force people to deplete their assets too quickly, this temporary fix was far from adequate. Far better would be simply to abolish these rules. If such a change appears too radical, changing a handful of numbers to adjust the current formula, which dates from 1992, to take account of longer life expectancies and lower recent investment returns is imperative (Robson 2008b).

Beyond 2010

These are the first steps: realizing the promise of richer, more accessible and more secure pensions for Canadians requires much more. When it comes to saving, a lifetime limit makes sense. An alternative would be lifetime averaging, in which savers carry earned income above the annual contribution limit forward or backward to create additional room in years when income is below the limit (Mintz and Wilson 2002). Pending tax reform on that front, unused contribution room could be indexed to inflation and DC members permitted past service contributions up to their unused RRSP contribution room.[14] A reform that would complement broadening the categories of income eligible for pension-plan coverage would be amending the *Income Tax Act*'s "primary purpose" provisions to allow coverage to continue post-employment, so that leaving an employer did not automatically end participation in a plan.

13 The rationale for the prohibition appears to be simply that annuities were a defined benefit (Pierlot 2008) – a nice illustration of how the false dilemma has hampered the development of hybrid plans.

14 To protect plan administrators from liability in the event of an overcontribution, the member would have to be uniquely responsible for any tax penalty incurred.

Turning to nudging, "good faith" or "safe harbour" provisions would help sponsors, including employers that support group RRSPs, to encourage people to save more, invest sensibly, and decumulate safely. Liberalized rules about who can sponsor and participate in plans and how plans pay benefits – including more flexible arrangements for annuitization in DC plans – would create new opportunities for pooled plans run by private providers that would fill the rich space between classic DB plans and DC/RRSPs.

These last proposals require federal and provincial action on several fronts – indeed, they are part of the larger, and more complex, debate about fundamental third-pillar reform. That debate is important – but in the meantime, Canadians need to move past the false choice and avoid getting blocked by complexity. Early action can improve the retirement prospects of Canadians in defined-contribution pension plans and RRSPs and promote the evolution of a richer pension system. At the federal level, the right place to start is the 2010 budget.

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