

Evaluating the Proposed Ontario Pension Plan

by Philip Cross



SUMMARY

■ The Ontario government has proposed its own supplement to the CPP in an attempt to force more saving. In reality, Ontarians typically have an above-average saving rate, double that of the rest of Canada as recently as 2009. Saving in Ontario returned to the national average after real income per capita fell outright in the last two years.

■ The assumption underlying Ontario's plan is that a lack of discipline prevents households from saving. However, if saving instead is being constrained by falling real incomes, any attempt to mandate higher saving will likely be offset by lower voluntary saving, as people struggle to maintain their standard of living. This is what occurred in the late 1990s, despite rising incomes at the time.

■ The ideal scenario would be stronger income growth, which allows both spending and saving to increase. Instead, the higher contributions required for the Ontario pension plan will depress household income and spending when introduced. It will cost individuals up to \$3,420 a year, or nearly \$7,000 for a working couple.

■ Large provincial pension plans do not always generate a better return on investments than individual investors. The poor performance of the Quebec Pension Plan since 2007 is a good example, as millions of contributors were exposed to the same risk of an ill-timed investment.

Introduction

In its proposed budget, the Ontario government unveiled a plan to proceed with its own supplement to the Canada Pension Plan (Ontario, May 1, 2014), elaborating an idea sketched in the Ontario Ministry of Finance's *Long-Term Report on the Economy*, released earlier in the month (Ontario, Ministry of Finance, 2014). This bulletin analyzes the assumptions upon which the government based its plan and points out some of the flaws in the design of Ontario's plan.

The Ontario Retirement Pension Plan (ORPP) would require workers to contribute 1.9 percent of their earnings up to \$90,000, matched by a 1.9 percent contribution from employers. Nearly three million workers would be required to participate, with exemptions for those who have "comparable workplace pensions" (presumably defined benefit plans offered by employers) as well as the self-employed. The estimated \$3.5 billion in revenues would be invested through a government pension fund and would eventually pay out retirement benefits up to \$12,815 a year. However, it is difficult to evaluate the details of the plan, which remain sketchy. Lower income workers would be exempt, but the threshold is not defined (it is \$3,500 for the CPP). What constitutes "comparable workplace pensions" remains unclear, as is what will motivate the investment of pension funds.

Faulty assumptions behind the Ontario plan

One of the main assumptions behind the move to more compulsory government pension plans is that Canadians are not saving enough. This assertion is never proven in the background document to the ORPP, but remains an assumption about working and saving behaviour decades into the future. In fact, Canada's national saving rate had more than doubled over

the decade before the recession to 10 percent, twice as high as the personal saving rate.¹ One reason that the national saving rate was higher than the personal saving rate is that the national rate captures the saving being held for households inside of government-controlled pension plans (Cross, 2014).

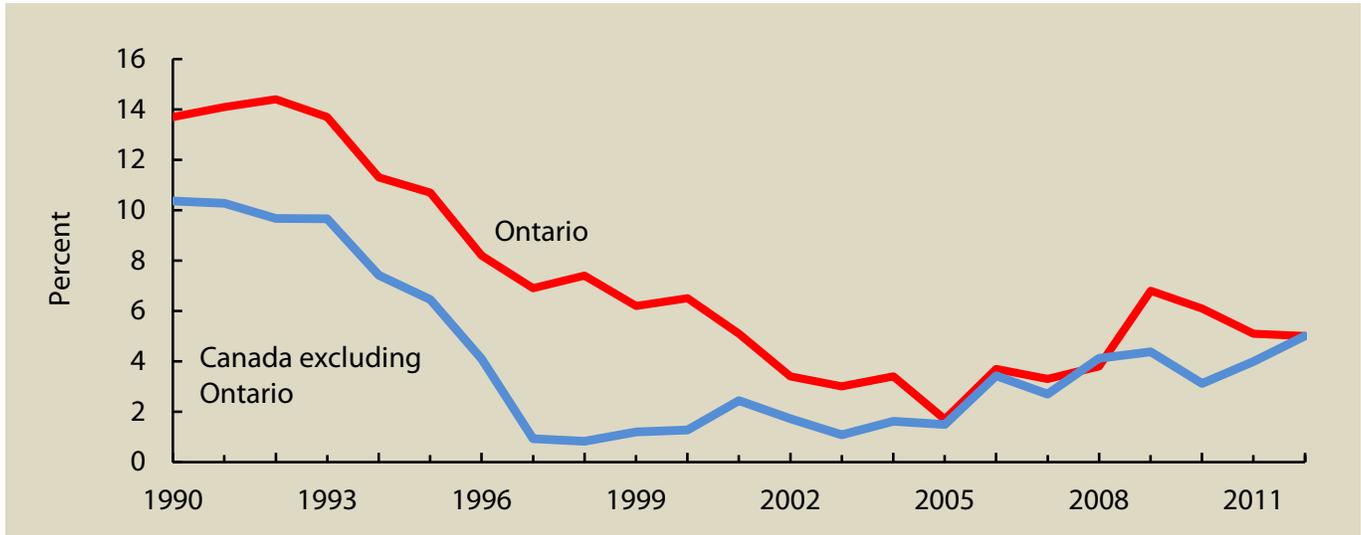
It is ironic that the Ontario government stresses that people are not saving enough when Ontarians have had one of the highest personal saving rates in the country over the past two decades (Figure 1). From 1990 to 2008, Ontario's personal saving rate was always higher than in the rest of Canada, with the gap reaching 6.6 points in 1998.

After the recession hit in 2008, households across the country started to save more. The increase was led by Ontario, where the saving rate more than doubled from 3.3 percent in 2007 to a high of 6.8 percent in 2009. This compares with an increase in the rest of Canada from 2.7 percent to 4.4 percent. In 2012, saving in Ontario and the rest of Canada converged to 5.0 percent. Part of the dip in Ontario's saving rate in the last two years was a result of a marked slowdown in income growth (which is discussed later in this paper).

Another assumption that is not quantified in the Ontario budget but permeates the government's thinking is that what prevents Ontarians from saving more is their lack of discipline in managing their finances, not that they simply lack sufficient income to save after making their everyday expenses. To back this up, the budget cites polls of people wishing they could

¹ The national saving rate fell after 2008 because of higher government deficits. The Ontario government can best contribute to a higher saving rate by cutting its own deficit.

Figure 1: Household saving rate



Source: Statistics Canada, Cansim Table 384-0040.

save more.² Of course, the vast majority of people, if asked, would also say they would like bigger and better homes and cars, more travel, more entertainment, better clothing, and so on.

The underlying problem is that real personal disposable income growth in 2011 and 2012 slowed to an average of just 1.0 percent a year, worse than any two years during the 2008–2009 recession or during the implosion of Ontario’s high tech industry in 2000–2001. In per capita terms, real incomes edged down over the past two years, their first declines since the early and mid-1990s.

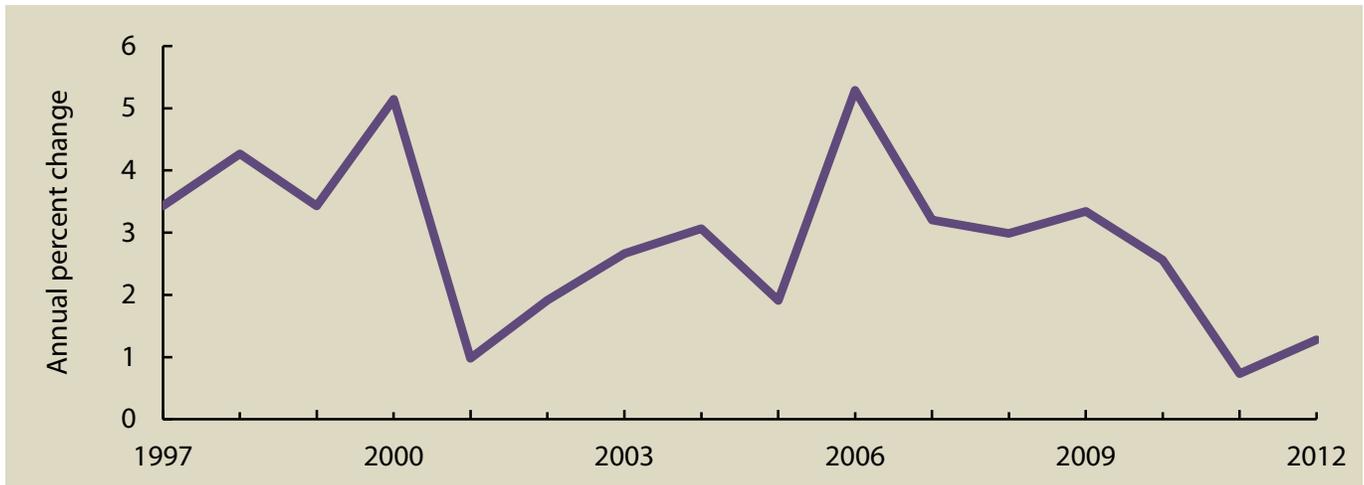
The squeeze on household incomes makes it difficult to boost saving without cutting back on some other expenses (a logic that households in Ontario seem to understand a little better than their government). In such a con-

strained environment, any attempt to raise mandatory saving is not likely to achieve its goal of boosting overall household saving. Instead, people will reduce other forms of saving—they will make lower contributions to voluntary retirement saving options (such as RRSPs or TFSAs)—to maintain their standard of living. There is evidence that this is what happened in the late 1990s, the last time the CPP contribution rate was increased (Lamman, Palacios, and Clemens, 2013: 14). However, today’s much weaker income growth than in the late 1990s makes it even more likely that households will resist an attempt to mandate higher saving.

The ideal scenario is to get incomes growing again, after which Ontarians will have the ability to both spend and save more. As it is, the household saving rate in Ontario has returned to the national average, reflecting the pressure on households to stretch almost every dollar to sustain their living standard. This pressure on household finances exists despite a drop of nearly 2 percentage points in the share

² The Budget cites a Scotiabank poll that nearly 70 percent of Canadians are concerned about not having enough saving to support their retirement.

Figure 2: Real household disposable income in Ontario



Source: Statistics Canada, Cansim Table 384-0040.

of household income in Ontario that is needed to service its debt, the timely (if unsustainable) product of record low interest rates.³ In other words, despite the freeing up of nearly two percentage points of income from servicing debt, income growth since 2010 has been so weak in Ontario that workers have had to lower saving to maintain consumption.

Another questionable assumption is that retirees need to replace 70 percent of their pre-retirement income to maintain their standard of living. In fact, almost all studies by researchers outside of banks conclude that an income replacement rate substantially below 70 percent is adequate for most people (see Vettese, 2013; Hamilton, 2001: 251). In a recent report he co-authored, former Governor of the Bank of Canada David Dodge noted that for a 60 percent replacement rate, the necessary saving rate needed outside of the CPP falls to 10 percent of income for the average retiree (Dodge and

Dion, 2014). However, he did not pursue recent research findings that a 50 percent replacement rate is all that most people need. For a 50 percent replacement rate, no saving outside of the CPP is necessary, including no need for supplementary saving in the ORPP.

The Dodge report also identifies transfers within the family as a leading source of support to retirees, something I call a fifth pillar of support in retirement. Almost all of the literature on pensions does not even acknowledge the existence of family or friends in discussing retirement, focusing instead on the relationship between retirees and government simply because government has abundant data on what it spends and scarce data on what goes on within families. However, the Dodge report does not develop the implication of this uncertainty about our knowledge of a key aspect of retirement, which is that the focus on the traditional three pillars (social security, government mandated pensions, and voluntary pensions) ignores important sources of support for

³ Statistics Canada, Cansim Table 384-0042.

retirees. The fourth pillar of retirement is the \$8.6 trillion of wealth Canadians hold outside of formal pension plans.

The Ontario Ministry of Finance endorses the argument that more saving would be good for the economy, sidestepping the issue of whether savings are too low or are adequate. It maintains that higher household saving is beneficial because it “would mean more capital being available for investment” and “increased investment would result in higher productivity.”⁴

The obvious problem with the assumption that more saving will stimulate investment is that there is no evidence that investment is currently being limited by a lack of saving. In fact, firms have increased their saving substantially over the past two decades. Given the high internal saving of firms, how would boosting household saving increase business investment? The factor limiting business investment has been a dearth of profitable opportunities, not a lack of funds. It is noteworthy that investment has floundered the most since the recession in Ontario and Quebec, where the failure to create a good business environment has clearly played a role. Large government deficits contribute to this poor environment for investment, since they promise unknown but inevitable tax hikes and spending cuts in the future.

Increasingly, analysts of Canada’s pension system are coming to the conclusion that rather than any society-wide problem, the problem

of insufficient income in retirement is concentrated in particular groups. The most obvious is single elderly individuals who never worked, mostly women who only get 60 percent of their spouse’s CPP benefits when they are widowed (Bazel and Mintz, 2014). The creation of the ORPP would do nothing to help this group.

Flaws in the design of Ontario’s Retirement Pension Plan

There are several flaws in the design of the ORPP. It will substantially reduce household income and spending when implemented in 2017, lowering economic growth. Because the fund will be very large, its investments necessarily will be concentrated in fewer areas than individual investors would make on their own. This exposes the fund to the risk of a spectacularly poor investment decision, as happened to the Quebec Pension Plan in 2007, potentially offsetting whatever efficiencies are gained from lower management costs.⁵ As well, there is an intimation that investment decisions will be directed by what is deemed best for the province and not only its retirees, as was the case for the QPP. The result for the QPP has been lower returns on investment, a fate the ORPP will have difficulty avoiding.

It should be remembered that the CPP already exerts a drag on the economy. It requires a contribution rate of 9.9 percent of income, but pays out benefits as if the contribution rate was 6.0 percent.⁶ This 3.9 point difference reflects the net saving kept by the CPP to make up for its funding shortfalls, before the plan was over-

4 The Ontario Long-Term Report makes this claim without establishing how this link works. In the case of investment in the oilsands, the quirky result has been lower productivity in the mining industry. At a minimum, this requires acknowledging that the link between investment and productivity is much more complex and nuanced than that assertion the more investment will boost productivity makes it sound.

5 The value of assets in the QPP fell 27.7% in 2008 because it was heavily-invested in the asset backed commercial paper market, which froze in 2008.

6 The 9.9 percent is split between the employee and the employer.

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hauled and put on a sound footing in the late 1990s.⁷ Raising employment contributions to 13.8 percent of income, as the ORPP plans to do without the prospect of higher benefit payouts for years or even decades, clearly will depress domestic demand, as the Dodge report acknowledges.

The plan is not transparent about its true cost to workers. The Ontario Budget says that workers will contribute only 1.9 percentage points of their income, with the other 1.9 points coming from employers. But both economic theory and an extensive literature say that employers will extract this pension benefit from their employees, through reductions in future wage gains or other benefits. Employers cannot suddenly increase compensation to employees without a compensating increase in productivity, or they will have to raise prices in an increasingly competitive marketplace.

As well, the Budget glosses over the implication of employees paying 3.8 percentage points more on nearly twice as much income as the current CPP. The tax for the ORPP will apply to the first \$90,000 of earned income, compared with a cap of \$52,500 for the CPP. So individuals

7 The overhaul involved raising the contribution rate to 9.9 percent and ending its pure pay-as-you-go model of funding by allowing the plan to accumulate assets ahead of the retirement of the boomer cohort.

ultimately will pay up to \$3,420 more a year in taxes to finance the ORPP, or nearly \$7,000 for a couple who both work.

The Quebec Pension Plan already requires a contribution rate higher than the CPP's 9.9 percent, and more hikes are inevitable because of funding shortfalls, partly due to a poor rate of return on investments.⁸ The QPP's experience with allowing social and political considerations to interfere with what is best for future pensioners raises a red flag next to statements in the Ontario budget that the contributions raised by the ORPP "would be available for Ontario-based projects such as building roads, bridges, and new transit." The clear lesson from the investment strategies of the QPP compared with the CPP is that they should be completely independent from government.⁹

The Ontario budget asserts that investing in pooled pension plans is more efficient than in-

8 The QPP will exhaust its current funds by 2039, according to Quebec's chief actuary. At that time, contribution rates will have to jump to 12.2 percent. (See *Regie des Rentes du Quebec*, 2009.)

9 One reason why the QPP's rate of return has lagged is that its investment arm, the Caisse de depot et placements, is asked to make investments that satisfy the government's social and political priorities, rather than maximize the rate of return for retirees. For example, the QPP took a \$1.1 billion loss from helping Quebecor, owned by Pierre Karl Peladeau, take over Videotron, thwarting a hostile takeover from Rogers Communications. The lower rate of return leads to underfunding, which creates pressure to increase contribution rates or lower future benefits. Faced with this prospect, the fund made riskier investments in an attempt to boost its rate of return, such as its large purchases of Asset-Backed Commercial Paper because of a marginally higher return than normal commercial paper. When the market for ABCP froze during the 2007 financial crisis, the Caisse lost billions.

dividually-directed investments because management fees are lower. However, lower management fees do not produce a better outcome, unless good investments are made. The QPP's track record demonstrates that it cannot be assumed that the net rate of return on a state-run pension plan will be higher, as the Ontario government asserts. For example, the QPP has earned 2.9% since 2007, according to Statistics Canada's Pension Satellite Account, the same as individual investors have earned on their RRSPs.¹⁰

Conclusion

The proposal to supplement the CPP with Ontario's own plan is based on a series of faulty assumptions. The fundamental assumption is that people are not saving enough to support their retirement. The Ontario plan also assumes that investment is currently constrained by a lack of saving, and any increase in saving will boost investment. It then assumes that higher investment automatically will translate into increased productivity. A fourth faulty assumption is that Canadians cannot make the link between insufficient saving and retirement, and unwittingly retire before saving enough to secure their retirement. A fifth is that governments can mandate higher household saving, when the evidence is that, in an environment of minimal income growth, people will reduce other saving if the government imposes mandatory pension taxes. A final faulty assumption is that large pension plans always generate a higher rate of return than smaller plans, and minimize risk.

10 Statistics Canada, Cansim Table 378-0118 and 378-0117. The calculation takes the investment income earned in each retirement vehicle from the former, and divides it by the overall value of the investments in every year from the latter.

The Ontario proposal is based on the argument that people are not saving enough, and more saving will lead to more investment. Whatever the merits of such a view, it is difficult to see how the proposed introduction of an Ontario Retirement Pension Plan will bring about such a broad restructuring of asset holdings in the corporate and household sectors. In fact, not even one of these outcomes is guaranteed by the creation of the ORPP. Households may simply reduce saving outside the ORPP to offset the increase in mandatory saving in the ORPP, mimicking exactly what happened in the late 1990s when pension rates were raised. Faced with rising taxes, households have a further incentive to increase their investment in housing, since that is one investment that acts as an unlimited tax-free saving account. It is also quite possible that a further intrusion of government into Ontario's economy will lead firms to save more and defer spending until the business environment improves, after the government has boosted hydro rates, raised minimum wages, and increased corporate and personal income taxes.

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ISSN 2291-8620

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Acknowledgments

As the researcher has worked independently, the views and conclusions expressed in this paper do not necessarily reflect those of the Board of Trustees of the Fraser Institute, the staff, or supporters.