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HIGHLIGHTS

- The current retirement income system needs to be bolstered. A greater number of individuals are at-risk of experiencing a decline in their standard of living during retirement due to inadequate replacement of pre-retirement income.
- The most at-risk population is low-middle income individuals that do not have an employer pension.
- Although a new national public pension plan with coverage for all workers without an employer pension would be the most targeted policy response, enhancing and expanding the private pension system could prove very beneficial.
- Expansion of the CPP is not a targeted policy response and carries the disadvantage of being a payroll tax. If CPP enhancement is pursued, the most benefit would come from raising the earnings ceiling by 1.5 times its current level to \$70,800.

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RETIREMENT INCOME REFORM AND CPP ENHANCEMENT

This paper is a submission to the Ontario government in response to the consultation document entitled “Securing Our Retirement Future”.

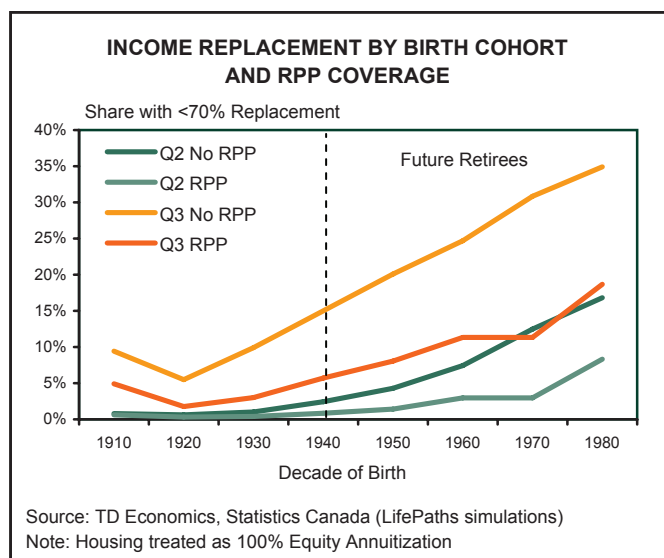
Introduction

The goal of the Ontario government to strengthen the retirement income system is very commendable. Although the existing system is keeping the vast majority of seniors out of poverty, there is a significant minority that is experiencing a drop in their standard of living upon entering retirement. Various studies suggest that perhaps 20% to 25% of individuals at the national level are currently replacing less than the desired 60% to 70% of their pre-retirement income when leaving the labour force. Projections by TD Economics suggest that weaker saving rates, lower asset returns, reduced pension coverage and other factors will lead to a greater minority being at risk in the future. So, it is prudent to bolster the retirement income system and enhance the incentives to save. We also commend various government efforts to boost financial literacy.

Low middle-income individuals at risk

The question is how policy should be shaped to address the retirement income replacement challenge? In our opinion, the policy response should target the at-risk population. In June 2010, TD Economics published a Special Report on retirement income security reform where we attempted to diagnose the challenge using the LifePaths microsimulation model from Statistics Canada (available at www.td.com/economics/special/gb0610_retire.pdf). Specifically, we looked at projections for the changing share of the population replacing less than 70% of pre-retirement income subdivided by income level (we examined income brackets divided into five quartiles from lowest to highest) and by the characteristic of whether the individual has a registered pension plan (RPP) or not.

According to the LifePaths model, the outlook over the coming decades is a gradual increase in the share of retirees with less than 70% income replacement. Overall, the share of retirees failing to meet the ‘desired’ savings rises from 15% for those born in the 1940s to just over 24% for those born in the 1980s. While not dramatic in aggregate, the deterioration masks a critical underlying detail: the share of the upper income quintile that falls below 70% replacement remains rela-



tively constant, but the share of those in the middle income quintiles under 70% replacement deteriorates worryingly.

Those without pensions most vulnerable

Importantly, the LifePaths results provide a strong indication that coverage by an employer pension (RPP) matters greatly. For those with pre-retirement incomes in the second and third income quintiles, there is a marked difference in replacement rates in retirement depending on whether the individual has RPP coverage. A much greater share of households without RPP coverage fail to achieve 70% replacement than those who do. Indeed, the modeling results predict that this differential will widen for more recent born cohorts.

More explicitly, for the third income quintile of the 1940s-born cohort, only 6% of RPP-covered individuals will fall below 70% replacement relative to 15% for non-RPP individuals in the cohort. For the third income quintile of the 1980s-born cohort, 19% of RPP-covered individuals will fall short of 70%, while over 35% of non-RPP individuals will have under-70% replacement. Although the share with under-70% replacement deteriorates slightly even for those with RPP coverage, the increasing share of second and third quintile households in more recent birth cohorts without 70% is most marked for those lacking RPP coverage.

There are two ways of looking at the issue. You can examine what share of the income quintile without a pension will fall short of the 70% income replacement, or you can

look at the percentage of those who fell short of the desired income that did not have a pension in each income quintile. This latter approach shows that for the 1940s-born cohort, 100% of those in the second quintile without 70% replacement lack a RPP. For the 1980s-born cohort, the projection is that over 90% of the second income quintile without 70% replacement will be those without an RPP. It should be noted that pension coverage itself is not projected to deteriorate markedly during the coming decades. In other words, if this assumption is wrong, the at-risk population will be larger.

One should note that it is quite reasonable to question whether the 70% income replacement is the correct benchmark. The simple reality is that there is no universal needed replacement rate. Much depends on the individual's income. At the low end of the income scale, close to 100% of income replacement may be needed to avoid a material drop in one's standard of living. At high-income levels, less than 50% might be required. Regardless, the analysis shows that a significant minority, particularly those without registered pension plans are at risk of some deterioration in their standard of living.

Policy response should be targeted, not universal

The central issue then is how policy-makers should respond to this challenge. The current Ontario proposal is for a modest expansion of the Canada Pension Plan (CPP) and pension innovations to increase pension coverage and decrease pension costs.

In our June 2010 report, TD Economics argued that the

| PROJECTED SHARE OF INDIVIDUALS WITH < 70% RETIREMENT INCOME REPLACEMENT BY BIRTH COHORT AND INCOME QUINTILE | | | | | | | | |
|--|----------|-------|-------|-------|-------|-------|-------|-------|
| Income Quintile | Born in: | | | | | | | |
| | 1910s | 1920s | 1930s | 1940s | 1950s | 1960s | 1970s | 1980s |
| Of Individuals with RPP Coverage | | | | | | | | |
| 1 | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 1% |
| 2 | 1% | 0% | 0% | 1% | 1% | 3% | 3% | 8% |
| 3 | 5% | 2% | 3% | 6% | 8% | 11% | 11% | 19% |
| 4 | 21% | 14% | 18% | 20% | 21% | 24% | 24% | 32% |
| 5 | 38% | 38% | 41% | 38% | 37% | 39% | 39% | 44% |
| Of Individuals without RPP Coverage | | | | | | | | |
| 1 | 0% | 0% | 0% | 0% | 0% | 0% | 1% | 1% |
| 2 | 1% | 1% | 1% | 2% | 4% | 7% | 12% | 17% |
| 3 | 9% | 6% | 10% | 15% | 20% | 25% | 31% | 35% |
| 4 | 32% | 29% | 36% | 35% | 37% | 40% | 44% | 47% |
| 5 | 53% | 57% | 57% | 47% | 47% | 46% | 48% | 49% |
| Of all individuals | | | | | | | | |
| 1 | 0% | 0% | 0% | 0% | 0% | 0% | 1% | 1% |
| 2 | 1% | 1% | 1% | 2% | 3% | 6% | 10% | 13% |
| 3 | 8% | 4% | 6% | 10% | 13% | 17% | 22% | 25% |
| 4 | 25% | 18% | 22% | 23% | 25% | 28% | 33% | 36% |
| 5 | 41% | 40% | 43% | 39% | 39% | 40% | 43% | 46% |
| All | 15% | 13% | 14% | 15% | 16% | 18% | 22% | 24% |

Source: TD Economics, Statistics Canada (LifePaths simulations)
Note: Housing treated as 100% Equity Annuitization

optimal targeted response was the creation of a supplementary public pension plan with default enrolment (voluntary opt-out) for all workers without employer pension plans. We felt that this would provide increased coverage for the most vulnerable population and would have a scale that could provide the service at a relatively low cost. The default-opt-in feature was really what made this option superior to enhancing the available private pension vehicles. The final report of the Standing Senate Committee on Banking, Trade and Commerce released in October 2010 reached a similar policy recommendation.

In the absence of pursuing our preferred approach, TD Economics recommended a broadening of pension services from the private sector, similar to the current Ontario proposals. The Income Tax Act requires that pensions be based on “service as employees”. By eliminating the employee-employer relationship requirement, an expanded range of competitive private sector options could be made available. TD Economics supports this initiative and any others that would enhance the availability and efficiency of private sector pension vehicles.

TD Economics is less enamored with the concept of expanding the CPP. The Ontario government has suggested three options. First, increasing the income replacement rate from the current 25% to 35%. Second, increasing the earnings ceiling from the current \$47,200 by 1.5 times to \$70,800 or doubled to \$94,400. Third, both options mentioned above could be implemented.

The main criticism of raising the replacement rate is that it would impact all workers. Low-income Canadians do not have difficulty replacing their pre-retirement income and forcing them to save more may require a reduction in their current standard of living due to forced reduced expenditure. Many middle- and upper-income Canadians are also saving adequately, or have pensions that meet their income replacement needs. Again, increasing their saving through the CPP is not required and doing so might distort their other saving decisions. Remember that only 1-in-4 is part of the “at-risk population”.

Another drawback to raising the CPP is that it increases payroll taxes, since half of the CPP contribution for paid workers is made by the employer. Payroll taxes are a tax on job creation and should be avoided if alternative policies are available to tackle the income replacement challenge.

So, TD Economics does not feel that the CPP enhancement approach is sufficiently targeted; but, there is no disputing that raising the income replacement from the CPP would create additional forced savings and it might prove particularly beneficial to those without an employer pension.

One CPP enhancement option that has greater merit is raising the earnings ceiling. Although the current limit of \$47,200 covers the first and second income quintiles (the latter of which is in the at-risk population), raising the earnings ceiling to \$70,800 could be beneficial for individuals in the third income quartile (the group most at risk of a deterioration in income replacement) and even help the majority in the fourth income quartile. It does not appear necessary to raise the CPP ceiling more aggressively than 1.5 times the current level, since a greater increase would really be aimed at high-income individuals that have good opportunities to save.

So, improving the earnings ceiling is the most targeted CPP enhancement option, but there is a question of whether increased saving through the CPP might be offset by reduced saving through other vehicles. And, the CPP would impact all workers with the higher earnings, when only a significant minority is vulnerable. Finally, the payroll tax drawback is still present. Regardless, enhancing private pension options combined with raising the CPP earnings ceiling by 1.5 times its current level could materially bolster the retirement income system.

Conclusion

Once again, the Ontario government should be commended for taking this issue on. TD Economics believes that pension reforms allowing more flexibility in the provision of private pension vehicles would be highly beneficial if a new public pension option is not pursued. However, enhancing the CPP is not a targeted policy response. Low-income Canadians could be forced to save more when income replacement is not necessarily a problem and the additional savings might come at the expense of their current standard of living. Many middle- and high-income individuals also do not need to save more through the CPP. There is also no guarantee that additional saving within the CPP will not be offset by reduced saving through other means. If modest CPP enhancement is pursued, raising the earnings ceiling might be the most effective at helping the most at-risk group – that being low-middle income individuals.



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