Pensions at a Glance: OECD Forecast and Canada's Fate

The OECD just released its 2011 report *Pensions at a Glance* ("the Report"), now in its fourth edition. The Report this year focuses on the link between pensions, retirement ages and life expectancy – topics which are coming to the forefront in Canada's pension system.

The Report's editorial talks about the "pension paradox", meaning the dilemma governments face trying to maintain retirement-income ***adequacy*** without risking the pensions financial ***stability.*** It suggests three solutions to deal with this paradox as follows:

1. Longer working lives;
2. Concentrate the efforts of public retirement provisions on the most vulnerable; and
3. Encourage people to save more for their own retirement to make up for reductions in public benefits that are already in the pipeline or are likely to be required.

For Canadians looking to see how these solutions may be implemented, you need not look any further than Quebec. In the budget last month, Quebec announced a number of changes that they hoped would help bring financial stability back the Quebec Pension Plan in the face of a looming pension crisis. These included:

- Lowering of pension benefits for those retiring before age 65;
- Implement a tax credit for those who do not retire early (both points encouraging longer working lives); and
- Proposal for a new voluntary retirement savings program ("VRSP") (encouraging people to save more on their own).

It was estimated that Quebec's pension reserve fund would be depleted by 2039 should no steps be taken. There were several factors that contributed to this crunch. Most notably, Quebec faces an aging population, a forecasted worker shortage, and below average investment returns in the wake of the financial crisis.

The remainder of this article will look at some of the key OECD insights, and discuss how these issues may play out in Quebec, and the rest of Canada.

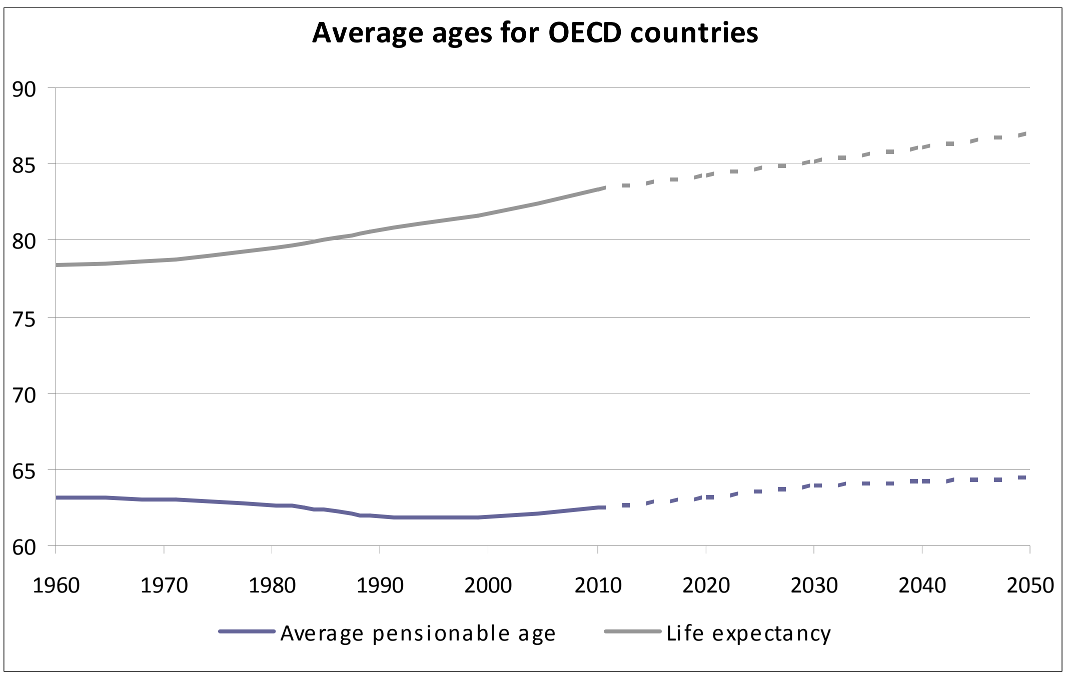
Longer Working Lives

Longer working lives seems like a pretty intuitive solution. The longer individuals are working the more wealth they can accumulate and the less time they will spend in retirement, thus reducing the burden on pensions. And in fact, OECD nations are on the right track with respect to longer working lives. The Report indicates that around half of OECD countries have already begun increasing pension ages or plan to do so in the near future. The report forecasts that the average pensionable age in OECD countries will reach 65 for both men and women by 2050, which represents an approximate increase of 1.5 years for men and 2 years for women.

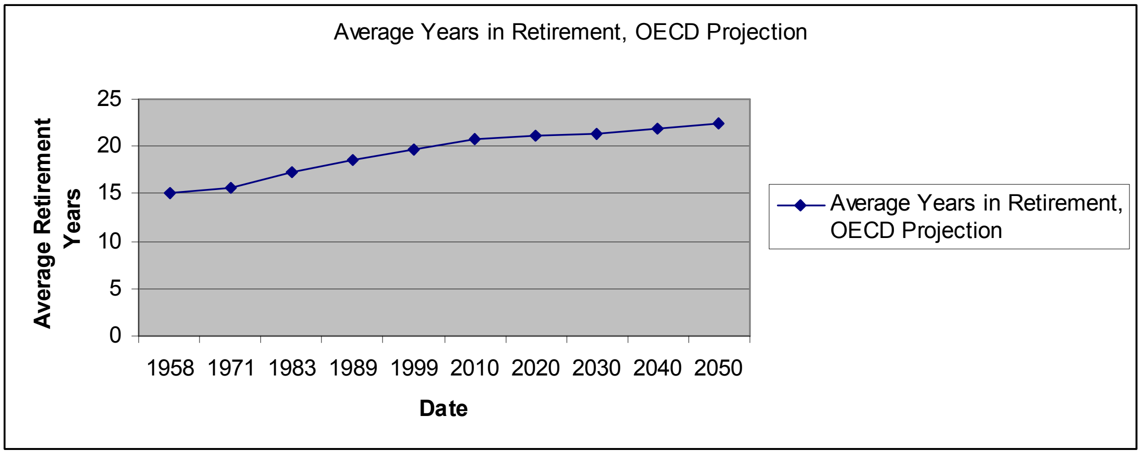
As mentioned above, Quebec, for its part is planning to offer a tax credit for those who do not retire before 65, as well as the promise of higher pensionable earnings.

Unfortunately, longer working lives does not tell the whole story. The assumption that longer working lives will mean less time in retirement and a lesser burden on pension plans is only true if people continue to have the same life expectancy. If life expectancy increases in lock-step with the longer working lives, then the benefit of longer working lives is offset.

Once we consider life expectancy among OECD nations, another story begins to unfold. Life expectancy is projected to increase at a *faster rate* than the increase in pensionable age. Therefore, the average years in retirement will increase, despite longer working lives (as illustrated below).



Source: Pensions at a Glance (OECD, 2011)



Canada's figures may be even more accentuated than the OECD average – a definite cause for concern for pension stability. In past decades, Canada has actually seen a trend toward shorter working lives and earlier retirement, as illustrated in the chart below.

Average Age of Retirement

	Public Sector	Private Sector	Self-Employed
1976-79	64	65	66
1980-89	62	64	66
1990-99	59	62	66
2000-05	59	62	66

Source: Canada's Pension Predicament: The widening gap between public and private sector retirement trends and pension plans (CFIB, 2007)

Another important observation from this data is that the trend toward earlier retirement has been driven largely from the public sector. This is most troubling because these employees are least likely to have private investments or pension plans that they can rely on should the stability (and adequacy) of public pensions waiver.

While the early retirement trend in Canada is likely to slow or reverse in the wake of the 2008-2009 financial climate, and with legislative incentives such as those from Quebec, the message remains clear: banking on longer working lives is not a viable strategy to maintain the financial stability of our pension plans at a level of adequacy that Canadians have traditionally relied upon because of the offsetting effect of increasing life expectancy.

Concentrate the efforts of public retirement provisions on the most vulnerable.

The second suggested solution out of the pension paradox is to focus on the most vulnerable members of the population. The OECD actually gave Canada high acclaim for this strategy. Canada currently spends well below the OECD average on pensions and pension replacement rates are already skewed to favour the most vulnerable. This too looks promising for the sustainability of Canada's pension system, but this also doesn't tell the entire story.

Since Canada has already leveraged this strategy, there is little room to continue to reduce the pension benefits of average earners to support the more vulnerable, should pension stability waiver. Therefore, any change to the adequacy of benefits means Canadians who earn an average or above-average income run a greater risk of not having enough in retirement to maintain the same standard of living.

This is significant because the Report analysis showed that 14 out of 20 major pension reforms in OECD countries will cut benefits for average earners by an average of around 20%. The Report also stated that it is "important to note that many pension reforms will mean that benefits for workers entering the labour market today will be significantly lower than for workers with the same career history retiring today."[1]

As this strategy is already being used, employing it further would have a detrimental effect on the adequacy of pension benefits, and so couldn't solve a pension paradox in Canada. This is likely the reason why recent Quebec pension change proposals did not include major changes in this area, but rather focussed on the other two areas of improvement.

Encourage people to save more for their own retirement to make up for reductions in public benefits that are already in the pipeline or are likely to be required.

The third solution is to encourage people to save more for their own retirement to make up for reductions in public benefits. This "solution" appears to be off-loading the problem, rather than actually solving the pension paradox. However, given our discussion negating the effects of the first two solutions, this appears inevitable.

The OECD, in its own right, acknowledges this as an inevitability. Public benefits are the cornerstone of old-age income support in OECD countries, account for 60% of old-age incomes on average. However, the Report states that "the public sector's role in providing incomes in old age will remain very important, but will diminish. Working longer and private pensions will inevitably have to fill the gap."[2]

With this insight, it is likely that the recent move by Quebec to encourage a VRSP will be watched closely by the rest of Canada. The VRSP will automatically enrol employees into the plan and will withhold deductions to the VRSP at source. The VRSP places obligations on an employer with respect to certain aspects of the plan, although the VRSP, in principle, will be administered by third parties (eg. Financial institutions) to reduce the administrative burden on employers.

While the VRSP will automatically enrol employees, there will be opt-out provisions for employees. The Report points to other countries who are adopting this approach. The

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[1] Pensions at a Glance (OECD, 2011) at page 63.
[2] *Ibid.* at page 10.

KiwiSaver scheme in New Zealand has rapidly expanded coverage of private pensions. The scheme, like the one proposed in Quebec, automatically enrols people in private pensions unless they opt out. The Report notes that the United Kingdom will follow this approach in 2012.

The messages from the OECD are consistent with those being heard in Canada. The financial burden of public pensions is going to increase and governments are unable (and unwilling) to maintain these programs at the same level of adequacy. Dependence on public pensions will diminish as governments put more responsibility on employers and individuals. In this sense, the trends in pension reform are likely to have a number of similiarities to health care reform – resulting in a greater burden for costs to fall on private employers and individual Canadians.