The report of the Expert Panel on Older Workers: How should public pensions be improved?*
Abstract

The recent report of the Expert Panel on Older Workers provided an important focus on retirement income policy. We comment here on the Panel’s recommendations that aim to support continued work by the elderly. We find that the focus on removing barriers to continued work is well-motivated, practical, and sensible. Particular attention must be paid to the full actuarial cost of reforms, however. Overall, the recommendations provide a sterling benchmark for future efforts to reform Canada’s retirement income system.
The Expert Panel on Older Workers has produced a wide-ranging and ambitious report that touches on a number of important issues for older workers. The underlying premises of the report are that changes in the economy present unique challenges for older workers and that, in the future, elderly Canadians may need to work longer to maintain current trajectories of economic growth and living standards. The panel urges us to focus on older workers as a long-term but critical challenge for public policy research and action.¹

The work of the Panel provides an important focal point for retirement income policy in Canada. The aim of increasing flexibility for retirement choices is well-chosen. It is important, however, to distinguish between allowing workers the flexibility to make choices and forcing people to work longer. Too often, policy discussion implicitly or explicitly sets as the goal the encouragement of more work by the elderly, because those extra hours of work will aid the macroeconomy through easing national-level demographic or fiscal shortfalls. Economic output would certainly be increased if individuals—be they young or old—were forced to work more hours. Forcing continued work from those who have the means and desire to retire is a poor goal for policy.

Wisely, the Expert Panel avoided this trap in setting out its principles for public pension reform by emphasizing the expansion of options through removing barriers to continued work. We believe that older workers should continue to be free to end work if they have sufficient assets and retirement income to meet their desired retirement lifestyle. We currently have too many policy barriers obstructing continued work. These barriers effectively deny workers the opportunity of higher retirement incomes through continued work. A sensible retirement security policy should strive to remove these barriers—while being mindful of any impact on equity.
concerns. The Expert Panel provides some excellent suggestions to move Canada in that direction.

We comment in this paper on the Panel’s recommendations for changes to Canada’s retirement income security system. Specifically, we focus on Recommendation 4, which aims to support continued work by the elderly (and minimize any work disincentives) when designing the different components of the income security system. Before engaging in a point by point discussion, it is worth first describing in brief the structure of the retirement income system and then reviewing why work disincentives may exist in the first place.

Canada’s retirement income system fits fairly neatly into the World Bank’s “Three Pillar” typology (World Bank 1994). First, there is a poverty alleviation pillar. In Canada, this consists of the Old Age Security pension and the Guaranteed Income Supplement and Allowance. These pensions are non-contributory (funding comes from general revenues) and payments do not depend on how much one worked throughout one’s life. Moreover, they favour those with low income. Second, there is an earnings replacement pillar consisting of the Canada Pension Plan (and Quebec Pension Plan in Quebec). This pension is funded by employee and employer contributions and benefits depend only on one’s own and one’s spouse’s earnings over the lifetime. Finally, private savings through tax-favoured employer-provided pensions and Registered Retirement Savings Plans, as well as taxable savings, provide extra income on top of the public pension system. Recent research suggests this system is doing a good job of helping Canadians construct adequate retirement incomes.2

Even if we accept that the system is achieving the goal of income replacement, this achievement might come at some cost. Economists typically think of policy decisions residing in a range where there is a trade-off between the goals of efficiency and equity. Gains in equity
ought to be measured against the loss in efficiency that was necessary to achieve them. The desire to institute public pensions two generations ago came from a concern for equity, as poverty rates for the elderly were the highest of all Canadians. The core components of the public pension system have gone a long way in reducing the extremes of poverty among elderly Canadians. This marked improvement in equity, however, may have come at a cost to the efficiency of decisions made by the elderly.

To make this point clear, we take the example of the Guaranteed Income Supplement (GIS). The GIS is intended to top up the incomes of those who arrive at age 65 with insufficient retirement income. Because it is targeted at those with lower income, it necessarily must impose high implicit tax rates on those whose incomes fall in the range over which eligibility for GIS is phased out. These higher tax rates provide large disincentives for those who anticipate GIS receipt to save for their own retirement income; once one becomes a GIS beneficiary these same taxes discourage any further work. These disincentives to work and save distort decisions of younger Canadians and seniors—but the efficiency cost must be compared to the equity gain they generate.

A push to reverse some of the equity gains in order to improve the efficiency aspects of the retirement income system would have generated much controversy. The recommendations of the Panel, however, focus for the most part on reforms that aim to reconfigure the system to extract efficiency gains that build on the equity achievements of the past. This is an incremental approach; fix and reconfigure rather than dismantle and rebuild. Some may think that Canada should push harder at improving the efficiency of our retirement system through a bolder reform package. Whatever the merits of potentially more radical reforms, they certainly are politically riskier. In contrast, an attempt to fix the existing system is a relatively easy step that should bring
broad support. While we agree with this approach, we do have comments on certain specific recommendations of the Expert Panel. In the rest of this paper, we go through the three main components of Recommendation 4 in detail.

**Recommendation 4a: eliminate work cessation clause from CPP**

The work cessation clause was added to the CPP when the early retirement option was introduced in 1987. Presumably, it was added in order to limit the ability of individuals to ‘double dip’—that is, to collect a pension while working. As Milligan and Schirle (2009) point out, the concern about double dipping is somewhat curious for a contributory pension. Pension benefits are not a ‘gift’ that is being abused by taking a pension while working on the side, but rather an entitlement gained through one’s own (and the employer’s) contributions. If the pension system is structured so the expected net present value of the stream of benefits is independent of the timing of retirement, then an individual’s choice of a date to initiate benefit receipt should not be of great concern to policy makers. The work cessation clause in this case would be rendered unnecessary.

In order for the net present value of the stream of pension benefits to be independent of the timing of initiation, however, there must be finely balanced adjustments for those taking their pensions early or late. Those retiring early receive a smaller pension for a longer period. Those retiring later receive a larger pension for fewer years. An actuarially balanced adjustment ensures that the expected net present value of these two streams is approximately equal. If the adjustment is not properly balanced, then those retiring early may receive higher lifetime pension flows than those retiring later.
Currently, the adjustment is a “linear” 0.5 percent per month before or after the 65th birthday, up to 30 percent in total. So, someone retiring at age 60 (which is 60 months before age 65) suffers a 30 (60 × 0.5) percent reduction in the monthly pension—but should expect to receive that monthly pension for more months than someone retiring at a later age. The same 0.5 rate is applied after age 65, so that someone initiating at age 70 receives a 30 percent larger pension than someone retiring at age 65.

The concern about the appropriateness of the actuarial adjustment is not innocuous. For example, given that women and men have different life expectancies, and that these expectancies change in a non-linear way with age, the policy choice of using a linear 0.5 percent per month adjustment creates problems. The ‘one size fits all’ approach must necessarily give some large groups of people actuarially unfair adjustments. Given normal demographic assumptions, it is most likely that the 0.5 percent adjustment at younger ages provides workers—and especially shorter-lived men—an incentive to start collecting the pension early. This means the lifetime value of the pension is not independent of the timing of its initiation.

Since the current actuarial adjustment favours early initiators, removing the work cessation clause without reforming the actuarial adjustment may open the door for larger-than-expected flow of new claimants at younger ages, and this might have an impact on the long-run financial balance of the CPP. 6

Earlier initiation of benefits also raises the possibility of increased poverty among the oldest old. Gruber and Orszag (1999) argue that with more people claiming early, those who do survive to very old ages will have lower monthly benefits at those ages because of the larger actuarial reduction associated with their early initiation. Moreover, if the possibility of immediate income induces some myopic individuals to claim earlier than would be financially
advisable, this impact on the incidence of poverty would be exacerbated. In Canada, the GIS acts to protect these individuals from poverty. Consequently, this means a possible increase in long-term GIS payments may result from the elimination of the work cessation rule.

While these concerns with the interaction of the work cessation rule with the actuarial adjustments to the CPP are potentially important to consider, we agree with the Panel’s assessment that the increased flexibility of allowing workers to separate the retirement and the claiming decisions could improve workforce attachment among the elderly.

**Recommendation 4b: allow contributions on work after the initiation of benefits.**

Similar to Recommendation 4a, this would encourage more work among pensioners. A primary concern with this proposal is to get the parameters actuarially correct. Incremental benefits should be directly tied to incremental contributions in an actuarially sound manner, or this recommendation will lead to increased program expenditures without a compensating increase in revenues. Importantly, the current benefit formula may not fulfill this requirement.

In Quebec, workers may continue contributing to the QPP after initiating benefits, but earn pension credits using a different formula. Earnings in excess of the basic exemption result in a 0.5% increase in benefits for all future years. For example, consider a retiree, who is entitled to the average pension of about $500 month, and returns to the labour market and earns $25,500. Under the Quebec formula s/he would receive an extra $110 per year, or $9.16 per month in pension benefits in perpetuity for this extra year of work. If instead the individual had not yet initiated a pension, and made these same earnings over the year, his/her pension entitlement would rise, all else equal, by $30 (6% of $500) per month. If the relative payouts for claiming now and later become too far displaced, a behavioural response will have to be taken into
account by CPP actuaries. This example illustrates the care with which the parameters must be set in order to get the balance right.

**Recommendation 4c: minimize work disincentives of GIS**

This recommendation focuses on the interactions of the GIS with the actuarial adjustment of the CPP. As outlined in Milligan (2005) and Milligan and Schirle (2008), there is a large and important interaction of these two programs. All who continue to work after age 60 receive a higher CPP pension upon eventual retirement because of the actuarial adjustment. However, for those who will be receiving the GIS in retirement, the value of this actuarial adjustment is effectively halved. This is because each dollar of additional CPP benefits gained by delaying CPP receipt leads to a 50 cent reduction in GIS benefit entitlement—there is a 50 percent clawback of GIS benefits when CPP benefit income increases. This provides a strong incentive for lower-income workers to retire earlier.

The case for reform here is strong, particularly because future GIS recipients are those at greatest risk of falling into hardship. These seniors might prefer to work a little longer in order to secure a better retirement income for the rest of their lives. Instead, the large effective tax on continued work through the GIS-CPP interaction means that these seniors see little return for continued work and might settle for an earlier retirement with lower future income flows. We think this is a compelling argument for reform and that the Panel’s recommendation to remove this policy barrier to work is a sound one.

However, the case for improving work incentives for the elderly should be considered carefully. In general, removing excessive policy barriers to work almost always makes sense. For
example, the sentiment to “make work pay” has had a large impact on social assistance programs in Canada, and one can sense a similar attitude in the Panel’s report with this recommendation. However, there are important differences between social assistance and the GIS that make the link to the social assistance example less apt. First, GIS benefits are modestly more generous than welfare benefits and more widely received so there is less stigma attached to them (around one-third of OAS recipients are beneficiaries). Second, Social Assistance is (at least ideally) a temporary measure to help individuals through tough times. GIS is more of a permanent arrangement to assist individuals whose circumstances or choices prevented them from accumulating enough resources for retirement. So, with social assistance we might want to improve work incentives—which typically means higher benefits for those with some labour force attachment—in the hope that it provides a stepping stone to the economic mainstream. For the GIS, long-run continued employment is not the policy goal. Putting money into improved work incentives does not generate the same payoffs since we would not expect seniors to be permanently removed from GIS receipt.

Conclusion

Our review of the work of the Expert Panel on Older Workers finds us in agreement with the direction taken for public pensions in Canada. While they are ambitious, the proposals in Recommendation 4 are also realistic and achievable. These policies would have a substantial impact on the tail end of the working lives of Canadians. They provide a sterling benchmark for reforms now and into the future.

Our greatest concern lies with the actuarial balancing of the reforms. Seemingly small changes to one aspect of one program can have large implications for the long run fiscal balance.
as new incentives lead to changes in retirement behaviour. We hope that policy makers will keep these considerations in mind when designing reforms.
References


* This paper draws on comments made in the session on the Expert Panel on Older Workers by Michael Baker at the Canadian Economics Association meetings in Toronto in May, 2009. We thank Craig Riddell for organizing the session and session participants for their comments. We also thank the anonymous referees and the editor for helpful comments.

1 We note that, contemporaneous with the session at the CEA meetings in Toronto, an Information Paper on Proposed Changes to the Canada Pension Plan was released by the Federal, Provincial and Territorial Ministers of Finance. (See http://www.fin.gc.ca/n08/data/09-051_1-eng.asp.) These proposals act on many of the recommendations contained in the Expert Panel Report. For the purposes of this paper, we maintain our focus on the Recommendations of the Panel and leave comment on the proposals of the Ministers of Finance to future writing.

See Baker, Gruber, and Milligan (2009) on the contributions of Canada’s income security programs to the well-being of the elderly.

A more general discussion of the incentive effects of Canada’s Income Security system can be found in Baker, Gruber and Milligan (2003).

As of November 2009, the GIS pays a monthly amount of $653 for singles and $431 each to those with a partner receiving OAS. These amounts are reduced by fifty cents per dollar of income to the person or couple until the benefit hits zero. This means that the benefit is exhausted at $15,672 for singles and $20,688 for couples. Earned income up to $3,500 per year is exempt from this clawback calculation.

The proposals of the Federal Provincial and Territorial Ministers of Finance change the actuarial adjustments starting in 2011. The new rates are proposed to be 0.6 percent for each month before age 65 and 0.7 after age 65. The work cessation clause is also to be removed.

The $25,500 in earnings is reduced by the $3,500 basic exemption and multiplied by 0.5% to arrive at $110.

We assume here that the extra year of earnings maintains pension entitlement at $500 per month. The assumed earnings of $25,500/year was chosen by multiplying the Year Maximum Pensionable Earnings by the ratio of the average to maximum CPP benefit (using 2009 numbers).