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Communiqué

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Scale back CPP, abolish RRSPs, among reform proposals for Canada's retirement income system in C.D. Howe Institute study

Scaling back the Canada Pension Plan and abolishing tax-deferred saving plans such as RRSPs are among proposals to reform Canada's retirement income system contained in a study published today by the C.D. Howe Institute.

The study, a collection of essays entitled *When We're 65: Reforming Canada's Retirement Income System*, is the thirteenth volume in the C.D. Howe Institute's series, "The Social Policy Challenge."

In the opening essay, William B.P. Robson, a Senior Policy Analyst at the C.D. Howe Institute, likens the CPP to a "Ponzi scheme" — a scam under which contributions paid in by new members finance payouts to existing members. If the number of new contributors does not continue to grow, payouts dry up and the scheme collapses. In the case of the CPP, as current payments to recipients begin to exceed current contributions by wage earners, the plan's small rainy day fund is almost certain to be depleted early in the next century unless payouts or payroll taxes are adjusted. And the CPP will collapse entirely if future wage earners decide they no longer wish to contribute. Robson predicts that, as contribution rates rise, perhaps to as high as 14 percent, more and more wage earners will become reluctant to pay the higher rates. Without major reform, Robson says, political pressure to wind up the CPP will become overwhelming sometime during the second decade of the new century.

Robson's solution is to reduce the intergenerational unfairness of the plan. To prepare for this, CPP funding should be stepped up sharply, thus forcing current contributors to pay more of their own retirement and relieving part of the future burden on young people. Then, if CPP benefits were scaled back by 10 percent over a ten-year period, this would further lighten the load on future contributors and forestall his projected political melt-down. The tax and regulatory treatment of private pension plans and RRSPs have to be improved at the same time, thus gradually effecting a switchover from the CPP to these more private savings mechanisms.

In another essay, McGill University economist Christopher Ragan argues in favor of abolishing RRSPs and other tax-deferred savings plans such as registered pension plans and government superannuation plans, since they redistribute wealth from lower-income to upper-income Canadians and may not increase national saving, since any extra saving by contributors is offset by higher government deficits. They should be replaced, Ragan says, by a tax reform that would lower personal income taxes and raise the goods and services tax rate which, he says, would be more effective in encouraging saving and would not send such a large gift to upper-income people. Ragan also suggests increasing the role of mandatory saving, so as to reduce the need for the government to bail out low-income seniors. In short, he would move toward a public saving system that was more fully funded, invested in mutual funds for better returns, and managed privately, rather than by government.

Three other essays provide, in effect, background to the pensions debate. McMaster University economist John B. Burbidge looks at the economic underpinnings of the Canadian retirement system, and recommends that benefits to retirees increase no more quickly than the standard of living of the average worker. Newman Lam, Michael J. Prince, and James Cutt, of the School of Public Administration at the University of Victoria, examine the effects of demographic changes on the CPP, and propose several ways in which the plan could be put on a sounder financial footing. And McGill University economist Paul Dickinson discusses what he calls six common "misperceptions" about the CPP, including the widespread idea that poverty among seniors is no longer a problem.

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For further information, contact:

William Watson (514) 398-8962
Susan Knapp (media relations), C.D. Howe Institute
phone: (416) 865-1904; fax: (416) 865-1866;
e-mail: cdhowe@cdhowe.org
Internet: http://www.cdhowe.org

When We're 65: Reforming Canada's Retirement Income System, The Social Policy Challenge 13, by John B. Burbidge et al. (C.D. Howe Institute, Toronto, December 1996). 228 pp.; $16.95 (prepaid, plus postage & handling and GST — please contact the Institute for details). ISBN 0-88806-359-8.

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Communiqué

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Une réduction du RPC et la suppression des RÉER figurent parmi les propositions de réforme du système de revenu de retraite au Canada contenues dans une étude de l'Institut C.D. Howe

Une réduction du régime de pensions du Canada et la suppression des plans d'épargne à imposition reportée comme les RÉER figurent parmi les propositions visant à réformer le système de revenu de retraite au Canada, avancées dans une étude publiée aujourd'hui par l'Institut C.D. Howe.

L'étude, une série d'articles regroupés sous le titre *When We're 65: Reforming Canada's Retirement Income System (Quand nous aurons 65 ans : une réforme du système de revenu de retraite au Canada)*, est la treizième dans la série de l'Institut C.D. Howe intitulée « Le défi posé par la politique sociale ».

Dans le premier article, William B.P. Robson, analyste de politique principal à l'Institut C.D. Howe, compare le RPC à un « stratagème de Ponzi » — une escroquerie où les contributions versées par les nouveaux membres servent à financer les prestations versées aux membres déjà participants. Si le nombre de cotisants cesse d'augmenter, les cotisations tarissent et le plan s'effondre. Pour ce qui est du RPC, étant donné que les versements aux bénéficiaires dépassent les contributions actuelles des salariés, il est presque certain que l'argent mis de côté sera totalement épuisé au début du siècle prochain à moins d'un ajustement soit des prestations, soit des cotisations sociales. Et le RPC pourrait même totalement s'effondrer si les salariés de l'avenir décident qu'ils ne souhaitent plus y contribuer. Robson prévoit qu'avec l'augmentation des taux de cotisation, qui pourraient atteindre 14 p. 100, de plus en plus de salariés se montreront réticents à les payer. En l'absence d'une réforme importante, explique Robson, les pressions politiques exercées pour mettre fin au RPC deviendront incontrôlables vers la deuxième décennie de l'an 2000.

Pour remédier à ce problème, Robson propose de réduire l'iniquité du régime entre les générations. Pour mieux s'y préparer, il faudrait considérablement augmenter le financement du RPC, afin de forcer les cotisants actuels à contribuer davantage envers leur propre retraite et à soulager une partie du fardeau que devront assumer les jeunes de l'avenir. De plus, en réduisant les prestations du RPC de 10 p. 100 sur une période de 10 ans, on réduirait d'autant plus la charge imposée aux cotisants de l'avenir et on préviendrait ainsi son effondrement politique. Dans un même temps, il faudra améliorer le traitement fiscal et réglementaire des régimes de pension privés et des RÉER, en effectuant graduellement un changement du RPC vers ces mécanismes d'épargne privés.

Dans le cadre d'un autre article, un économiste de l'Université McGill, Christopher Ragan se prononce pour une suppression des RÉER et autres plans d'épargne à imposition reportée, comme les régimes de retraite agréés et les régimes de rente des employés de l'État car ils redistribuent la richesse des Canadiens à faible revenu vers ceux qui ont des revenus supérieurs, et qu'ils n'encouragent pas l'épargne nationale, puisque toute épargne supplémentaire des cotisants est neutralisée par des déficits gouvernementaux plus élevés. Comme l'indique Ragan,il faudrait les remplacer par une réforme fiscale qui réduirait les impôts sur le revenu des particuliers et qui hausserait la taxe sur les produits et les services, mesures qui, selon Ragan, favoriseraient l'épargne et n'entraîneraient pas un tel « cadeau » pour les particuliers à revenu supérieur. Ragan propose également de renforcer le rôle de l'épargne obligatoire, afin de diminuer la nécessité pour le gouvernement de renflouer les gens du troisième âge à faible revenu. En bref, il voudrait un système d'épargne publique qui serait plus pleinement capitalisé, qui serait investi dans des fonds communs de placement afin d'obtenir un meilleur rendement, et qui serait géré par le secteur privé plutôt que par le gouvernement.

Trois autres articles offrent en fait un cadre au débat sur les pensions. L'économiste de l'Université McMaster, John B. Burbidge examine les bases économiques du système de retraite au Canada, et recommande que les avantages versés aux retraités n'augmentent pas plus rapidement que le niveau de vie de la moyenne de travailleurs. Newman Lam, Michael J. Prince et James Cutt, de la School of Public Administration de l'Université de Victoria, se penchent sur les effets des changements démographiques sur le RPC, et proposent divers moyens de le remettre d'aplomb financièrement. Quant à l'économiste Paul Dickinson de l'Université McGill, il aborde ce qu'il appelle six « perceptions erronées » communes à l'égard du RPC, dont l'idée généralisée que la pauvreté n'est plus un problème pour les gens du troisième âge.

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Renseignements :

William Watson 514 398-8962
Susan Knapp (relations avec les médias), Institut C.D. Howe
téléphone : 416 865-1904
télécopieur : 416 865-1866
adresse électronique : cdhowe@cdhowe.org
Internet : http: / / www.cdhowe.org

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When We're 65

Reforming Canada's Retirement Income System

John B. Burbidge, James Cutt,
Paul Dickinson, Newman Lam,
Michael J. Prince, Christopher Ragan,
and William B.P. Robson

The Social
Policy Challenge 13

John Richards
and
William G. Watson,
Series Co-Editors

C.D. Howe Institute

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The Study in Brief

Canadians celebrated the end of World War II in the most wholesome and optimistic way possible, by procreating prolifically. In 1944, 294,000 children were born in Canada. But in 1945, 1946, and 1947, births totaled 301,000, 344,000, and 373,000, respectively. And the baby binge continued, passing 400,000 in 1952 and reaching an all-time high of 479,275 in 1959. By contrast, in 1994 only 386,350 new Canadians were born, even though the country's overall population was 2.4 times what it had been in 1946 and 1.7 times what it had been in 1959. Because the unprecedented baby boom was followed by an almost unprecedented baby bust — birth rates were only marginally higher in the 1970s and 1980s than during the Great Depression — Canada's baby boomers celebrated the fiftieth anniversary of the end of World War II and their own looming half-centuries much less optimistically, by worrying about how they would finance their retirements, if in fact they could afford to retire.

In theory, the pension problem is simple. Assuming the boomers *are* able to retire, some way has to be found to give them a share of whatever economic output Canadian society produces in the years after 2010, when they turn 65. One way is for them to acquire their own legal title to future output — that is, to save. They can save either entirely on their own, out of after-tax dollars, or with the help of their fellow taxpayers, in tax-assisted vehicles such as Registered Pension Plans (RPPs) or Registered Retirement Savings Plans (RRSPs). A second way in which they can provide for their future income is, in effect, to depend on the kindness of strangers and hope that younger Canadians will give them a share of whatever they may be earning in the years following 2010. This is not so unlikely a possibility as it may sound. Canadians have been sharing in this way since 1907, when the country's first public pensions were introduced (a year, it should be noted, after the first *parliamentary* pensions came into being: political charity has always begun at home in this country). An obvious disadvantage of this type of "pay-as-you-go" or "pay-go" scheme is that, when there are relatively few payers compared with the number of would-be retirees, the payers may decide they do not want to pay the very high premiums — taxes, really — necessary to finance the standard of living to which retirees would like to grow accustomed. On the other hand, they may not withdraw their generosity entirely for, in a chain-link version of Christianity's golden rule, they may wish to be treated in their old age the same way they treated the generation before them.

Ethics aside, there is also the problem of which of these two schemes — saving or sharing — will cause 2010's economic output to be greater. The US economist Martin Feldstein, Chairman of Ronald Reagan's Council of Economic Advisers, has written extensively on the possibility that the existence of pay-go savings plans may reduce future wealth by encouraging people to save less, thus reducing the future stock of real capital. His latest estimate is that Social Security reduces private saving in the United States by almost 60 percent, which obviously could have a large effect on future economic output (Feldstein 1996). If Social Security will finance my retirement, people may think, I only need to save enough to top it up. If this kind of thinking causes them to save less, the country's capital stock will not grow as much as it otherwise would. But if the future capital stock is smaller, future economic output will be lower, since capital accumulation is a major source of increased productivity. Of course, this kind of thinking may become less and less common as more and more people come to believe that Social Security — or in our case, the Canada and Quebec Pension Plans (CPP/QPP) — will not provide much, if any payoff in retirement.

How best to handle the retirement problem is obviously a fascinating mix of morality, politics, and the theory of economic growth, and it becomes ever more compelling as, for many of us, retirement moves closer to the middle of the radar screen. This thirteenth volume of the C.D. Howe Institute's "The Social Policy Challenge" includes five papers on different aspects of the retirement challenge. The volume opens with two papers presenting very specific policy proposals — one that CPP funding be stepped up sharply and then gradually phased out in favor of a privatized plan, and the other that RRSPs be replaced by a more general form of consumption tax. The book closes with three papers that, in effect, provide background to the pensions debate. The first looks at the economic theory of transfers between generations, the second examines the effects of demographic changes on the CPP, and the third discusses what the author regards as six common misperceptions about the CPP.

William Robson: Fix the CPP, Then Phase It Out

The book opens with a paper bearing the provocative title of "Ponzi's Pawns," written by William Robson, a Senior Policy Analyst at the C. D. Howe Institute. As Robson explains, Charles Ponzi (1882?–1949) was a particularly audacious practitioner of what came to be known as the "Ponzi scheme" or the "pyramid scheme" — a scam under which contributions paid in by new members finance dividends to existing members. In a Ponzi scheme, as Gertrude Stein said of Oakland, California, there is "no there there": no real investment underlies the scheme. If the number of new contributors does not continue to grow, dividends dry up and the scheme collapses. Robson argues this is precisely the danger faced by the Canada Pension Plan.

The CPP is not *exactly* a Ponzi scheme, of course. Ponzi went to jail for his plan because he represented to investors that there *was* a there there, that he was actually taking their money and investing in postal-reply coupons, which, to begin with at least, he had in fact been doing. The CPP, by contrast, is perfectly transparent, even if most Canadians are not familiar with its details. Moreover, it has at least a small there there: by law, it must maintain a small capital fund sufficient to pay out two years of benefits in case the payroll taxes that finance it suffer a cyclical decline. When people talk about the CPP "going bust," they are referring to the possibility that, as current payouts to pensioners begin to exceed current contributions by wage earners, this rainy day fund will be depleted. In fact, unless payouts or payroll taxes are adjusted, that is almost certain to happen early in the next century, but that does not mean the plan will have "gone bust." Quite the contrary, it will collapse only if future wage earners decide they no longer wish to contribute. Because official projections indicate that, as the ratio of pensioners to wage earners rises over the next few decades contribution rates will have to rise as high as 14 or 15 percent in order to maintain payouts, Robson believes that more and more wage earners probably will become "reluctant players" and vote for political parties that promise to reduce their contribution rates. The danger is compounded by current politicians' habit of making "soothing but misleading statements" (p. 31) about the importance of maintaining payouts to current beneficiaries, who naturally are upset by talk about one of their principal sources of retirement income "going bust."

At the heart of Robson's paper are calculations showing how young Canadians are likely to fare under the CPP. The chief actuary of Canada has estimated that, for people who reached retirement age in 1976, the CPP paid off at an effective annual return of more than 30 percent on their contributions; "[b]y contrast, average participants born in 1988 are expected to receive a return about one-sixth as high — 5.2 percent, which is barely more than 1.5 percent after allowing for projected inflation" (p. 35). Another way to look at this problem is to see how much worse off young Canadians would be under the CPP compared with how they could fare by contributing to a fully funded plan — that is, one that invested in assets such as stocks, bonds, mortgages, and so on. Assuming the return to money invested in such assets averaged 2.5 percent in real terms, Robson calculates that today's ten-year-olds who earned the CPP's maximum pensionable earnings (currently $35,000) over their working lives would be worse off by just over a year's earnings under the pay-go CPP, compared with what would have been available under a funded plan. Anyone born today would be worse off by a year and a half's earnings. If real returns were 4.5 percent instead of 2.5 percent, however, "[t]he representative [CPP] participant who is ten years old today stands to lose the equivalent of five and a half years of covered earnings at age 65 by participating in an unreformed CPP," while today's and tomorrow's toddlers would be six to six and a half years worse off (p. 41).

Robson calls this way of doing things "embarrassing" and "unconscionable." He also doubts it is sustainable. It currently appears to be: "most voters have already seen some of their funds disappear into the scheme and have therefore begun to develop an interest in preserving it long enough to get their benefits" (p. 42). The problem is that, while ten-year-olds and toddlers do not vote, 50- and 60-year-olds do. If the system were wound up in five years' time, with benefits continuing to be paid only to people who were already receiving them at that time, people who had contributed for 20 or 30 years would be big losers. Even though the gain to younger Canadians would exceed their loss, Robson calculates that more voters would be opposed to a windup than would favor it, which means it probably would not pass. In another ten years, however, the political balance begins to change: more young Canadians will reach voting age, while more older Canadians will already be receiving benefits and therefore would be unaffected by a windup. Sometime between 2011 and 2021, Robson reckons, the political balance will tip in favor of winding up the plan — although, of course, there may be an element of self-fulfilling prophecy in all this: once Canadians understand the balance eventually will tip toward a windup, "the increasing sense that money put into the plan was money thrown away would prompt demands for a quicker windup" (p. 47). Robson concludes that, "[o]n balance, those politicians who promise to overturn an unreformed CPP — and there will be many of them in the twenty-first century — will likely get an increasingly enthusiastic response" (p. 48).

What to do? Robson provides options both for the reform of the CPP and for its replacement. Phasing in much higher rates — a maximum rate of, say, 11.9 percent rather than the 9.5 percent rate currently projected in ten years' time — with a consequent buildup in the retirement fund, would force all current contributors to pay more of their own retirement, which would relieve part of the future burden on young people. If CPP benefits were scaled back by 10 percent over a ten-year period, this would also lighten the load on future contributors. The penalty they would face compared with what they could earn in a fully funded plan would fall to a little less than four and a half years' earnings, which is clearly better than the six to six and a half years' earnings the status quo costs them. Robson calculates that after these reforms the day when a majority of Canadian voters would find it in their interest to wind up the plan would be delayed until 2030.

One effect of this kind of CPP reform is that the CPP fund would grow dramatically, much as, with UI benefits cut and premiums raised, the unemployment insurance fund has swelled. The CPP fund would quickly dwarf the $5–7 billion UI fund, however, rising to "$100 billion in 2007 and $200 billion in 2012" (p. 52). Robson predicts that, just as the buildup in the UI fund has prompted salivation among many interest groups, a political tug-of-war over what to do with the CPP fund will break out. He foresees the possibility, as allowed by the legislation that originally set up the CPP, of provinces' deciding to do as Quebec did from the outset and set up their own plans. This would be particularly attractive for provinces, such as Alberta, with favorable demographics and low debt ratios. As Robson puts it, "provincialization would be a logical response by certain provinces to paralysis or inadequate reform of the CPP" (p. 54).

A more extreme reform would be to do away with the Ponzi-like attributes of the pay-as-you-go CPP and move toward a fully funded system. The alternative of "coercing unwilling participants into the Ponzi scheme" with the reassurance that, under a new and improved scheme, they will lose only four and a half years' worth of earnings instead of six and a half is unlikely to be "a viable option" (p. 54). In preparation for privatization, Robson recommends "not only...improving the CPP's financial condition with fuller funding but...trimming it back and simultaneously improving the tax and regulatory treatment of private pension and registered retirement savings plans," thus gradually effecting a switchover from the CPP to these more private savings mechanisms (p. 55). He concludes with the following sobering thoughts:

> It is irresponsible of today's adults to try to impose the CPP on today's children and unrealistic to think that, when those children reach adulthood, they will accept the attempt if it is made. Canadians need to start preparing for a future without the CPP. (Ibid.)

Christopher Ragan: Shut Down RRSPs, Raise the GST

As we have just seen, William Robson would like to expand RRSPs in anticipation of phasing out the Canada Pension Plan. Christopher Ragan, Associate Professor of Economics at McGill University, has quite a different plan for RRSPs. He wants to abolish them and replace them with consumption taxes. Like any good economist, Ragan is meticulous in setting out the logic of his argument: although tax-deferred savings plans (TDSPs), of which RRSP and RPPs are the best-known examples, very likely do not increase the overall amount of saving done by Canadians and their governments, they do cause a redistribution of wealth from lower-income to upper-income Canadians. They should therefore be replaced, Ragan says, by a package of complementary proposals that would encourage saving but would not send such a large gift to the upper regions of the income distribution.

As Ragan's introduction demonstrates, the RRSP stakes are considerable. In 1992, the annual flow of contributions into

RRSPs totaled $15 billion, compared with only $6.7 billion for RPPs, while the overall amount of wealth held in RRSPs is estimated at $220 billion in 1994. (The RRSP boom continued in 1995: total contributions were up 8 percent over the previous year, totaling $23 billion, although this was only 15 percent of the $153 billion in tax-deductible contributions Canadians could have made [Cohen 1996].) Of course, a main reason for the popularity of RRSPs is the favorable tax treatment they receive. Contributions can be deducted from taxable income, producing a current tax benefit equal to the taxpayer's marginal tax rate times whatever amount is contributed. Any investment income generated within the RRSP accumulates tax free until withdrawal, which can take place at any time, although for most people it occurs at retirement or shortly thereafter, with withdrawal obligatory by age 69.

Two hundred and twenty billion dollars is obviously a lot of money, and sounds as if it would have caused a substantial increase in Canada's capital stock, since much of the money Canadians put in their RRSPs is invested, either directly or through mutual funds, in the shares and bonds of companies whose business is accumulating real capital. Ragan argues, however, that TDSPs very likely *reduce* national saving. The reason is obvious once one realizes that national saving consists of saving by people and businesses but also by governments. In 1994, Canadian citizens and businesses between them saved 8.0 percent of GDP. Our deficit-ridden governments, on the other hand, "dissaved" 4.5 percent of GDP by spending more than they collected in taxes. What happens to national savings as a result of TDSPs depends on how they affect these three kinds of potential savers. People who invest in RRSPs almost certainly increase their overall saving as a result. Most people save at least something out of new income, and the tax breaks associated with TDSPs are like getting new income (even if, in reality, they merely let taxpayers keep old income). It is virtually certain that some of this new income is saved. On the other hand, it is also virtually certain that the provision of tax breaks reduces government saving (or, what is the same thing, increases government deficits). True, RRSPs drain away tax revenues both when contributions are made and when income accumulates tax free within the fund, but they boost tax revenues when withdrawals are made. Ragan calculates, however, that in 1992 the net loss to the federal government, even when taking the taxation of withdrawals into account, was $13 billion, with perhaps another $7 billion lost by the provinces. Ragan argues that this dissaving very likely offset any increase in saving out of the higher incomes of RRSP contributors.

That still might be good for national saving, however, if RRSPs had effectively turned Canada's income tax system into a consumption tax system. Economists generally favor the taxation of consumption rather than income for two reasons. First, much economic theory suggests that a society that discourages saving by taxing the interest, dividends, and capital gains it produces is like a farmer who eats his seed corn. Second, it is simply unfair that, of two people with the same assets today, the one who saves and earns a future income from them should be taxed more than the one who consumes them. Like most economists, Ragan accepts these arguments but argues that, if RRSPs are not completely comprehensive, so that any amount can be contributed to them, they are unlikely to produce the desired encouragement to saving. If they are to produce greater saving, they must induce a "substitution effect" — that is, they must raise the return to saving by reducing the taxes imposed on it. But a majority of Canadians do not have RRSPs, so the returns on whatever these people save are fully taxed. In the same way, Canadians who have hit their combined RRSP/RPP contribution limits also are fully taxed on any additional saving they do, for by definition that additional saving must occur outside their TDSPs. The only people who do not face full taxation of their savings at the margin are Canadians who have not hit their contribution limits and yet do all of their saving within their RRSPs and there simply may not be many such Canadians.

A third argument in favor of TDSPs such as the RRSP and RPP is that they encourage Canadians to save for their own retirement, thus reducing the need for government income support programs. On the other hand, they only *encourage* saving, they do not *require* it. Ragan argues that, if there is a real worry some Canadians will not bother to save because they know government stands ready to help them in their old age, the appropriate remedy is to force people to contribute to a reformed public pension system.

Although TDSPs have few social benefits, Ragan argues, they do have costs. *Somebody* pays for TDSPs. The tax revenue that is foregone has to be made up with other taxes, with reduced spending, higher borrowing, or the printing of money, which causes inflation. While it is theoretically possible that the only people who suffer from these changes are TDSP contributors, that would be something of a fluke. It is much more likely that nonbeneficiaries also pay, which means that the income redistribution that occurs is very probably perverse. Contributors to RRSPs generally have higher incomes than noncontributors. In 1991, for instance, only 24 percent of contributors had incomes less than $20,000 a year, while 12 percent had incomes higher than $60,000. Moreover, since they are in higher tax brackets, high-income contributors gain more from their contributions than low-income contributors. They also tend to contribute more than low-income contributors. As a result of both effects, contributors in 1991 who made more than $30,000 a year received a tax reduction averaging $879, while those making less than $30,000 a year received only $307. Ragan shows that, accumulated over many years, these differing benefits can add up to tens of thousands of dollars. "[I]t is unlikely," Ragan concludes, "that the typical Canadian would view TDSPs as a valuable instrument for improving the distribution of income" (p. 79).

What would Ragan do? First, he would end tax support for all tax-deferred savings plans, "including RRSPs, firm-sponsored pension plans, and the superannuation plans for the public service" (p. 81). Contributions to TDSPs no longer would be tax deductible, while their earnings would immediately be subject to tax. Employer contributions to defined-contribution pension plans no longer would be tax deductible, while employee contributions would not be excluded from taxable income. Anticipated benefits from defined-benefit plans could be "converted into an equivalent to current income that is taxable along with other current income" (ibid.). In effect, employer and employee contributions to pension plans would be treated as "ordinary payments to workers."

Second, Ragan would move toward a consumption-tax system by reducing income tax rates across the board and simultaneously increasing the goods and services tax (GST) rate (p. 83). At the same time, he would eliminate exemptions from the GST, such as groceries, thus dramatically reducing the system's administrative costs. Any undesirable redistributive effects that might result presumably could be avoided by increasing the generosity of the GST tax credit, which goes only to low-income Canadians. Ragan would not eliminate the income system entirely, however, as in his view it constitutes a useful administrative device for identifying those who need public income assistance.

Finally, Ragan would increase the role of mandatory saving, so as to reduce the need for the government to bail out low-income seniors. He would move toward a public saving system that was more fully funded; moreover, "there is no reason the management of these funds could not be entirely beyond the reach of government. They could be invested in private mutual funds and managed professionally" (p. 86).

Ragan closes his paper with what he calls a "crucial caveat" — that none of his recommendations be regarded as motivated by the need to reduce government deficits: since the abolition of TDSPs

> would represent a significant increase in the overall taxation of households....[t]he combination of...abolishing TDSPs plus lowering income tax rates and raising the GST...should be approximately revenue neutral. (Pp. 87–88.)

John Burbidge: Reality Checks for Retirement Policies

John Burbidge, Professor of Economics at McMaster University, helps the debate along by looking at the economic underpinnings of the Canadian retirement system. Though he does not recommend specific reforms, he argues that the public pension system, which includes Old Age Security (OAS), the Guaranteed Income Supplement (GIS), and the age exemption (soon to be combined into Ottawa's proposed Seniors Benefit), together with the CPP and tax assistance for RPPs and RRSPs, should be made more "feasible." In other words, the system should better reflect taxpayers' ability to finance it.

One way to do this would be to link the growth of various pension payments, not to the consumer price index (CPI) nor even to the overall rate of economic growth, but to the growth of average or median wages. As Burbidge puts it, "stagnant or falling real earnings of prime-age workers since the mid-1970s imply that the set of intergenerational transfers feasible in the long term today is smaller than it was 20 years ago" (p. 94). Comparing the varying fortunes of pension recipients and prime-age workers over the last two decades, Burbidge finds that, measured in 1993 dollars, OAS payments rose by roughly $300 a month through the 1970s and since 1980 have been roughly constant in real terms. GIS payments rose sharply to the mid-1980s and since then have also been more or less constant. The Spousal Pension Allowance, introduced in 1975, provides additional benefits to younger spouses of retirees. Over roughly the same period, CPP benefits also became more generous as the plan was fully phased in and began to mature. In addition, in 1987 the CPP disability allowance was increased by $150 a month. As a result of these changes, the current retirement system "provides better insurance across and within generations" than did earlier systems, which before the 1960s were mainly private (p. 107). On the other hand, Canadians have been reluctant to back up their unquestioned generosity to seniors with the tax payments it requires, thus leaving the country with a debt problem. In addition, the difficulty of amending the CPP, which requires provincial approval in a formula much like the 1982 constitutional amending formula, means many of the more important changes to the retirement income system have been made via the purely federal OAS/GIS program. As a consequence, "Canada's system, dominated as it is by age-conditioned transfers..., differs markedly from the primarily earnings-related systems of most other countries, including the United States" (pp. 107–108). The GIS was supposed to be a temporary supplement until the CPP had matured but it is now a key part of the system. (Although the new Seniors Benefit ends its separate existence, the income-tested GIS lives on in the benefit's taxback provisions.)

After summarizing the economic literature on the important questions of whether old age security systems discourage either saving or labor supply, Burbidge finds reason for skepticism in both cases. The dramatic reduction in labor force participation rates among older men — from 50.4 percent in 1961 to 16.6 percent in 1993 for men aged 65–69 and from 85.9 percent to 60.9 percent for those aged 55–64 — *is* consistent with the ideas both that public pension plans make older workers wealthier and that they discourage work by in effect taxing wages and salaries. In some cases, in fact, the combined taxback rate of public plans is greater than 100 percent, high enough to discourage anyone from working. On the other hand, Burbidge argues that, with the flood of baby boomers into the work force, many *private* pension plans were changed to encourage early retirement. Moreover, phasing in the CPP, which involved year-by-year increases in the proportion of pensionable earnings that would be paid out in pensions, created a strong incentive to delay retirement: "with the generosity of pensions increasing so quickly, working even a short while longer caused a sharp increase in retirement income" (pp. 112–113). Burbidge thinks it possible that work-discouraging changes in private pension plans could in fact be reversed over the next few decades as firms find themselves strapped for new workers: "Thus, some of the concern about the future high projected costs of caring for the elderly may be misplaced" (p. 113).

On the problem of savings, Burbidge contrasts the views of Harvard University's Robert Barro with those of Feldstein, whose work has already been mentioned. In a famous article published in 1974, Feldstein argued that social security payments had caused a large reduction in overall US saving, since workers felt the government would take care of a major part of their retirement needs. Barro, on the other hand, argued that public retirement pensions could have almost no effect on overall saving since the final decision as to how much older citizens consume lies with their families. If governments encourage more consumption by seniors than families think warranted, they can reduce their assistance to their senior members. Thus, if the government encourages "dissaving" — that is, greater consumption by seniors — families can offset this by doing more saving of their own. In the limit, Burbidge explains, "the private offset matches the public transfer dollar for dollar, leaving the consumption level of both young and old unchanged" (p. 114). Burbidge's own work indicates Canadian seniors do more saving than had been thought. In fact, saving *increases* slightly with age, which suggests that when resources are transferred to seniors the overall saving rate may not suffer.

Burbidge closes, not with specific policy proposals, but with candidates for further study. He notes that pre-tax annual incomes of urban married-couple families in which the husband was retired were 50 percent higher in real terms in 1989 than they had been in 1976, while over the same period real earnings for full-time, full-year workers either stagnated or declined over the period. He thus argues that "[g]overnment-mandated intergenerational transfers to the elderly should be brought into line with what working-age generations can afford and wish to provide" (p. 124). Where should cuts come from? Not from the OAS/GIS system, since the GIS is already income tested, while the Mulroney government began the clawback of OAS payments. (The new income-tested

Seniors Benefit confirms Burbidge's prediction that assistance targeted mainly at lower-income elders should not be reduced.) That leaves either RRSPs or the CPP. Since RRSPs are linked to pension rules so as to provide fairness between those who do and do not have private pensions, Burbidge argues that major changes will come through the CPP.

One possibility is to phase out the CPP over ten years. The blow for lower-income seniors would be cushioned by income-tested demogrants, while the higher-income seniors who clearly would suffer would at least be spared radical RRSP reform. Younger Canadians, as Robson's numbers suggest, would likely benefit from such a change.

A second possibility is to condition the overall amount spent on demogrants for elders — the new Seniors Benefit, basically — on the growth of the real earnings of the workers who must finance it. This would prevent discretionary increases in the well-being of seniors, and if it meant they could not do substantially better than the people who were financing their pensions, they also could not do substantially worse. In closing, however, Burbidge warns that "much more work is required to understand what the effects of this structural change would be" (p. 126).

Lam, Prince, and Cutt: Simulating the Future, Restoring the CPP

Newman Lam, Michael J. Prince, and James Cutt, who all teach public policy and administration at the University of Victoria, take a look at the program details and financing dynamics of the CPP, which they see as a "part of Canada's heritage that is worth keeping but needs prompt renovation" (p. 129). Fortunately, "fairly simple corrective measures do exist" (ibid.).

At the moment, Canadian workers and their employers each pay 2.8 percent of the employees' earnings into the CPP, up to the "year's maximum pensionable earnings," which is roughly related to the average industrial wage. The first 10 percent of earnings are exempt, however. Make at least ten years of contributions and you are entitled to a pension. What you get is one-quarter of the average "year's maximum pensionable earnings" in the three years before you retire, times your "earnings ratio." Your earnings ratio is whatever you earned in a month, divided by maximum pensionable earnings for that month, averaged over your entire working life. In calculating the average, however, you get to drop any time during which you were either over 65 or had at least one child less than seven years of age. You can also choose to drop another 15 percent of your earnings months, provided this still leaves you with ten years of contributions. The purpose of dropping months, of course, is to raise your earnings ratio: in fact, you only drop them if doing so achieves this. The earnings ratio thus provides a connection between what you paid into the plan and what you get out of it. But the connection is a loose one: if you are lucky enough to retire when maximum pensionable earnings are rising rapidly, you get more out of the plan than you paid in.

Lam, Prince, and Cutt note that the folklore of the CPP is that the plan is in trouble because of the baby boom, which will soon cause a sharp increase in the proportion of Canada's population aged 65 and over. On the other hand, CPP payouts began to exceed contributions as early as 1984, when the first of the baby boomers were just turning 40 and entering their prime earning years. The obvious conclusion is that, although population aging "does have serious implications for the CPP[,]...that challenge is not the only reason for the plan's financial problems. They are, in fact, caused by a number of factors that have reduced revenues and increased expenditures" (pp. 135–136). Among these other contributing factors, Lam, Prince, and Cutt identify a "low contribution rate, low returns on CPP investments, increased CPP benefits, rapid increases in the upper limit on pensionable earnings..., and the short contributory period for entitlement to a full pension" (p. 136). They proceed to run computer simulations examining the influence of each of these factors.

The first factor is the plan's low contribution rate, which started in 1966 at 3.6 percent and remained there for 21 years, even though, "[i]n 1975, survivor benefits were provided to widowers as well as widows, retirement and earnings tests were dropped for retirement benefits, and all CPP benefits were fully indexed to increases in the CPI" (p. 139) and, in 1978, the option of dropping low-income months from the formula was introduced.

The CPP also suffers from low real rates of return — an average of 1.5 percent — on its investment funds. By 1989, a dollar that in 1967 had been placed in provincial bonds, the CPP's only permitted investments, was worth $5.41. Placed in private investment funds, it would have been worth $8.60. Finally, the granting of full pension rights on the basis of only ten years of contributions meant the plan was bound to experience difficulty. In fact, Lam, Prince, and Cutt show that "even a full 30 years of contributions is insufficient to finance today's retirement pensions (much less other benefits, such as survivor and disability benefits)" (pp. 144–145).

What can be done? One obvious option is to raise the contribution rate. Assuming a 2 percent real rate of return on investments, a life expectancy of 85 years, and a contributory period of fully 40 years, the authors calculate that a contribution rate of 7 percent (1.4 percentage points higher than today's 5.6 percent) would be required to fully finance the current average retirement pension of $8,600 per year. Survivors and disability benefits would take that to 10 or 11 percent, however, although Lam, Prince, and Cutt recommend that these in fact be paid for by workers' compensation or out of general revenues. Eliminating exemption of the first 10 percent of a worker's earnings would increase the accumulated funds available for the payment of his or her pension by more than 12 percent at the age of 65. On the other hand, as British Columbia has pointed out in recent federal-provincial discussions on pensions, the attendant rise in taxes would impose a proportionately greater burden on low-income workers.

Lam, Prince, and Cutt also find big payoffs to making a wider array of investments available to the CPP's managers: "for every percentage point increase in real return, the accumulated funds [at retirement] increase by 20 percent or more" (p. 152). They also suggest serious consideration be given to reforms that would give plan holders — that is, the general public — more control over investment decisions, and possibly even hand over control of the fund to an independent authority.

Another obvious way to improve the financial health of the CPP would be to reduce benefits. Though Lam, Prince, and Cutt note that, in 1992, retirees were only 8.0 percent of poor Canadians, compared with 20.4 percent just ten years earlier, they judge that directly reducing benefits would be "politically difficult" (p. 154). One way to reduce them indirectly, however, would be to raise the minimum contribution period that entitles contributors to a full benefit, a change that would not necessarily be unfair, since "individuals with a shorter contributory period are not necessarily the most in need" (ibid.). The authors note that to finance the current average annual pension of $8,600 with only ten years of contributions requires a real rate of return on investment of 14.4 percent, which is much higher than the long-term Canadian average. With a contribution period of 40 years, by contrast, a return of only 2.1 percent provides full financing. To put it another way, a five-year reduction of the contributory period from 40 years to 35 years reduces the pension funds available at age 65 by 10.6 percent.

Yet another way to improve the CPP's financial health would be to eliminate the dropout provision that allows people to delete their worst earning years when calculating their earning ratio. Lam, Prince, and Cutt calculate that this would reduce the value of CPP entitlements at age 65 by 3 to 6 percent. An option that would improve the CPP's finances more significantly would be to raise the retirement age to, say, 70, which would simultaneously shorten the payout period and lengthen the contribution period by five years. It would also provide five more years in which investment returns could compound themselves. The overall result, the authors figure, would be an 80 percent increase in the accumulated pension funds available at retirement. The downside, of course, is that it would require five more years of work from senior citizens.

On balance, Lam, Prince, and Cutt argue that clawing back CPP benefits would be unfair since, rightly or wrongly, people regard them as having been earned by contributions. On the other hand, it might be possible politically to sell the idea of de-indexing CPP payouts and instead having an independent committee decide how much of an increase was justified at any time, given the overall economic climate. The authors also suggest the possibility of tying benefits, not to the average industrial wage, but to the rate of inflation, which is forecast to grow more slowly than wages over the next few years. They calculate that, if contributions grow with wages but benefits grow with prices, the saving would be fully 65 percent of funds accumulated at age 65.

After considering these many possibilities, Lam, Prince, and Cutt favor a five-part package:

- Quickly raise the combined employer/employee contribution rate to 8 percent, which would be sufficient to raise more than 14 percent in additional funds over the contribution period and, with the other measures they recommend, pay off the existing unfunded liability.
- Invest contributions through the capital market under the supervision of an independent authority "set up to regulate investment activities and to protect the interest of contributors" (p. 164).
- Gradually raise the retirement age for full pension entitlement to 70 years. Phasing this in over 25 years could bring an overall improvement of almost 80 percent in the funds available at retirement.
- Freeze the retirement pension at its current level of purchasing power, which could increase funds available by fully two-thirds.
- Remove survivor and disability benefits from the CPP and provide them through workers' compensation or the Seniors

> Benefit. In fact, unless these programs are moved out of the CPP — which, after all, is supposed to be a contributory pension, not a social insurance program — the first four recommended measures would not in fact bring the plan into balance.

In their overall effect, Lam, Prince, and Cutt conclude: "[t]he recommended policy options should be able to provide enough funds to finance the CPP pensions with a surplus to absorb the existing unfunded liabilities" (p. 166). They end by suggesting that the national project of restoring the CPP to health in the 1990s "could help revive Canadians' collective sense of themselves in the pursuit of peace, order, and good government as well as dignity and security in old age" (p. 168).

Paul Dickinson: Six Common Misperceptions about the CPP

Paul Dickinson teaches economics at McGill University and has written extensively on questions of Canadian social policy. Here, he attempts to set the record straight on the status quo, or at least the status quo as it existed before the federal government announced the new Seniors Benefit. Dickinson neither proposes nor defends any particular policies but instead tries to dispel six common misperceptions about Canada's retirement income system. In an area of study too often characterized by heated pronouncements about the imminent bankruptcy or collapse of this or that program, but especially of the "unfunded" CPP, Dickinson's phlegmatic approach is like a welcome breeze on a hot summer day. It is also in many ways persuasive.

The first misperception Dickinson addresses is that the retirement system brings about a perverse redistribution of income by giving generous handouts to retired Canadians who are, by and large, no worse off than the rest of the population. He argues, first, that the criticism is irrelevant to the CPP and QPP, which are designed to replace wage earners' incomes, not to guarantee a minimal level of retirement income for poor seniors, which is the job of OAS/GIS. "To complain that the CPP pays pensions to high-income retirees is like complaining that private pension plans pay bigger pensions to people who contribute more to them" (p. 185). If people contributed to the CPP, they have a right to benefits. More fundamentally, Dickinson argues that the attack's premise is wrong: while the vast majority of seniors are now above Statistics Canada's "low-income cutoff" (what people normally refer to as "the poverty line"), many are only just above it, and this only because of old age assistance. In 1994, only one in eight households containing a senior had family income greater than $50,000. Finally, Dickinson notes that the degree of redistribution effected by the CPP is much greater than the simple spending numbers suggest: simulations on 1993 data indicate that 40 percent of benefits is effectively returned to governments in the form of taxes or reductions in other programs, especially OAS/GIS.

A second misperception is that contribution rates to the CPP are seriously regressive and will become more so as these rates rise over the next decade to finance perceived shortfalls in CPP funding. Dickinson takes on several aspects of this misperception. To begin with, although the current CPP contribution rate is 5.6 percent of earnings (and is expected to increase to almost 14 percent by 2030), no one actually pays (or would pay) this rate. The first 10 percent of earnings is exempted, so at most people pay 90 percent of 5.6 (or 14) percent. Moreover, both Ottawa and the provinces provide a tax credit for CPP contributions, thus giving a partial rebate of income taxes. Finally, contributions are not levied on all earnings, but rather on earnings up to a maximum. Anyone who earns precisely the maximum will pay taxes equal to the statutory values (subject to the preceding qualifications), but people who earn more than that pay no tax on their extra earnings, which has the effect of reducing their overall liability. Dickinson notes that, at 180 percent of the Year's Maximum Pensionable Earnings ($61,920 in 1994), employee contributions paid at the 13.04 percent rate projected for 2030 would in fact equal only 2.39 percent of earnings after income taxes. This rate could be even lower if it went to finance only the retirement income proportion of CPP payouts, but in fact something less than two-thirds of CPP payouts is for traditional retirement benefits, while the other one-third goes to disability, survivor, death, and orphan benefits, as well as administrative costs. At bottom, however, Dickinson rejects the progressivity/regressivity argument, since it applies to taxes, while contributions that give rise to tied benefits are not taxes.

A third perceived fault of the CPP is that low-income seniors do not receive benefits, no matter how much they have contributed. The reason is that other parts of the retirement income system, most notably the GIS and, in Ontario, GAINS-A, are reduced by whatever other income seniors may receive, including CPP benefits. Here, Dickinson argues that the system must be seen in its entirety. As a whole, it certainly does get money to low-income seniors; in fact, it is the main reason most seniors are above the poverty line. It is also true that, if the GIS and GAINS-A are regarded as the frontline of the system, then their effective taxation of other income does mean that no such income, including CPP payments, gets to low-income seniors. But Dickinson argues that this is an “upside-down” view of the system. If the CPP is regarded as the system’s frontline — which, as a contributory pension scheme designed to replace earnings, it should be — then, in effect, low-income Canadians’ prior receipt of CPP payments causes their incomes to rise to the point where they are prevented from getting these other forms of support, rather than these other forms of support preventing them from getting CPP payments.

A fourth misperception about the CPP is that future generations of contributors will be either unwilling or unable to finance future payouts. Where today there are five people of working age for every senior, in 2030 there are expected to be only three. On the other hand, if productivity grows at the 1 percent annual rate that the official projections forecast, future workers will be richer than today's workers and therefore better able to support a larger retired population at a given absolute standard of living. Moreover, Dickinson argues, while Canada's *retired* population will be larger than it is today, its *dependent* population may not be. In effect, financially dependent children and teenagers will be replaced by financially dependent seniors. It is true that more of the burden of financing young people has been borne privately, rather than publicly, but if private burdens fall, there may be more room for the assumption of public ones. It is also possible that the work force will continue to grow in relation to the overall population. In fact, if the labor force participation rate of Canadian women were to reach the current male rate, in 2021 the overall dependency ratio would be the same as it is now. Dickinson concludes this section of the argument by looking at what happens to the real disposable incomes of future taxpayers under certain assumptions about future taxes and economic growth. If real economic growth proceeds at 1 percent a year and if tax brackets are adjusted to keep overall revenues constant at 22 percent of earnings at the maximum CPP earnings level, then the real disposable earnings of such workers increase by more than a third between 1992 and 2030, while tax revenues rise by 40 percent. It appears there is ample room to finance both a reasonable return on the CPP and at least respectable growth in real, after-tax incomes.

The fifth and perhaps most widely held misperception about the CPP is that it offers current contributors a very low, perhaps even negative, real rate of return on their savings. As Dickinson notes, it has been widely reported that people born in 1980 will receive one dollar of CPP benefits for each dollar they contribute and that people born in 2000 will receive only 80 cents (p. 204), a raw deal by almost anyone's standards, especially when the CPP's original recipients have done very well out of the program. In Dickinson's view, there are several dimensions to this misperception. First, the fact that, beginning in 1976, Canadians who had contributed to CPP for only ten years were able to retire with full benefits meant that these original contributors did very well, earning real returns on their savings of almost 20 percent. But they are not a continuing burden on the plan: by 2005 they will be roughly 95 years old, and the pensions of 95-year-olds account for less than one-twentieth of a percentage point of future contribution rates. By contrast, people who retire at age 65 in 2005 will have been paying in for almost 40 years and will receive a much lower real rate of return. Young workers of that day will not be financing "gold-plated" pensions for their elders. So what kind of plating *will* future pensions have? Many Canadians apparently anticipate lead-plating, but Dickinson argues that this is partly because they confuse the insurance and pension features of the CPP. When the disability insurance component of contributions is excluded, the retirement return on the employee's share of contributions for members of the cohort born in 1974 (today's 22-year-olds) exceeds 7 percent (7.68 percent) if they live to age 80, and is almost 8 percent (7.92 percent) if they live to age 85. Since these calculations assume an average future inflation rate of 3.5 percent, the corresponding real rates of return are 3.73 percent and 4.42 percent, respectively. These rates, however, are for people who earn the CPP maximum earnings. People who earn only half of maximum earnings would experience real rates of return that are higher still (4.18 percent at age 80, 4.83 percent at age 85). Of course, the real returns are lower for self-employed workers, who pay both the employer's and employee's shares of contributions — approximately 1 percent (0.97 percent) at age 80, and 2 percent (1.9 percent) at age 85. These may or may not be competitive with what could be earned by private pension plans, but the nominal returns are certainly not zero or less.

The last misperception Dickinson addresses is the doomsday question: Is the CPP fiscally viable? In other words, will the plan go broke? Dickinson answers that it is very misleading to use "bankruptcy" in the context of the CPP, since it is basically a pay-as-you-go plan. CPP benefits are paid mainly out of current contributions, so if contributors decide they no longer wish to contribute, or wish to contribute less, then beneficiaries will have to make do with less than they had expected to receive. But precisely because the CPP is not fully funded, it cannot "go broke." True, at the end of 1992 assets in the CPP Account covered only about 8.5 percent of total future obligations, but "[t]he account is a small proportion of the total liability because the plan was designed that way, not because it is going broke" (p. 214). Dickinson argues that the CPP's "unfundedness" should be seen in perspective. OAS payments (since folded into the Seniors Benefit) are widely expected to be there when future seniors become eligible for them and they therefore constitute an informal unfunded liability of the federal government, but "government accounting methods do not ask how much money is needed now to finance such programs for the next 50 years" (p. 215). Contrasting the CPP with the national debt, which clearly is a legal obligation to pay, Dickinson notes that, while the debt has already been spent, the CPP's unfunded liability has yet to be spent. In Dickinson's view, changes to the CPP formula that would cause less money to be spent would not necessarily violate the spirit of public pension programs. In a comment very much in accord with Burbidge's message, Dickinson closes by noting that public pensions are contingent promises linking the standard of living of pensioners to the general standard of living, and their contingent formulas may have to change in response to other economic and fiscal pressures.

In sum, while Dickinson is not opposed to changes in the current retirement income system — and in fact suggests change will be a normal state of affairs for any such system — he believes changes should be founded in a sound perception of reality, not in misperception. That is an instructive coda both for his paper and for this book.

William Watson

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The Contributors

John B. Burbidge obtained his PhD from McGill University in 1974 and has taught Economics at McMaster University since then. He held the Faculty of Social Science Chair at the University of Western Ontario in 1993–94. In the late 1970s, he co-authored a paper for the Economic Council of Canada on how public and private pension plans affect the incentive to work. This paper led to a series of publications on social security and the behavior of wealth-holding and consumption over the life cycle, including recent articles in the *Journal of Labor Economics* and *Empirical Economics* (forthcoming).

James Cutt has been a faculty member in the School of Public Administration at the University of Victoria since 1977. Before that, he was a faculty member in the Department of Economics at York University and Foundation Professor of Administrative Studies at the Australian National University.

Paul Dickinson has worked in the area of social policy for two national governments and a provincial government. For the past ten years, he has been a consultant while teaching part time in the Department of Economics at McGill University.

Newman Lam is a Visiting Professor in the School of Public Administration at the University of Victoria. He specializes in the financial analysis of public policies and management information systems.

Michael J. Prince is the Lansdowne Professor of Social Policy in the Faculty of Human and Social Development at the University of Victoria. From 1978 to 1987, he was a member of the School of Public Administration at Carleton University.

Christopher Ragan is Assistant Professor of Economics at McGill University. He received his Master's degree from Queen's University and then completed his Doctoral studies at the Massachusetts Institute of Technology. His general area of research is in macroeconomic theory and policy; his current areas of interest include unemployment theory and monetary policy. He is the co-author (with Richard Lipsey and Paul Courant) of *Economics* (9th Canadian ed.), to be published by Addison-Wesley in 1997. He is also editor of *World Economic Affairs*.

William B.P. Robson is a Senior Policy Analyst at the C.D. Howe Institute and Canadian Liaison Officer for the British-North American Committee. He specializes in Canadian monetary and fiscal policy and has written and edited numerous Institute publications on government budgets and their economic effects and on the Bank of Canada and inflation. He is a familiar commentator on economic issues in the media.