No. 146, January 2012

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Pension Papers

Fixing MP Pensions:
Parliamentarians Must Lead Canada's Move to Fairer, and Better-Funded Retirements

William B.P. Robson

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In this issue...
The pension plan for federal Members of Parliament offers benefits vastly greater than other Canadians can achieve, and holds no assets to back its promises. Pension reform in Canada must start at the top.

The Study in Brief

The Author of This Issue

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The pension plans of federal government employees are relatively generous and badly underfunded, with the Pension Plan for Members of Parliament (MPs), which covers members of the House of Commons and the Senate, standing out on both counts.

The MP plan promises much higher retirement incomes than most Canadians can dream of: the implied accumulation of wealth in these plans amounts to more than 50 percent of pay – with today's very low yields on sovereign-grade securities, arguably closer to 70 percent. In addition, the plan has set aside essentially no assets to pay future benefits: a realistic appraisal of its financial condition would show, not the 'actuarial excess' of $176 million that appears in the latest actuarial report on the plans, but a deficit as large as $1 billion.

This plan subjects taxpayers to financial risks few appreciate, and undermines the federal government's authority to lead Canada's search for a better retirement income system.

MPs should save real money for their retirements and do it in a properly funded pooled registered or target-benefit plan. Increases in MPs' current compensation could compensate for their more modest retirement benefits. The federal government should also legislate more generous limits on tax-deferred saving, giving everyone a chance to achieve retirement incomes closer to what MPs promise themselves. Canadians need better, and properly funded, pensions. Federal MPs should lead by example.

$12.00
ISBN 978-0-88806-857-6
ISSN 0824-8001 (print);
ISSN 1703-0765 (online)

Canada, like most other countries, is searching for new, better ways to deliver retirement incomes. A key force behind this search is the realization single-employer, defined-benefit (DB) plans as traditionally run are fraught with danger.

Those plans appear to turn modest contributions into relatively rich, and secure, benefits. The temptations they create for sponsors and participants to substitute optimistic assumptions about future investment returns for adequate levels of saving, however, have proven hard to resist. Recent years have seen some high-profile failures of DB plans, and with lower returns available on many financial assets, fair-value accounting typically shows that DB plans now operating would not be able to cover their obligations with assets on hand.

Fair-value accounting is a useful antidote to over-optimism. It requires pension plans to report assets at what they would sell for and, more importantly, to measure liabilities at the market cost of buying out participants or offloading those liabilities to a third party. This approach is controversial, especially now, when it shows the financial positions of most plans as much worse than assessments using more optimistic assumptions about rates of return. Yet the current reality is incontrovertible: as savers in money-purchase arrangements such as RRSPs and defined-contribution plans know all too well – and as DB plans that invest in assets that match their liabilities can attest – with low investment returns, achieving a given stream of retirement income requires more saving. These higher costs, and deeper appreciation of the risks sponsors take on in guaranteeing benefits, are eroding DB plan coverage in the private sector.

In the public sector, by contrast, participation in DB plans is still rising. Not because they work better there – indeed, the ability to take tax revenue to cover shortfalls worsens the temptation to underfund. The federal government's Public Accounts, which use assumed rather than market yields to value liabilities, show the liabilities of all Ottawa's employee plans exceeding their assets by $146 billion. A fair-value calculation puts the unfunded liability at an astonishing $227 billion (Laurin and Robson 2011).[1] This situation subjects taxpayers to a risk few appreciate – and, moreover, undermines the federal government's authority, and arguably its capacity, to lead Canada's search for a better retirement income system.

Further hurting the federal government's moral authority, and arguably policymakers' capacity to understand the urgency and nature of the problem, is the fact that one of the most problematic federal plans is the Pension Plan for Members of Parliament (MPs), which covers members of the House of Commons and the Senate. That plan has set aside essentially no assets to pay future benefits, and the gap between its reported financial condition and a fair-value assessment is proportionally far worse than that of Ottawa's larger public-service plans.

A solution is to reform MPs' compensation to provide richer current pay in exchange for more modest retirement benefits in a properly funded pooled registered or target-benefit plan. This, ideally combined with measures to give all Canadians more opportunities to achieve retirement incomes closer to what MPs promise themselves, would move Canadians a key step toward sounder and fairer retirement incomes.

I thank Alex Laurin, Colin Busby, an anonymous official, and several members of the C.D. Howe Institute's Pension Policy Council for comments on an earlier draft; I alone am responsible for any errors and the opinions offered.

1 Private-sector pension plans must nowadays use fair-value principles in calculating their solvency, but public-sector plans generally do not have to follow such rules – the rationale being the convenient but historically unfounded assumption that public-sector organizations will always honour their obligations.

Table 1: Current Service Cost for MP Pensions, 2011

(as percent of pensionable pay)			
	MPRA	MPRCA	**Total**
MPs' Required Contributions	2.85	4.22	**7.07**
Government Currrent Service Cost	13.20	30.95	**44.15**
Total Current Service Cost	***16.05***	***35.17***	***51.22***

Source: OCA 2011, Table 8.

MP Pensions: A Primer

DB plans can be opaque, with terminology that confounds non-experts. So it is helpful that the report on MP pensions produced by Canada's Chief Actuary in March of 2011 (OCA 2011) was tabled in the House of Commons later that year. The Actuarial Report's summary of the plan makes a few facts clear. MPs who have contributed for six years can receive a retirement allowance at age 55. For service after the beginning of 2001, the allowance accrues at 3 percent annually up to a maximum of 75 percent of the best five years' average pay, that pay being the annual "sessional indemnity" – $157,731 for Members of the House of Commons and $132,731 for Senators (as of 1 April 2010) – plus additional salaries and allowances.[2] The plan provides benefits to spouses and surviving children under age 25. The benefits are indexed to inflation.

Anyone familiar with pensions will see immediately that these benefits are extraordinarily rich. The annual increase in retirement wealth MPs enjoy under these plans far exceeds what most Canadians can set aside. The report calculates the "current service cost" – the rate at which benefits are accruing for plan contributors – at about 55 percent of pensionable payroll for Members of the House of Commons and 37 percent for Senators, or more than 51 percent for MPs as a whole (OCA 2011). In contrast, the *Income Tax Act* (ITA) lets the average Canadian set aside only 18 percent of pay, up to a maximum of about $23,000 annually.[3]

Because the MP plan's benefits exceed what the ITA allows, they are paid from two accounts: the MP Retiring Allowances (MPRA) Account for pensions up to the ITA limits, and the MP Retirement Compensation Arrangements (MPRCA) Account for pensions beyond them. The allocation of the 51 percent current service cost between the two accounts (Table 1) shows 16 percentage points, less than one-third of the total, in the MPRA and 35 percentage points, more than two-thirds of the total, in the MPRCA.

Employers who set up Retirement Compensation Accounts (RCAs) for retirement benefits that exceed the ITA limits must pay a refundable tax equal to half the accumulating credits in the account, with the refund coming when the benefits are paid. The federal government does this for its own employee RCAs, including those of MPs. To anticipate the discussion in the next section, however, Ottawa as an employer is in a

2 The accrual rate before July 1995 was 5 percent annually; between then and the end of 2000 it was 4 percent annually.

3 The limit on tax-deferred saving in 2012 is $23,820 for members of DC pension plans and $22,970 for RRSP savers.

Table 2: Financial Position of MP Pension Plans as Reported by the Chief Actuary

	31 March 2007	31 March 2010
Credits	*($ millions)*	
MPRA Assets and Accounts Available for Benefits	486.7	606.7
MPRA Present Value of Past Service Contributions	0.5	0.4
MPRA Subtotal	*487.2*	*607.1*
MPRCA Assets and Accounts Available for Benefits	155.1	197.5
MPRCA Present Value of Past Service Contributions	1.6	1.1
MPRCA Refundable Tax for Past Contributions	137.7	187.1
MPRCA Subtotal	*294.4*	*385.7*
Total Credits MPRA and MPRCA	***781.6***	***992.8***
Debits		
Actuarial Liability: MPRA	354.9	433.3
Actuarial Liability: MPRCA	297.6	383.7
Total Debits MPRA and MPRCA	***652.5***	***817.0***
Actuarial Excess (Deficiency)	***129.1***	***175.8***

Source: OCA 2011, Table 1.

unique position: the transaction is not the actual transfer of cash required of other employers, but an internal book-keeping entry: a transfer from one federal-government ledger to another.[4]

Funding of MP Pensions: The Appearance versus the Reality

The non-cash nature of these refundable taxes is only a small example of appearance vastly diverging from reality when it comes to the funding of this plan. On this vital question, the Actuarial Report is unhelpful to the casual reader.

On the surface, the plan looks well funded – with assets that would at least cover its obligations. The report shows contributions to it (also summarized in Table 1): 7 percent of pensionable pay by MPs themselves, and 44 percent by the government as the employer. The attention-grabber in those figures is the huge share of the total contribution – more than six times the employee share – from the employer. That aside, it reassuringly suggests money is going into the plan. Notable in this regard is the very first exhibit in the report (much of which is reproduced here as Table 2). It shows "Assets and Amounts Available for Benefits" of $993 million as at 31 March 2010, compared to "Actuarial Liabilities" of $817 million, producing an "Actuarial Excess" of $176 million in the plan.

4 Worse, the government's book-keeping is incomplete, since the taxes the CRA must repay do not appear in any of the federal government's financial statements.

A careful reader of the report might pause here. How, when virtually every DB plan in the country has liabilities greater than its assets, has the MPs' plan managed what looks like a surplus? The figures in Table 2 showing changes since the previous actuarial report, as at 31 March 2007, suggest an answer. "Assets and Accounts Available for Benefits" grew 27 percent over the three years – compound annual growth exceeding 8 percent – outpacing growth in recorded liabilities, leaving the "actuarial excess" up $47 million over the period. Yet that too, seems odd, with the intervening collapse of many financial asset prices, and rock-bottom interest rates making DB plan liabilities vastly more expensive.

A weird and unpleasant truth behind the numbers in the Actuarial Report's first exhibit is, in fact, only discoverable by searching the MPs' plan out in the federal government's Public Accounts. There, a diligent reader will discover the accounts the report shows as available to pay benefits – but as part of the federal government's interest-bearing debt![5] These accounts are book-keeping entries, in which notional contributions earn notional interest. MPs' contributions vanish into the federal government's consolidated revenue fund. The government's contributions are a fiction. No actual saving happens in this plan.

A generous interpretation might say the (very small) present values of prior service contributions are assets for this plan – though they, like all contributions, will flow into the consolidated revenue fund. An even more generous interpretation might also say the refundable taxes held by the CRA in respect of the MPRCA are assets – though these taxes are also a book-keeping entry, not claims on any entity other than the government. Even being so generous as to set both these amounts against the liabilities of the two accounts, the "actuarial excess" disappears. Instead, the plan has a deficit of $628 million at 31 March 2010, $116 million worse than the figure three years earlier. Leave them out, and the deficit is $817 million, $165 million worse than three years earlier.

Since the prior service contributions have yet to be received, and the refundable taxes held by the CRA are book-keeping entries, it is reasonable to say that not one dollar of real saving backs MPs' pension promises. When the time comes to pay cash to retiring MPs, Ottawa has to raise it at that time – by taxing more, spending less elsewhere, or borrowing. The MP pensions that are yet to be paid have yet to be paid for.

The Cost of MP Pensions: A Fair-Value Approach

Unfortunately, the appearance of non-existent assets is not the only misleading element in this plan's reported position. To repeat, a key flaw in classic DB pension plans is the historical practice of calculating liabilities by discounting the plan's future payouts using a discount rate based on assumed returns on its assets rather than yields actually available in the market. This practice arose because of a belief that investors with long time horizons could reap "equity premiums" and other margins by investing in assets, such as common shares, that did not closely match their liabilities.

Whatever the wisdom of that approach – and the new thinking and plan failures mentioned at the outset make it look less wise – it is clearly nonsensical when the assets that would earn the turbo-charged returns to justify the high discount rate do not exist! What would be a sensible discount rate? Any non-federal employee who wished to save with assets, and retire on an annuity, backed by taxpayers and indexed to inflation would need to buy an asset that is backed by taxpayers and indexed to inflation – namely, the federal government's real-return bonds (RRBs). Since the value of a promise to a pension-plan participant is an obligation to the pension-plan sponsor, the best benchmark for

5 Receiver General for Canada (2011), Tables 6.25 and 6.26 on pp. 6.25-6.26.

discounting Ottawa's pension promises to its employees is the yield on the RRB.[6]

The Actuarial Report uses a real discount rate – that is, the interest rate adjusted to remove the effects of inflation – of 2.71 percent to calculate the MP plan's actuarial liabilities.[7] This assumption is not as aggressive as in some DB plans: it is based on a view, informed by history, about what real interest rates on sovereign-grade securities will be over time. Critically, however, it is considerably above the market yield available at the time of the report. On 31 March 2010, the real-return bond was yielding 1.56 percent.

As Canadians struggling to provide for retirement in DC pension plans and RRSPs know well, lower yields make a given income in retirement harder to fund. The report shows how different assumptions would affect its results by providing estimates of the additional value of plan promises when yields are lower, and the additional liability they create for the federal government and Canadian taxpayers.[8]

To start from the perspective of MPs themselves, with interest rates 1 percent lower, the current service cost of the plan – the annual saving rate required – would have been 8.5 percentage points higher. Increasing this adjustment to match the actual gap of 1.15 between the assumed yield currently used and observed yields on RRBs puts the value of their pension promises at 61 percent of pensionable pay.

Turning to the value of the plan liabilities, the Actuarial Report's estimates show it as $97 million higher with yields 1 percent lower. Increasing this amount to match the actual gap of 1.15, a fair value calculation would put it $111 million higher. Generously treat the prior service contributions and the refundable taxes as assets, and the deficit in the plan using fair value for the liabilities would have been $740 million. More realistically leave them out, and it would have been $928 million.

As noted at the outset, fair-value assessments of DB plans that do not match their assets to their liabilities not only typically reveal deficits nowadays, but also reveal considerable volatility – and hence risk to both the sponsor and the participants – in the bottom line over time. The MPs' plan is no exception. Since the end of March 2010, aggressive monetary easing by central banks and a flight of funds from sovereign risks in Europe has driven interest rates on Canadian federal government debt even lower – the RRB yield was about 0.50 percent at the time of writing.

Using the Actuarial Report's sensitivities to value the MP plan's promises using this real-return bond yield produces even more startling numbers. The current service cost of the plan – the annual contribution rate – rises to 70 percent of pay. And the liabilities to the plan sponsor rise by $214 million.[9] Treat both the prior service contributions and the refundable taxes as assets, and the deficit in the plan using the current real-return bond yield would be $842 million; leave them out, and it would be more than $1 billion (Table 3 summarizes these different calculations of the plan's financial position).

6 See Laurin and Robson (2011) for a similar discussion of the liabilities of all federal pension plans, including the plans for the public service, the Canadian Forces, and the RCMP. The suitability of yields on RRBs as a discount rate for government pensions is not universally accepted, but they are better than any alternative (Laurin and Robson 2009): as noted in the text, any non-federal employee wanting a retirement income like that of an MP would need – leaving ITA restrictions aside – to save by buying RRBs at the accrual rates described in this section.

7 OCA 2011, Table 17, p. 36. The nominal interest rate starts at 4.4 percent in 2011, then rises to its ultimate level of 5.2 percent by 2016. The assumed inflation rate starts at 2.0 percent in 2011, and rises to 2.4 percent over time. Over a 40-year horizon, the compound annual real interest rate, calculated geometrically, is 2.71 percent.

8 The sensitivities are in OCA (2011), Table 10, p. 17. The calculations in the following paragraphs use the information in this table and real return bond yields from the Bank of Canada.

9 Two caveats attach to these calculations. First, the sensitivity of the current service cost and the liabilities to changes in the discount rate is not linear: both increase more the lower the interest rate used in the valuation is relative to the starting assumption. So this estimate understates the fair value of the liabilities: the actual fair-value liability calculated from the plan's cash flows would be larger. Second, the promises to be discounted have themselves increased since 31 March 2010, another factor that makes these numbers too low.

Table 3. Financial Position of MP Pension Plans under Varying Treatments of Assets and Liabilities

($ millions)

		Assets			
		As per Actuarial Report	Past Service Contributions and Refundable Taxes Only	Past Service Contributions Only	No Real Assets
Liabilities	As per Actuarial Report	176	-628	-816	-817
	Valued at RRB rate as of 31 March 2010	65	-740	-927	-928
	Valued at RRB rate as of Time of Writing	-38	-842	-1,029	-1,031

Source: Author's calculations based on data in OCA 2011, Tables 1, 10 and 17 and Bank of Canada (for real-return bond yields).

Reforming MPs' Compensation: Why and How

Rule-makers exempting themselves from the rules is always troubling. The ITA has long given members of DB pension plans greater opportunities to accumulate and maintain tax-deferred retirement wealth than it gives savers in DC plans and RRSPs.[10] The importance of that gap has grown as financial-asset returns have fallen. While the value of promises to DB plan members – especially those that, like those of Ottawa's employees, are indexed to inflation – has ballooned, the prospects of comfortable retirement for savers in DC plans and RRSPs have dwindled. It is at least plausible that simple measures to help DC plan participants and RRSP savers, such as higher contribution limits, later ages when contributions must stop, and lower mandatory withdrawals after that age, would have already occurred if the rule-makers had shared the pain now being felt by most of their compatriots.

However that may be, the fact that Ottawa's employees have badly underfunded pensions, and future taxpayers with far smaller pensions will have to fill that gap, is unacceptable. Funding pensions is a fiduciary duty and a key discipline. Even if a funded MPs' plan ends up holding mostly federal government market debt in its portfolio, the need to pay the full cost of MPs' compensation in cash, and to actually achieve, rather than simply assume, higher investment returns will curb tendencies to promise overly rich benefits. MPs will also find putting other federal employee pensions on a sounder footing easier if those employees cannot retort that MPs have even richer and worse-funded pensions than they do.

Either way, most Canadians would benefit if the retirement saving schemes of federal MPs were more in line with their own. At a minimum, the employer and employee contributions to the MPs' plan should from now on be actual cash that flows into an arm's-length fund, as occurred with Ottawa's Public Service, Canadian Forces, and

10 Pierlot (2011) benchmarks money-purchase saving options against various DB plans; Robson (2008) shows how the ITA forces unsustainable decumulations of tax-deferred saving on people without DB annuities.

RCMP plans in 2000.[11] Moving from the minimum, the actual cash contributions should be higher than the current notional ones. Using fair-value principles to calculate the financial condition of the plan and calibrate its contributions would keep MPs and other Canadians conscious of its richness, the exposure it creates for taxpayers, and the huge amounts of saving that current low yields require to cover these benefits.

These higher contributions would reduce MPs' current salaries and allowances, which would be a concern for MPs themselves and potentially also for Canadians worried that lower pay might reduce the quality of elected representatives. A hike in current pay can and should make up the difference.

A more thorough reform would wind up the current MPs' plan completely. One option would be a target-benefit plan of the kind that is now common in much of the broader provincial public sector.[12] While this option would be better than the current situation, most Canadians do not participate in such plans, and the alignment of interest between MPs and most of their constituents would be better if MPs were in a money-purchase arrangement, in which retirement income is a straightforward function of the amount accumulated. At present, such an arrangement would be a DC plan or a group RRSP. If and when the Pooled Registered Pension Plans outlined in Bill C-25[13] come into existence, federal MPs could participate in one of them – which might bring the more generous saving limits and other regulatory steps that would make these more beneficial for the rest of the population about more quickly.

Higher current salaries and allowances to compensate for the change should accompany any of these reforms, to alleviate concerns about overall cuts in MPs' compensation. In the case of a plan wind-up, salaries and allowances that previously earned pension credits would logically increase by the sizeable difference between the current service cost of the plan and the contributions MPs are (notionally) making to it. Even leaving aside the loss of tax deferral – which MPs would only recoup if they lifted the contribution limits for Canadians generally – the salary increase would amount to about 44 percent of pensionable pay using the assumptions in the Actuarial Report; and more than 61 percent of pensionable pay using the current yield on the real-return bond. Compensating MPs for the loss of the tax deferral would not make sense. Canadians need more generous limits on tax-deferred saving in a low-return environment. So it would be better to raise the limits for everyone – perhaps using a lifetime limit as proposed by Pierlot and Siddiqi (2011) – than to further boost MPs' compensation to offset the tax penalty.

Hiking MPs' current pay might be a hard political sell. A careful reading of the Actuarial Report, however, shows that MPs are actually already getting far more than most people know. Paying them more transparently would be a virtue in its own right. As things stand, MPs' pay is so non-transparent that most Canadians – indeed, possibly most MPs – do not understand it. Its pension component is far richer than other Canadians enjoy, exposes taxpayers to underappreciated risk, and undermines Ottawa's authority and capacity to lead reforms that would improve most Canadians' prospects for a comfortable retirement.

11 Filling the entire existing gap with a transfer from the federal government funded by issuing new market debt is unattractive: higher contributions should fill some of the gap, and borrowing on that scale all at once would be problematic. Filling part of the gap that way, however, is attractive because it hedges the plan: the same low interest rates that make the liabilities so expensive also mean that the cost of borrowing to make the transfer is low.

12 The Ontario Teachers Pension Plan is a prominent example of a jointly governed pension plan with provisions allowing adjustments to benefits as well as contributions in the event of inadequate funding.

13 The *Pooled Registered Pension Plans Act*, which was given first reading on 17 November 2011.

Conclusion

A careful reading of the 2011 Actuarial Report on the pension plan for Canadian MPs reveals two key facts. One is that the plan promises much higher retirement incomes than most Canadians can dream of – an accrual rate of more than 50 percent of pay, and arguably closer to 70 percent, with today's very low yields on sovereign-grade securities. The other is that the plan is effectively unfunded: no actual saving has occurred in it, and a realistic appraisal of its financial condition would show, not the "actuarial excess" of $176 million shown in the report, but a deficit as large as $1 billion.

Fixing this situation would be a vital step toward reforming federal employee pensions and implementing measures to improve Canadian retirement incomes generally. MPs should save real money for their retirements and do it in a target-benefit plan or money-purchase arrangement such as a PRPP, and should legislate more generous limits on tax-deferred saving for everyone. Canadians need better, and properly funded, pensions. Federal MPs should lead by example.

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