Changing Signals in Social Insurance and Beyond?
Introductory Comments – Jean-Claude Ménard
Washington, DC, November 17-18, 2008

Good morning and welcome to the session Changing Signals in Social Insurance and Beyond. My name is Jean-Claude Ménard and as the Chief Actuary of the Canada Pension Plan I am very interested in today's topic. I am pleased to be the moderator of this session and will begin with some opening comments.

Today's presentations by John Turner will focus on two countries: the United States and Sweden. The first presentation on retirement age signalling will discuss the concept of signalling and how it may affect retirement age. The second presentation will focus on the Swedish pension reform and the lessons that can be learned from it.

(Slide 2) To this conversation, I would like to add how the Canadian social security system uses signalling. Age 65 is considered the normal retirement age in Canada; however, the Canada Pension Plan has an early retirement age provision such that contributors can retire as early as age 60, but with a reduced pension. Conversely, contributors can delay receipt of their pension beyond age 65 (to a maximum of age 70) and increase their pension. Retirement pensions are permanently adjusted downwards or upwards by 0.5% for each month between age 65 and the age when the pension commences.

In March 2003, the Office of the Chief Actuary conducted an actuarial study that reviewed the appropriateness of the actuarial adjustment factor of 0.5% per month. The study found that the actuarial adjustments are too generous for contributors who elect to take their retirement benefit before age 65. Conversely, benefit uptake after age 65 is penalized. Currently, early benefit uptake is far more prevalent than late benefit uptake: in 2006, the retirement rate at age 60 was 37% for males and 44% for females whereas the retirement rate at age 70 was less than 1% for both males and females. Thus, the net result of the current actuarial adjustment factors is a financial disadvantage to the Plan.

(Slide 3) However, it is worth noting that the Plan is financially sustainable even though the legislated actuarial adjustments are not cost neutral. This is because the legislated contribution rate of 9.9% exceeds the minimum contribution rate of 9.82% determined in the 23^{rd} Actuarial Report on the Canada Pension Plan. The early retirement incentive in the CPP has signalled to contributors that age 60 or shortly thereafter is an acceptable retirement age. In the context of an aging population and economic uncertainty, is this a signal that should be changed so as to encourage individuals to remain in the labour force longer? If increasing life expectancies and financial turmoil increase the minimum contribution rate, restoring cost neutrality to the actuarial adjustment factors could create manoeuvring room that would absorb some of the possible unforeseen fluctuations without causing a contribution rate increase. In addition, incentives for early retirement would decrease, thus encouraging individuals to remain in the labour force longer and possibly reduce the impact of a future labour shortage.

(Slide 4) The second aspect of the Canada Pension Plan that I would like to discuss is the CPP Default Provisions, which is a balancing mechanism. According to the Canada Pension Plan Act, Finance ministers must review the plan every three years. In making recommendations, the ministers shall consider the most recent CPP Actuarial Report prepared by the Chief Actuary and must set the contribution rate at a level that is no lower than the minimum rate calculated by the Chief Actuary.

In the case where, for a review period, the Chief Actuary calculates a minimum contribution rate that is above the legislated contribution rate of 9.9%, Finance ministers could take any of three actions:

1. Reach an agreement that restores financial sustainability. This could be done by increasing the contribution rate, changing benefits or a combination of the two. If the ministers choose to only increase the contribution rate, it must to a level at least equal to the minimum contribution rate. Alternatively, if the ministers change benefits, with or without increasing the contribution rate, the new minimum contribution rate must be less than or equal to the legislated contribution rate.
2. Reach an agreement that fails to restore financial stability. In this situation, the ministers could reach an agreement, either by increasing the contribution rate, changing benefits or a combination of the two, without necessarily restoring the Plan's financial stability.
3. Finally, the finance ministers may not reach an agreement.

(Slide 5) In the case that the minimum contribution rate exceeds the legislated contribution rate of 9.9% and the ministers fail to reach an agreement to restore financial sustainability, the built-in hedge of steady-state funding is applied. The default provisions (or balancing mechanism) of the Canada Pension Plan Act may result in adjustments being made to the contribution rate and benefits in payment. The contribution rate will be increased over a period of up to three years by ½ of the excess of the steady-state rate over the legislated rate of 9.9%, subject to a maximum annual increase of 0.2%, plus the entire full-funding rate. In addition, benefits in pay will not be indexed to inflation for the upcoming three-year period. In other words, the contributors and the beneficiaries would share the additional cost shown in the actuarial report, though not necessarily in equal proportions. At the end of the three-year period, another review will be performed to determine the financial status of the Plan and whether it is necessary to further increase the contribution rate and freeze benefits for an additional three-year period.

(Slide 6) Balancing mechanisms are also used in Germany, Japan and Sweden. The main difference between the mechanisms used in Canada and Sweden is whether or not they are automatically applied. In Canada, the application is not automatic. It is only applied if the Ministers of Finance are unable to reach an agreement regarding a change to the contribution rate and/or benefit level. In Sweden, the mechanism automatically reduces the indexation of earned pension rights and outgoing pensions when the system faces a deficit.

By employing a balancing mechanism that is not automatic, the CPP is enabling its stakeholders to restore financial sustainability with a better solution. This signals to Plan members that the legislated balancing mechanism is not necessarily the optimal solution in all situations and stakeholders will strive to reach a solution that is fair and equitable before relying on the default provisions. If, for example, the minimum contribution rate increases above 9.9%, the stakeholders may decide to adjust the actuarial adjustment factors such that cost neutrality is restored. This would decrease the minimum contribution rate while removing incentives for early retirement. If the decrease is enough to bring the minimum contribution rate below 9.9%, then financial sustainability has been restored to the Plan with a fair and equitable solution that does not involve an increase to the contribution rate or a decrease in benefits.

This concludes my introductory remarks.

I would now like to call on John Turner for the first of his two presentations.