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The 20% Foreign Property Rule
Increasing Risk and Decreasing Returns
on RRSPs and RPPs

by Jason Clemens and Fazil Mihlar

with Johanna L. Francis



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Executive Summary

The 1999 budget provided an opportunity for the federal government to create the conditions under which Canadians could improve their investment returns and, at the same time, reduce portfolio risk through increased diversification. This they could have done by eliminating the Foreign Property Rule (FPR). Instead, bound to an antiquated and discredited industrial policy, the federal government chose to maintain the FPR.

Canada, like many industrialized nations, has an aging population. Seniors as a percentage of the working-age population will increase from 19.8 percent to 38.9 percent between 1995 and 2030, an increase of 96.5 percent.

The foundations of the public social-security system, one-half of the retirement income system is composed of Old Age Security (OAS) and the Canada / Quebec Pension Plans (C/QPP). The two programs combined, provide for up to 40 percent of the average industrial wage in Canada. The 40 percent income provision falls short of the generally accepted replacement ratio of 75 percent required to maintain the standard of living in retirement that one enjoyed during one's working life. It is clear, that the pension benefits provided by the public system must be augmented by additional income sources.

There are a host of constraints facing the public system which make the possibility of extended public benefits implausible. The two public plans, namely OAS and CPP, already have unfunded liabilities totalling \$1,094 billion. That is, the public system has promised to provide benefits in the amount of approximately \$1 trillion without any commensurate income or assets. The government will, therefore, have to either increase taxes and/or adjust benefits in order to provide for the level of benefits already promised. However, given Canada's relatively higher tax and debt burdens, it is highly improbable that taxes will be increased or additional deficits incurred to fund further public social security programs.

Clearly, the public social security system must be augmented by private savings in order to afford Canadians an

adequate level of retirement income. Indeed, approximately 8 million Canadians already use private tax-sheltered savings plans. Put another way, 77 percent of eligible Canadians use some type of private savings vehicle, whether it is Registered Retirement Savings Plans (RRSP) or a Registered Pension Plans (RPP).

The use and popularity of Registered Retirement Savings Plans has increased dramatically over the past two decades. The number of RRSP contributors has increased by over 253 percent between 1979 and 1996, representing an annual average increase of 7.7 percent. The increase in contributions is remarkable given that the number of tax filers has increased during the same period at an annual average rate of only 2.2 percent.

More important is the growth in the value of RRSP contributions. The value of RRSP contributions increased every year, on average, between 1979 and 1996, in real dollar terms by 8.6 percent. Again, the increase in the value of RRSP contributions significantly outpaced the growth in the value of total income assessed (1.9 percent per year).

In 1995, 82.1 percent of all RRSP contributors earned less than \$60,000 per year and represented 63.0 percent of the total value of all RRSP contributions. The largest increase in usage was in the younger age groups. The 20-29 age group increased their RRSP usage from 6.0 percent in 1982 to 21.8 percent in 1995, representing a total increase of 263.3 percent. Increases in usage by other age groups were also large but incrementally less as the age group increased: 30-39 (147.9 percent increase), 40-49 (91.4 percent increase), and 50-59 (52.2 percent increase).

The increasing importance and popularity of the Registered Retirement Savings Plans has not, however, convinced the federal government to loosen the onerous regulations placed upon private tax-sheltered savings. For instance, there remain relatively strict rules regarding the eligibility of certain investments that may be included in RRSP and RPP accounts. Further regulations exist regarding the age up to which contributions can be made and the

maximum amount of contributions, both as a percent of income and a total dollar value.

The most onerous of the restrictions, however, is the Foreign Property Rule (FPR) which limits the amount of foreign assets an investor can hold in their RRSP and RPP to 20 percent of the book value of the total portfolio. Any amount over this limit results in a 1 percent penalty tax.

The entrepreneurial nature of financial markets has resulted in the development of two methods for increasing foreign exposure without violating the FPR. The first entails the purchase of portfolios, commonly referred to as “double-dipping” wherein the investors maximizes their foreign content to 20 percent, but also purchase other funds (e.g. mutual funds) which invest 20 percent of their book value in foreign assets. Thus, the investor is able to achieve 36 percent foreign asset exposure.

The second method available is the purchase of derivative-based funds, primarily index mutual funds. The derivative funds mirror indices like the Standard & Poor 500 Index and the Morgan Stanley Capital Investment (MSCI) International Stock Index. The investor does not actually purchase the index but rather purchases a fund which derives its value from the index. This particular trend is becoming increasingly popular in Canada as individuals attempt to maximize the amount of foreign exposure present in their portfolios.

It is critical to note that these two methods do not represent an efficient alternative to the elimination of the FPR. Rather, they represent productive investment alternatives given the constraint of the FPR. It would be far more efficient if investors were able simply to purchase an index rather than be forced, due to tax laws, to purchase derivative-based funds which derive their value from the index.

The losses, or foregone capital accumulation of investors in Canada due to the FPR are real and material. Depending on the particular savings rate, risk tolerance, and wage growth assumptions, and whether Management Expense Ratios (MERs are the fees charged by mutual fund companies) are included, the loss of capital ranges from:

- Age 25: \$3,213 - \$510,306
- Age 35: \$2,031 - \$296,306
- Age 45: \$1,158 - \$155,132

The dollar values do not, however, indicate the severity or depth of the foregone capital accumulation. In order to gain a perspective on the extent of the losses, one must compare the foregone capital accumulation with the total amount of cumulative savings.

- Age 25: 18.8% - 118.5%
- Age 35: 16.0% - 93.9%
- Age 45: 13.6% - 75.2%

The relative losses are substantial, ranging from a low of 13.6 percent to 118.5 percent of total savings. The fact that in some cases the foregone earnings actually exceed the total amount of funds saved cumulatively over an investor's lifetime indicates the depth of losses associated with the FPR.

The foregone capital accumulation are similar regardless of the nature of the assumptions. For instance, lump-sum assumptions were used in addition to periodic savings and in both cases the losses were substantial and material.

The original intent of the FPR, namely to capitalize domestic firms has very little to do with domestic savings. The liberalization of capital markets can provide, and indeed has provided a wealth of capital for Canadian firms. In fact, foreign direct investment (FDI) between 1975 and 1996 totalled \$126.5 billion, in nominal dollars. Increasing both the amount of domestic as well as foreign capital is much more dependent on Canada's tax regime and the productivity of Canadian companies.

It is clear that the FPR imposes huge costs on individuals through both reduced diversification and a reduction in the rates of return garnered from savings. The magnitude of foregone capital accumulation of investors in Canada, coupled with the material need to augment public social security benefits in order to maintain a reasonable standard of living in retirement, combine to form a solid rationale for eliminating the FPR.



Introduction

The proportion of retired Canadians in Canada’s population has been increasing steadily. More critically, the proportion of retired Canadians has been increasing relative to the proportion of workers. This “greying” of the population has had, and will continue to have, a profound impact on the ability of the government to provide state-funded social security programs. The limitations placed on the public social security system will inevitably affect the ability of retirees to maintain a reasonable standard of living¹ over the long term.

Given Canada’s changing demographics and the limitations on the public pension system, it is incumbent upon the federal government to provide mechanisms by which Canadians can save. It is equally important for Canadians to earn a reasonable rate of return on their investments to augment their public social security benefits.

The importance of Registered Retirement Savings Plans (RRSP) and Registered Pension Plans (RPP) cannot be underestimated, as almost 8 million Canadians use one or both of these instruments to accumulate private savings for retirement. In addition, according to the Association of Canadian Pension Management, 77 percent of eligible Canadians use private pension savings to augment their public social-security benefits.

The Foreign Property Rule (FPR) limits the amount held as foreign assets in Registered Retirement Savings Plans (RRSP) and Registered Pension Plans (RPP). It has, therefore, significant ramifications for the ability of both future and current generations to save for their retirement. By its very nature, the FPR inhibits the ability of Canadians to diversify their portfolios and maximize the possible rates of return for a particular level of risk.

Grave questions have been raised by a number of authors and scholars regarding the effects of the FPR on investment returns and performance. A number of reports examining the impact of the FPR have concluded that Canadian tax-sheltered investments are under-performing and that risks for savers are higher than they would be in the absence of the FPR (Ambachtsheer 1995; Ernst & Young 1997; Conference Board of Canada 1997; Turner 1999). For in-

stance, Garth Turner estimates that Canadians investing in the Canadian market over the last ten years garnered a nominal cumulative return of 75 percent while investment in global markets achieved a nominal cumulative rate of 500 percent or more (Turner 1999). Similarly, in a recent *National Post* editorial, Terry Corcoran quoted a private study from the Bank of Nova Scotia that concluded that markets in the United States, Japan, France, Germany, and the United Kingdom out-performed the Canadian market, on average since 1970, by 248.7 percent (Corcoran 1999).

This study will assess, on the basis of the empirical evidence, the efficacy of maintaining the FPR given the limitations of the public social-security system and the importance of ensuring the ability of Canadians to maintain an adequate level of income in retirement.

Objectives of the study

Although the empirical focus and intent of this study is to examine the limitations and difficulties associated with the Foreign Property Rule, the study will also examine a number of other related areas.

The first section presents a summary of Canada’s public social-security system with a discussion of the inherent limitations and difficulties currently facing it. This section also provides a brief overview of Canada’s relative tax position in order to illustrate the tax constraints inhibiting reform in the public system. Appendix A presents supporting theoretical and empirical research relating to the effect of taxes on productivity and economic growth.

The second section explains Registered Retirement Savings Plans (RRSP) (and, summarily, Registered Pension Plans). Longitudinal data (i.e., data over time), as well as statistics taken from the 1995 tax year highlight the tremendous growth in RRSP-based savings.

The third section of the study provides a theoretical overview of investing and the importance of portfolio diversification. A summary of the relationship between risk and

return that underlies investment decisions is presented along with the general principles of portfolio management and diversification.

The fourth section summarizes the Foreign Property Rule, which limits the amount of foreign assets an individual can hold in an RRSP or RPP account. The section also discusses the definitional problems associated with the FPR, namely defining what is "foreign" and what is "Canadian." In addition, two provisions that allow investors to increase their foreign exposure are discussed, with particular emphasis on the effect of the provisions.

The fifth section of the study presents specific examples of how the FPR inhibits diversification. A series of data

are presented, including profiles of major exchanges, summary statistics on the Toronto Stock Exchange, and comparative Canadian and provincial data to illustrate the efficacy of diversification and the real limitations associated with the FPR.

The sixth section presents three case studies of the foregone capital accumulation of investors due to the FPR. Appendices D(1) through D(9) contain specific profiles that augment the data presented in this section.

The seventh section briefly presents the initial public policy rationale for the FPR and assesses its validity in the current environment. The final section presents a summary of the main findings of the study.



1 Canada's social security system: the public system

Canada's retirement-income system has two components: public and private. The public system is *not* a savings system but rather an income replacement system based on taxes. The public system is composed of Old Age Security (OAS), the Guaranteed Income Supplement (GIS), and the Canada and Quebec Pension Plans (CPP/QPP).

Old Age Security and the Guaranteed Income Supplement

Old Age Security (OAS) came into effect in 1952, and introduced universal pensions for qualified Canadian residents. OAS is a flat benefit paid to all retirees regardless of their level of income or previous earnings; that is, recipients are not subject to a means-test and their previous employment income is not taken into account. OAS benefits are calculated as 15 percent of the average industrial wage (AIW) in Canada, which in 1999 provided a maximum benefit of \$4,929 (Cooper 1999).

In 1967, Old Age Security was expanded to include a Guaranteed Income Supplement (GIS) for Canadians with low income.² GIS is a monthly benefit made available to OAS pensioners with limited income, separate and distinct from OAS benefits.

Changes to Old Age Security and the Guaranteed Income Supplement

Beginning in 1972, OAS and GIS were indexed to reflect increases in the cost of living (inflation) as measured by the Canadian Consumer Price Index (CPI). In 1989, the federal government introduced a special "clawback" tax on OAS pension benefits (Canadian Institute of Actuaries 1995; and Human Resources Development Canada 1994). So, while both OAS and GIS are protected against inflation, OAS is now considered a taxable benefit while GIS remains exempt from taxation.

Canada Pension Plan and Quebec Pension Plan

The second component of the public social security system comprises the Canada Pension Plan (CPP) and Quebec Pension Plan (QPP). The CPP and QPP were created in 1966 to provide a pension benefit based on past employment earnings. The CPP and QPP provide up to 25 percent of the average industrial wage (AIW) depending on past employment earnings. The maximum benefit per person provided by CPP in 1999 is \$9,020 (Cooper 1999).

The CPP and QPP, combined with the universal OAS, provide up to 40 percent of the average industrial wage in pension benefits. For the average industrial worker, public pension benefits represent just over half, 53.3 percent, of the 75 percent of pre-retirement income needed to provide a reasonable standard of living in retirement (Canadian Institute of Actuaries 1993).

Contribution rates

Contributions to CPP and QPP are calculated based on the Year's Maximum Pensionable Earnings (YMPE). There is also an exemption for Canadians with low incomes. Thus, contributions are made on earnings above the Year's Basic Exemption (YBE) and below the Years' Maximum Pensionable Earnings (YMPE).

Prior to 1997, both the YMPE and YBE were indexed to wage growth, that is, they were adjusted each year to reflect increases in the average wage. The Year's Basic Exemption, which shields Canadians with low incomes from CPP and QPP contributions, was frozen as part of a larger reform package passed in 1997.

Between 1966 and 1986, the contribution rate for CPP and QPP was 3.6 percent of pensionable earnings, divided equally between employers and employees. The rate was increased by 0.2 percent each year until it reached 4.6 percent in 1991.

In the 1988 Statutory Actuarial Report on the CPP, it was revealed that this series of increases would not be sufficient to meet the long-term costs of the plan. Therefore, an adjusted schedule of future CPP contributions was proposed and adopted. This new schedule required that total contribution rates rise in annual increments of 0.2 percent (1992 to 1996), 0.25 percent (1997 to 2006) and 0.20 percent (2007 to 2016). Thus, by the year 2016, the combined employer and employee contribution rate was scheduled to be 10.1 percent of pensionable earnings (Office of the Superintendent of Financial Institutions, 1998).

Under federal-provincial reforms passed in 1997, the contribution rate is now set to rise from 5.6 percent to 9.9 percent in 2003 and then remain stable. (McCarthy 1998). In addition to the accelerated increase in contribution rates, several other changes were made to the CPP in 1997, including expanding the eligible investments to include stocks and bonds and a host of changes to marginal benefits and eligibility requirements. (For further information on the changes enacted to the Canada Pension Plan, see Appendix B.)

Rates of return on the CPP

The rate of return for the Canada Pension Plan³ is the amount of investment income required on contributions in order to pay for the promised benefits. From the point of view of the contributor, the rate of return is the yield on the investment (contribution) in the CPP or QPP as determined by the level of future benefits received.

Table 1 contains the Rate of Return for the CPP between 1966 and 2030.⁴ It is clear that those participating in the CPP in its early stages received enormous benefits relative to their contributions, while those participating later have received smaller relative benefits.

The rates of return are clearly decreasing over time from a relatively high rate of return for contributors born in 1922 to a relatively low rate of return for those born after

Table 1 Nominal rate of return on CPP funds

| Year of Birth | Beginning of Contribution Period | Nominal Rate of Return |
|---------------|----------------------------------|------------------------|
| 1922 | 1966 | 19.21% |
| 1942 | 1966 | 10.70% |
| 1952 | 1970 | 8.46% |
| 1962 | 1980 | 7.02% |
| 1972 | 1990 | 6.12% |
| 1982 | 2000 | 5.50% |
| 1992 | 2010 | 5.15% |
| 2002 | 2020 | 5.05% |
| 2012 | 2030 | 5.05% |

Source: Canadian Institute of Actuaries 1993: 11.

1952. These later nominal rates of return, once adjusted for inflation, are well below the real rates of return that could be earned in most private sector pension plans and individual Registered Retirement Saving Plans (RRSPs).

For instance, the long-term, real rate of return for contributors born after 1982, given the underlying assumptions, is approximately 1.5 percent (Canadian Institute of Actuaries 1993). This rate of return is below the real rates of return currently garnered in many private RRSPs and RPPs as well as below the Government of Canada's real return bond, which currently yields a nominal rate of 4.12 with inflation running at approximately 1.5 percent (Bank of Canada 1999).⁵

The information contained in table 2 suggests that elderly Canadians are increasingly relying on private sources of retirement income rather than public (government) sources. For instance, state-provided income relative to total income of retirees grew for men and women, between 1988 and 1996, by 7.1 percent and 11.7 percent, respectively. The increases for both men and women in the percentage of income provided by private pensions and Registered Retirement

Table 2 Select income sources for retired Canadians (1988 and 1996)

| Select Income Sources | 1988 | | 1996 | |
|------------------------|-------|-------|-------|-------|
| | Men | Women | Men | Women |
| OAS/GIS | 14.8% | 22.2% | 14.8% | 22.5% |
| CPP/QPP | 16.3% | 12.9% | 18.5% | 16.7% |
| Total Public | 31.1% | 35.1% | 33.3% | 39.2% |
| Private Pensions | 20.0% | 11.2% | 27.3% | 16.7% |
| RRSP | 1.5% | 1.0% | 3.2% | 2.9% |
| Total Selected Private | 21.5% | 12.2% | 30.5% | 19.6% |

Source: Statistics Canada, *Tax Statistics on Individuals*, 1988 and 1996 Tax Years.

ment Saving Plans (RRSPs) significantly outpaced the growth of state-provided benefits. The increase in private benefits for men and women, between 1988 and 1996, were 41.9 percent and 60.7 percent, respectively, more than 5.9 times and 5.2 times the rate of growth of state-provided benefits. Retired Canadians are increasingly relying on private sources of retirement income.

Challenges to the public social security system

Challenge 1: an aging population

The number of elderly people in Canada’s population is increasing due to a number of factors including declining fertility rates, slow population growth, healthier life-styles, and advances in medical technology. Table 3 presents select data for two factors contributing to the aging of Canada’s population, decreasing birth rates and increasing life expectancy.

Table 3 Factors influencing the aging of Canada’s population (select years*)

| Year | Fertility Rate (Births per Woman) | Life Expectancy at Birth |
|------|--------------------------------------|-----------------------------|
| 1962 | 3.7 | 71.5 |
| 1967 | 2.5 | 72.0 |
| 1972 | 2.0 | 72.8 |
| 1977 | 1.8 | 73.8 |
| 1982 | 1.7 | 75.4 |
| 1988 | 1.7 | 76.7 |
| 1992 | 1.7 | 77.8 |
| 1996 | 1.7 | 78.7 |

Note: years selected based on the availability of the data.
Source: World Bank 1998.

The contrast between the assumptions used in creating the public social-security programs and the actual outcomes is stark. Birth rates declined by 54.1 percent between 1962 and 1996 while life expectancy increased by 10.1 percent during the same period. In 1966, the year the CPP was launched, there were 5.5 Canadians under the age of 20 for each Canadian over the age of 65. Today, there are 2.3 Canadians under the age of 20 for every retiree, and this is expected to further decrease to 1.1 by the year 2030 (Canadian Institute of Actuaries 1995).

A more alarming trend is the relationship between workers and retirees. In our pay-as-you-go system⁶ it is the

income of current workers that provides the retirement benefits for current retirees. There is no fund of capital assets set aside for future payment of benefits. In 1992 [table 4], seniors represented 19.8 percent of the working age population. This is expected to increase dramatically to 38.9 percent by 2030 (table 4). In other words, the ratio of workers to retirees will fall from 4 to 1, to approximately 1.5 to 1 by the year 2030. These demographic changes have undermined the ability of the retirement income programs to provide the promised level of benefits in the future (Alexander and Emes 1998).

Table 4 Number of seniors (1992–2030)

| | 1992 | 2030 | % Increase |
|---|-------------|-------------|------------|
| Number | 3.3 million | 8.0 million | 142.4% |
| As a percentage of the Working Age Population | 19.8 % | 38.9% | 104.7% |

Source: Canadian Institute of Actuaries 1995.

This phenomenon is not restricted to Canada. It is a problem confronting all the major developed countries. As Peter G. Peterson, Chairman of the Council on Foreign Relations notes:

Unlike with global warming, there can be little debate over whether or when global aging will manifest itself. And unlike with other challenges, even the struggle to preserve and strengthen unsteady new democracies, the cost of global aging will be far beyond the means of even the wealthiest nations—unless retirement benefit systems are radically reformed. Failure to do so, to prepare early and boldly enough, will spark economic crises that will dwarf the recent meltdowns in Asia and Russia. (Peterson 1999: 42–43).

In light of the changing demographics (low birth and death rates), lower levels of economic growth, and stagnant wage growth, the federal and provincial governments have collaboratively initiated some reforms, discussed in Appendix B: Changes to the Canada Pension Plan. These reforms, however, are not bold enough to cope with a problem of this magnitude.

Challenge 2: unfunded liabilities

Many programs in Canada—retirement income support plans like the CPP, QPP, OAS, and GIS as well as the health-care system—have unfunded liabilities, a deficit between the prom-

ised level of benefits and the resources provided to fund those benefits in the form of contributions and investment returns.

These programs represent government obligations, or promises to provide specific benefits in the future. They are not funded benefits because contributions are not placed in an account from which taxpayers may draw in retirement as is the case in Registered Retirement Saving Plans (RRSP). Rather, the current contributions are used to pay for the benefits currently consumed by others. It is in this sense that the OAS and CPP/QPP are pay-as-you-go income systems. Table 5 and figure 1 present the unfunded liabilities of Canada's two largest public-retirement income programs (OAS and CPP) and the medical system.⁷

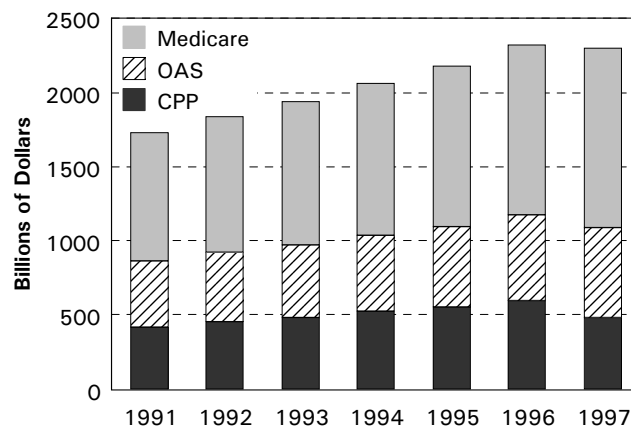
Table 6 presents the gross and net transfers made to seniors in a single year, 1996, to illustrate the magnitude of resources already allotted to retirees in Canada and funded by payments from current workers.

In spite of these huge cost escalations, some policy makers subscribe to the view that the changes enacted to the social-security system over the past few years are adequate to deal with the growing costs associated with the aging of Canada's population. They also insist that economic growth will help Canada support an older population.

The Canadian economy did, indeed, grow in real terms at an average rate of 3.8 percent per annum over the last 35 years. Some of the factors contributing to this growth include:

- 1 working-age population increased by 2% per annum;
- 2 workforce participation rate (i.e., the work force as a percentage of the working age population) increased by 0.5% per annum;
- 3 real wages increased at the rate of 1.3% per annum.

Figure 1: Unfunded liabilities



Source: Alexander and Emes 1998.

During the next 35 years, however, the working age population will increase by less than 0.5 percent per annum. Labour-force participation rates may increase but not as fast as during the 1960s and the 1970s. In the most recent Annual Report for the Canada Pension Plan, real (inflation-adjusted) wages were assumed to increase at a rate of 1 percent per annum. Combining these factors, the economy might reasonably be expected to grow at about 2 percent per annum, half the average rate of the last 35 years (Hamilton 1995; Canadian Institute of Actuaries 1995).

Policy alternatives

As the number of elderly in the Canadian population increases, the cost of Canada's social-security system will increase over the course of the next 30 years. The economic pressure of this increase coupled with the subsequent increased cost

Table 5 Summary of unfunded liabilities (\$billions)

| Year | CPP | OAS | Medicare | Total | Total Relative to GDP |
|-----------------------|-------|-------|----------|---------|-----------------------|
| 1991 | 420.4 | 445.0 | 867.0 | 1,732.4 | n/a |
| 1992 | 454.0 | 470.0 | 917.0 | 1,841.0 | 126.2% |
| 1993 | 487.5 | 488.0 | 969.0 | 1,944.5 | 133.3% |
| 1994 | 527.3 | 515.0 | 1,024.0 | 2,066.3 | 138.6% |
| 1995 | 555.5 | 544.0 | 1,082.0 | 2,181.5 | 139.2% |
| 1996 | 600.1 | 576.0 | 1,144.0 | 2,320.1 | 143.4% |
| 1997 | 485.0 | 609.0 | 1,209.0 | 2,303.0 | 129.1% |
| Average Annual Growth | 3.0% | 5.4% | 5.7% | 4.9% | 0.6% |

Note: Excluding 1997 from the average annual growth calculation for total unfunded liabilities relative to GDP results in an annual rate of growth of 3.3 percent.

Source: *Special Report for the Fraser Institute*, June 1996 and January 1998, Actuarial Services Division, Office of the Superintendent of Financial Institutions Canada, Ottawa, Canada. Taken from Alexander and Emes 1998: 15, 48.

Table 6 Net transfers to seniors, 1996 (\$thousands)

| | |
|---|---------------------|
| OAS | \$14,548,533 |
| CPP/QPP | \$14,126,955 |
| Medicare* | \$20,446,000 |
| Total | \$49,121,488 |
| Federal and Provincial Income Taxes Paid by Senior Citizens | \$11,181,670 |
| Net Transfer | \$37,939,810 |

* Health care costs are projected figures for 1993.
 Source: Revenue Canada, *Tax Statistics on Individuals, 1998*: 84–87; Office of the Superintendent of Financial Institutions, 1996, *Health Care Cost Projections*; calculations by the authors.

of social programs will force Canadians to choose among several options for the public social-security system:

- 1 an increase in general taxes;
- 2 a further increase in CPP and QPP contribution rates;
- 3 a reduction in social security benefits;
- 4 a combination of options 1, 2, and 3;
- 5 the privatizing of a portion or all of the current government social-security system.

Canadians appear to be concerned about the future of the social security programs. In fact, according to some surveys, less than 30 percent of Canadians under the age of 50 are confident that they will receive benefits from OAS and GIS programs and the CPP and QPP (Canadian Institute of Actu-

aries 1995). In other words, a large percentage of younger Canadians do not believe that there will be a government-funded safety net for them when they retire.

Some Canadians believe that the social security programs can be maintained in their current form by increasing the taxes required to support these programs gradually and that these increased costs will be borne by a population whose standard of living is improving. Table 7 presents Canada's comparative tax burden (figure 2), and the composition of taxes (figure 3) relative to a selected group of countries.

Raising either general taxes or specific taxes like the payroll tax seems unrealistic given the already high rates of taxation in Canada relative to our trading partners (table 7). High taxes also have an adverse impact on productivity and job growth, which could cause general economic stagnation or, at least, a reduction in economic growth rates and the standard of living of Canadians (OECD 1998; Gwartney and Lawson 1998; Law and Mihlar 1996; for further information see Appendix A).

It is clear that Canada's debt position (table 8) as illustrated in figure 4, coupled with its faltering productivity (Appendix A) and already high taxes (table 7 and figure 2) limit any type of adjustment or reform to the public social-security system based on increasing premiums or deficit financing.

A reduction in the benefits afforded under the social-security system is perhaps possible in the longer term but its political feasibility is suspect in the short term. As the population ages and older Canadians gain greater political leverage, it will become increasingly difficult to reform the social-security system provided by the state. For instance, the median age of the electorate is expected to increase from 42

Table 7: International tax comparisons (1996)

| | Total tax as a % of GDP | Specific taxes as a percent of total taxes | | | | |
|----------------|-------------------------|--|-----------------|----------|--------------------|-------|
| | | Income and Profits | Social Security | Property | Goods and Services | Other |
| United States | 28.5% | 47.2% | 24.7% | 11.0% | 17.2% | 0.0% |
| Japan | 28.4% | 36.6% | 36.5% | 11.3% | 15.4% | 0.2% |
| United Kingdom | 36.0% | 36.8% | 17.3% | 10.6% | 35.2% | 0.1% |
| Canada | 36.8% | 47.3% | 16.3% | 10.4% | 24.9% | 1.1% |
| OECD average | 37.7% | 35.3% | 25.1% | 5.4% | 32.5% | 1.7% |
| Germany | 38.1% | 28.4% | 40.6% | 3.0% | 27.9% | 0.1% |
| Italy | 43.2% | 34.4% | 34.2% | 5.4% | 25.9% | 0.1% |
| France | 45.7% | 18.0% | 43.1% | 5.1% | 27.3% | 6.5% |
| Sweden | 52.0% | 41.0% | 29.8% | 3.8% | 22.8% | 2.6% |

Source: OECD, Revenue Statistics, 1965-1997, 1998. Taken from Emes and Walker 1999.

years of age in 1995, to 49.5 years of age by 2030, an increase of 17.9 percent (Canadian Institute of Actuaries 1993).

It is not the intent of this paper, however, to assess and recommend proposals for reforming the public social security system⁸ but, rather, to examine the impact of the Foreign Property Rule on retirement income.

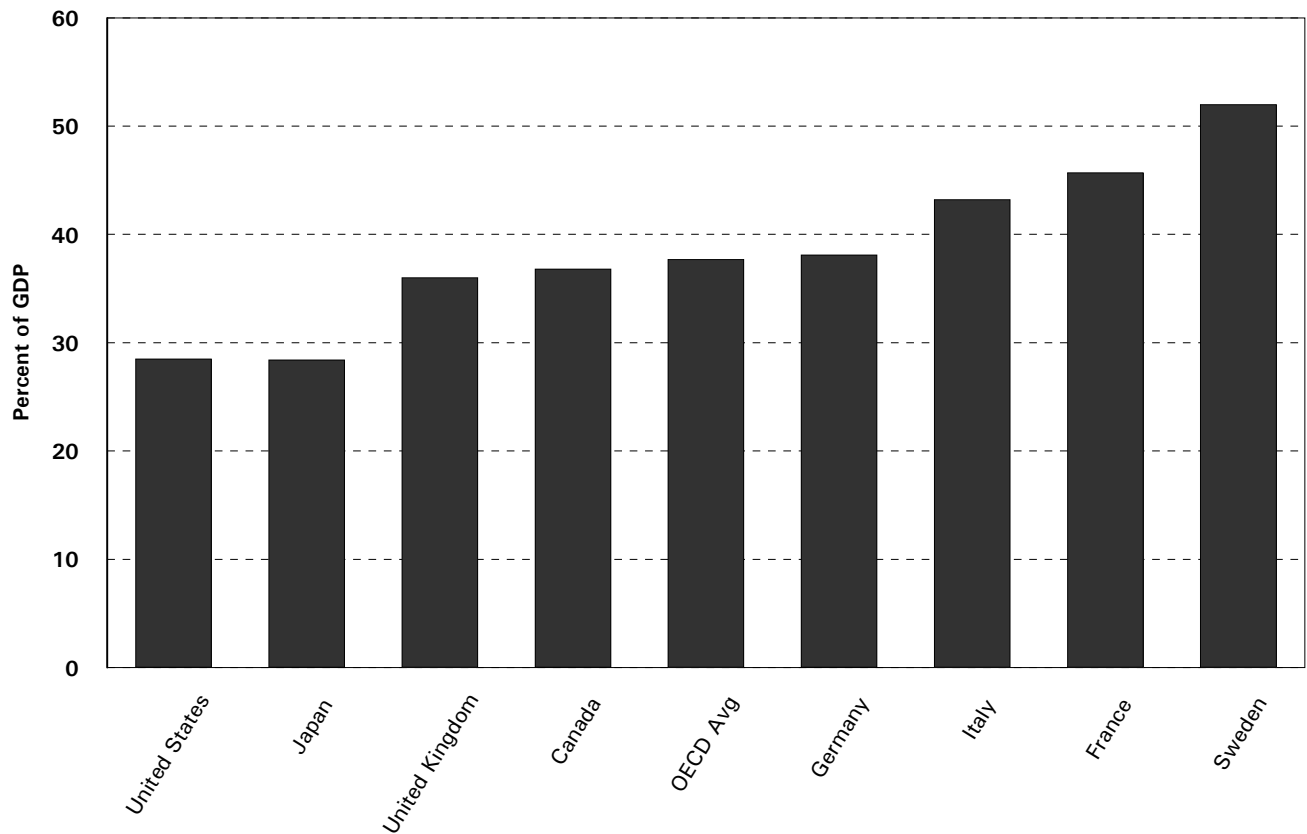
It is, however, critical to note that the social-security system offers a modest benefit depending on the level of pre-retirement income⁹ and that it is improbable that benefits will be expanded. The limitations on the public social-security system make the soundness of the private system that much more important for the future ability of retirees to maintain a reasonable standard of living.

Table 8 Net government debt as a percentage of GDP, 1998 (estimate)

| Country | Percent |
|----------------|---------|
| Sweden | 19.7% |
| Japan | 26.9% |
| United Kingdom | 42.7% |
| France | 44.8% |
| United States | 45.5% |
| Germany | 50.2% |
| Canada | 60.0% |
| Italy | 106.2% |

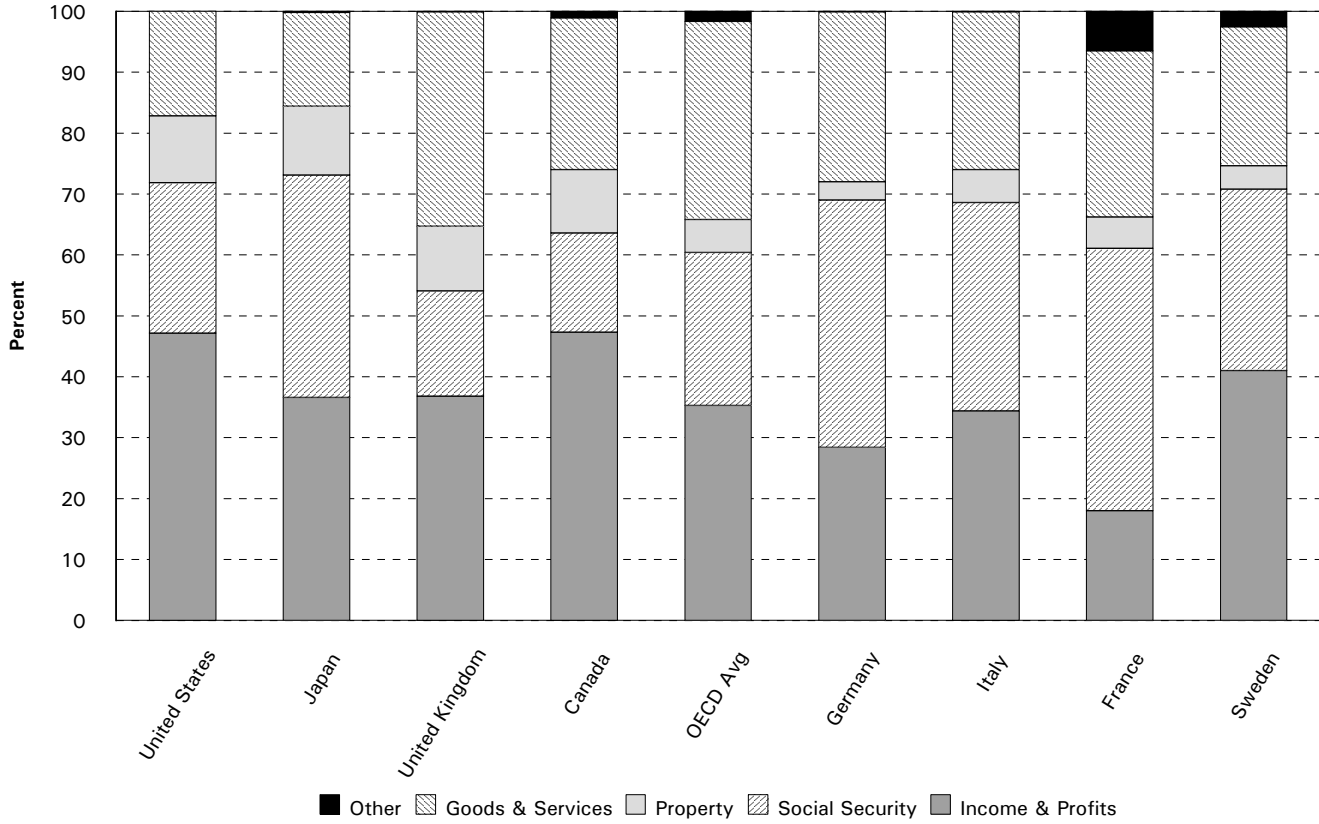
Source: OECD (1998). *OECD Economic Outlook 63*. Taken from Emes and Walker 1999.

Figure 2: Comparative Tax Burden (percent of GDP)



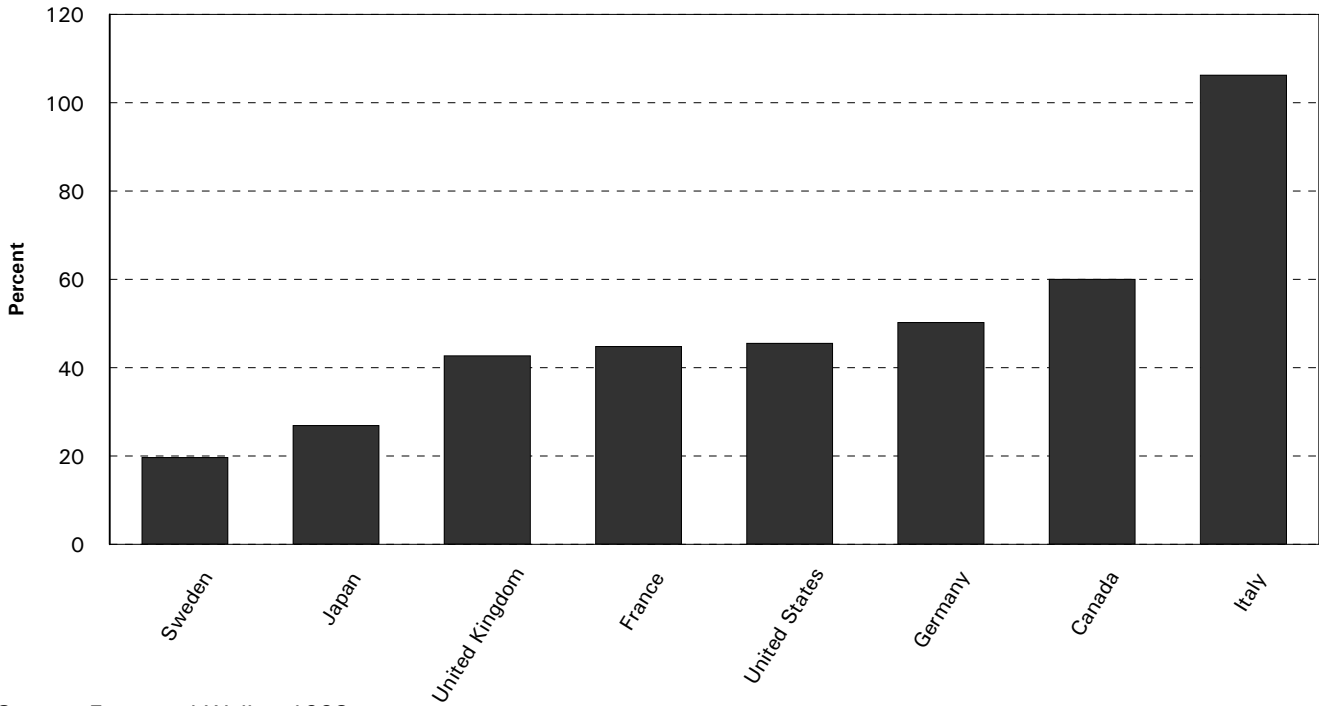
Source: Emes and Walker 1999.

Figure 3: Composition of Taxes



Source: Emes and Walker 1999.

Figure 4: Debt to GDP 1998



Source: Emes and Walker 1998.