The Canada Pension Plan Investment Board (CPPIB) reported its operating expenses as $490 million in fiscal 2012–13, or 0.28% of its assets, up from 0.11% six years earlier, touting this as a measure of its efficiency and low costs. However, this definition of operating expenses does not include all the costs related to the CPP. The total cost of running the CPP has grown from $0.6 billion (0.54% of assets) to $2.0 billion (1.15%) over the last seven years. Of the $2.0 billion of total costs involved in the CPP last year, almost one-third ($0.6 billion) were incurred by the federal government, a cost not explicitly included in the CPPIB accounting statements.

External management fees, which have risen from $25 million to $782 million in six years, and the transaction costs of executing the CPPIB's investment strategy are nearly twice as large as its operating expenses. The investment strategy of the CPP now costs nearly as much as all its operating expenses, including the government's collection of all contributions and paying of benefits. The CPPIB needs to be more transparent about the expense of designing and implementing its investment strategy; every dollar spent on behalf of the CPP is one less dollar available to beneficiaries. As well, a full accounting of all CPP costs, including those incurred by the Government of Canada, is necessary.
Introduction

In the recent debate over an expanded Canada Pension Plan (CPP), its low cost was offered as one of the main benefits for larger government-managed pensions. The Ontario government, introducing its own version of the CPP, argues that:

traditional investment vehicles like mutual funds often carry high management fees that can significantly erode savings growth . . . Over time, relatively small increases in fees can have an impact on an individual's retirement savings. Relative to individual retail customers, the fees or management expense ratios (MERs) associated with certain investments are much lower for pension plans. As such, members of pension plans, even small plans, can benefit. (2014: chapter 4, 4)

Not surprisingly, the Canada Pension Plan Investment Board1 (CPPIB), which independently manages the surplus assets of the CPP, burnishes this image of high efficiency and low cost. Every year it publishes its operating expense ratio, narrowly defined as operating expenses relative to assets under management. In 2012–13, these operating expenses totalled $490 million (2013: 60), or 0.28% of its average2 assets. Sounds like quite a bargain. In the words of one senior manager of a public fund, the advantages of a large public pension plan include “investment efficiency and expertise” and “lower members' administrative and investment expenses” (Leech and McNish, 2013: 155).

However, the operating expenses cited by the CPPIB cover only a select subset of the total costs involved in running the CPP. These total costs include those related to the CPP's design and routine operations like collecting contributions and paying benefits that are done on its behalf by the federal government, plus all the costs related to the CPPIB, including its internal operating expenses and its external costs. External management fees and the transaction costs of executing the CPPIB's investment strategy are nearly twice as large as its operating expenses. Currently, one needs to consult the Public Accounts and annual reports from both the CPPIB and CPP to get a complete picture of CPP costs and investment returns.

This paper attempts to identify all the costs of both administering the CPP and managing its assets and suggests one possible way to bring this information together. This is an important exercise, because every dollar spent on behalf of the CPP is one less dollar available for beneficiaries. As well, it helps answer the question of whether government-run pension plans are significantly more efficient than private plans. This paper does not provide an in-depth evaluation of the investment strategy adopted by the CPP in 2006. The focus is on the total costs of the CPP and maximizing its value for Canadians.

The administrative structure of the CPP

The CPP is administered by Human Resources and Social Development Canada. The CPP has existed since 1965, and for years functioned only on a “pay-as-you-go” (PAYGO) basis, paying out pension benefits solely from CPP contributions levied on working Canadians. Any surplus funds were automatically invested in government bonds. It became evident in the 1990s that this PAYGO model was not going to function when the large boomer generation retired. So the CPP’s basic model was changed to a hybrid of PAYGO plus building up invest-

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2 The average of “assets available for benefit payments” at the beginning and end of the year.
ment assets in anticipation of the coming wave of retirees. With this change, the functioning of the CPP became a joint responsibility divided between the Government of Canada and the CPP Investment Board (CPPIB).

The CPP Investment Board is a Crown corporation created by Parliament in 1997 to administer these assets, and is overseen by the federal and provincial ministers of finance. It operates at arms length from governments with a mandate to maximize returns without undue risk of loss. Starting in 2006, it developed a more aggressive investment strategy that extended beyond traditional stocks and bonds to assets such as infrastructure and real estate. This created challenges for the valuation of some of these assets, which are often illiquid with no readily available market price or benefits that will yield returns decades in the future, making it difficult to determine their value today. The complexity of these accounting challenges is not addressed in this paper, which focuses on the overall costs of the CPP and the rising cost of this new investment strategy since 2006.

The Government of Canada administers the CPP's calculation and collection of contributions and the issuance and verification of cheques, as well as holding some of its assets while turning over the bulk to the CPPIB. In return for these services, the government deducts these costs from the revenue it transfers to the CPP. In 2012–13, these costs involved four departments and totalled $586 million. Some of these functions are analogous to costs incurred by a private annuity fund, notably verifying eligibility and issuing cheques. It is also worth noting that these costs do not include the compliance costs imposed on employers and self-employed individuals for calculating and remitting their CPP payments. A cost estimate for this is included in Speer et al. (2014).

This list of costs does not include all the services the Government of Canada provides to the CPP. The lengthy negotiations with the provinces and background studies about a possible reform of the CPP conducted by the Department of Finance is an obvious exclusion. The CPP has a unique structure and relationship with its pensioners, which makes comparisons with private sector pension funds difficult to determine precisely.

The next two sections look specifically at the activities conducted by the Government of Canada and the CPP Investment Board on behalf of the CPP.

The government of Canada’s spending on the CPP

The government of Canada’s financial transactions related to operating the CPP are outlined in table 1 (note that this refers only to the Government of Canada and not the CPP Investment Board, which is discussed next). At the beginning of each year, the Government of Canada holds a relatively small amount of assets on behalf of the CPP. During the year, the government collects contributions (column 2 in table 1), pays out pensions and other benefits (column 3), and has operating expenses (outlined below) to administer the plan (column 4). The net result of these three actions is summarized in the column marked net contributions (column 5) in table 1. Adding in the gross investment income earned by the government on the assets it holds (column 6) and removing assets not required to meet specified obligations of the CPP which are transferred weekly to the

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Assets throughout this document refers to “assets available for benefit payments,” which are net of liabilities. See page 6.70 of Volume 1 the Public Accounts of Canada 2013 (Canada: 2013) for more detail.
CPPIB (column 7) results in the net change in money available to the government-held CPP assets at the start of the following year. These holdings represent less than 3% of the CPP’s assets, with the remainder under the control of the CPPIB.

The Government of Canada explicitly identifies some of its direct costs related to the administration of the CPP in its Public Accounts. For the latest year these included:

- $405 million for pension and benefit delivery, accommodation, and corporate services provided by Human Resources and Skills Development Canada;
- $169 million for the collection of contributions as well as investigation services by the Canada Revenue Agency;
- $10 million for cheque issuance and computer services by Public Works and Government Services Canada, and;
- $2 million for actuarial services by the Office of the Superintendent of Financial Institutions and the Department of Finance (Canada, 2013: 6.70).

The CPP pays these costs by receiving less money from the government than the government collects in contributions. This reduces the money available for the CPP to ultimately pay pensioners, so it is in the public interest to be aware of and minimize these costs. However, this withholding of funds from the CPP makes it appear the CPP’s costs are less than they are in reality.

### Table 1: Government of Canada CPP Assets and Transactions (in $ millions)

<table>
<thead>
<tr>
<th>Assets, Beginning of Year (1)</th>
<th>Gross Contributions (2)</th>
<th>Pensions and Benefits (3)</th>
<th>Operating Expenses (4)</th>
<th>Net Contributions (5)</th>
<th>Gross Investment Income (6)</th>
<th>Net Transfer to CPPIB (7)</th>
<th>Assets, End of Year (8)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006-07</td>
<td>12,589</td>
<td>32,355</td>
<td>(26,115)</td>
<td>(460)</td>
<td>5,780</td>
<td>(14,729)</td>
<td>3,896</td>
</tr>
<tr>
<td>2007-08</td>
<td>3,896</td>
<td>35,346</td>
<td>(27,536)</td>
<td>(445)</td>
<td>7,365</td>
<td>(7,190)</td>
<td>4,082</td>
</tr>
<tr>
<td>2008-09</td>
<td>4,082</td>
<td>36,506</td>
<td>(29,005)</td>
<td>(505)</td>
<td>6,996</td>
<td>(6,563)</td>
<td>4,521</td>
</tr>
<tr>
<td>2009-10</td>
<td>4,521</td>
<td>36,276</td>
<td>(30,363)</td>
<td>(498)</td>
<td>5,415</td>
<td>(6,147)</td>
<td>3,790</td>
</tr>
<tr>
<td>2010-11</td>
<td>3,790</td>
<td>37,069</td>
<td>(31,598)</td>
<td>(522)</td>
<td>4,949</td>
<td>(5,336)</td>
<td>3,405</td>
</tr>
<tr>
<td>2011-12*</td>
<td>3,405</td>
<td>38,925</td>
<td>(33,288)</td>
<td>(740)</td>
<td>4,897</td>
<td>(3,944)</td>
<td>4,360</td>
</tr>
<tr>
<td>2012-13</td>
<td>4,360</td>
<td>41,655</td>
<td>(35,590)</td>
<td>(586)</td>
<td>5,479</td>
<td>(5,382)</td>
<td>4,460</td>
</tr>
<tr>
<td>Sum</td>
<td>258,132</td>
<td>(213,495)</td>
<td>(3,756)</td>
<td>40,881</td>
<td>281</td>
<td>(49,291)</td>
<td></td>
</tr>
</tbody>
</table>

Sources: Government of Canada Public Accounts (various years); calculations by authors.

*Government of Canada operating expenses were high in 2011-12 due to the settlement of a human rights complaint by medical adjudicators.
The CPP Investment Board

While the CPP Investment Board operates at arms length from governments in terms of its investment strategies, its finances are inextricably linked with governments. Governments collectively set the contribution rate, while the federal government alone collects the contributions, pays the benefits, and then turns over most of the remaining funds for the Investment Board to manage.

The CPPIB reported its operating expenses as $490 million in fiscal 2012–13, or 0.28% of its assets, up from 0.11% six years earlier. This is the figure the CPPIB touts as a measure of its efficiency and low costs. However, this definition of operating expenses does not include the almost $1 billion in external management fees and transaction costs\(^4\) incurred by the CPPIB. There seems no apparent reason to exclude these costs, especially external management fees which have increased from 0.20% of average assets in 2007–08 to 0.45% last year, except the “customary practice” cited by the CPPIB of reporting “investment returns net of fees paid” (2013: 60). Contracting out investment strategy consultations may be justifiable but excluding these rising costs from reported expense ratios is not. After all, designing and executing its investment strategy is the very reason the CPPIB exists. The CPPIB’s first and only loyalty should be to taxpayers, not the “customary practice” of the pension industry.

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\(^4\) Page 60 of the Canada Pension Plan Investment Board 2013 Annual Report notes:

Transaction costs are often associated with the acquisition of private market assets, especially infrastructure, real estate and private equity. They include investment banking advisory fees in public company bid situations, due diligence consulting fees, legal and tax advisory fees, taxes on the transfer of real estate, and a variety of other non-recurring expenses.... In public markets, we pay commissions when trading securities. Commission costs vary depending on the volumes and markets in which we trade and are also driven by portfolio rebalancing. Transaction cost information detailed by asset class can be found in note 8 to the Financial Statements.
ers transferred from the Government of Canada (column 8).

The CPPIB follows an active approach to investing and compares its investment performance relative to its Reference Portfolio of what a passive and low-cost investment strategy would have generated. The approach is designed “with the primary goal of maximizing return without undue risk of loss, and with the expectation of adding value, after all costs, over the CPP Reference Portfolio returns” (CPPIB, 2014a: 22). Since its inception in 2006, the CPP Reference Portfolio earned $72.7 billion, while active investment has generated an additional $5.5 billion. However, deducting cumulative operating costs of $2.5 billion leaves a net benefit of $3.0 billion. In the latest fiscal year, the value-added from its investment portfolio was $514 million above the Reference Portfolio; however, deducting operating expenses resulted “in negative $62 million value-added on a net basis,” in the CPPIB’s words (40).

The total costs of the CPP

Table 3 brings together all reported CPP costs and presents them with total CPP assets. Assets increase with member contributions (column 2) and gross investment income (column 3). Costs consist of external management fees and transaction costs (column 4—investment costs) and total operating expenses (column 6).

It is worth noting that over the last seven years, contributions from payroll taxes on CPP members have been almost as important as net

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5 Contributions less pensions and benefits; this differs from table 1 where operating expenses are removed to create net contributions.
investment income in the growth of CPP financial assets ($44.6 billion versus $47.7 billion). This contradicts claims that large public pension plans generate two-thirds of their income from investments and only one-third from member contributions (Leech and McNish, 2013: 29). Taxes on contributing members will always play an important role.

Table 4 draws from the first three tables to present different cost ratios varying by which costs are included. Column 1 is the CPPIB’s reported operating expenses and column 2 the ratio generated by dividing these costs by average CPPIB assets. Column 3 adds the costs related to devising and implementing the CPPIB’s investment strategies to its operating expenses. The ratio in column 4 then is CPPIB operating plus CPPIB investment costs divided by average CPPIB assets. Total costs (column 5) adds CPP operating expenses to the sum of CPPIB expenses. The final ratio is for all costs (CPPIB operating, CPPIB investing and Government of Canada operating) divided by average CPP assets.

Unlike the benign picture of a miniscule expense ratio portrayed by the CPPIB (column 2), a fuller accounting of all the costs associated with the CPP paints a different picture. These “all-in” costs are at least four times higher than the narrowly-defined operating expenses ratio touted by the CPPIB. In addition, comparing the annual flow of costs to the stock of total assets, as the CPPIB does in annual reports, is misleading. Its stock of assets varies with investment returns and the contributions collected from Canadian workers, which has nothing to do with costs as calculated by the CPP. The marginal cost of the CPPIB’s investment strategy is the external management fees and transaction costs (we exclude its operating expenses, which presumably are largely unaffected by the investment strategy it pursues). The marginal benefit is the flow of investment income this strategy generates, not the stock of total assets, which also changes because of

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6 In addition, comparing the annual flow of costs to the stock of total assets, as the CPPIB does in annual reports, is misleading. Its stock of assets varies with investment returns and the contributions collected from Canadian workers, which has nothing to do with costs as calculated by the CPP. The marginal cost of the CPPIB’s investment strategy is the external management fees and transaction costs (we exclude its operating expenses, which presumably are largely unaffected by the investment strategy it pursues). The marginal benefit is the flow of investment income this strategy generates, not the stock of total assets, which also changes because of
higher external management fees, which have risen from $25 million to $782 million in just six years. The costs of conceptualizing and executing the CPP’s increasingly complex investment strategy has grown from less than $200 million to $1.0 billion over the last seven years. The investment strategy of the CPP now costs nearly as much as all its operating expenses, including the government’s collection of all contributions and paying of benefits. As a result, the total cost of running the CPP has grown from $0.6 billion to $2.0 billion, or from 0.54% of assets to 1.15%, over the last seven years. Meanwhile, of the $2.0 billion of total costs involved in the CPP last year, almost one-third ($0.6 billion) were incurred by the federal government, a cost not explicitly included in the CPPIB accounting statements.

**Conclusion**

The CPP is Canada’s largest pension fund. Its investment strategy is independent of government and has served Canadian workers well during the last seven years of financial market turmoil. However, the fund needs to be more transparent about the expense of designing and implementing its investment strategy. As well, a full accounting of all its costs, including those incurred by the Government of Canada, for its day-to-day operations is necessary. These costs represent one-third of all the costs of the CPP, which is important since every dollar spent on the CPP is one less dollar available for its beneficiaries. The reporting of all costs should be explicitly made by the CPP in its annual reports and by the CPPIB in theirs.

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**Table 4: CPPIB and CPP Costs**

<table>
<thead>
<tr>
<th></th>
<th>CPPIB Operating Expenses ($ millions)</th>
<th>Costs / Average Assets</th>
<th>CPPIB Costs ($ millions)</th>
<th>CPPIB Costs / Average Assets</th>
<th>Total Costs ($ millions)</th>
<th>Costs / Average Assets**</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006-07*</td>
<td>(114)</td>
<td>0.11%</td>
<td>(139)</td>
<td>0.14%</td>
<td>(599)</td>
<td>0.54%</td>
</tr>
<tr>
<td>2007-08</td>
<td>(154)</td>
<td>0.13%</td>
<td>(500)</td>
<td>0.42%</td>
<td>(945)</td>
<td>0.77%</td>
</tr>
<tr>
<td>2008-09</td>
<td>(189)</td>
<td>0.17%</td>
<td>(665)</td>
<td>0.58%</td>
<td>(1,170)</td>
<td>0.99%</td>
</tr>
<tr>
<td>2009-10</td>
<td>(236)</td>
<td>0.20%</td>
<td>(850)</td>
<td>0.73%</td>
<td>(1,348)</td>
<td>1.12%</td>
</tr>
<tr>
<td>2010-11</td>
<td>(328)</td>
<td>0.24%</td>
<td>(1,001)</td>
<td>0.73%</td>
<td>(1,523)</td>
<td>1.08%</td>
</tr>
<tr>
<td>2011-12</td>
<td>(440)</td>
<td>0.28%</td>
<td>(1,318)</td>
<td>0.85%</td>
<td>(2,058)</td>
<td>1.30%</td>
</tr>
<tr>
<td>2012-13</td>
<td>(490)</td>
<td>0.28%</td>
<td>(1,449)</td>
<td>0.84%</td>
<td>(2,035)</td>
<td>1.15%</td>
</tr>
</tbody>
</table>

Sources: Government of Canada Public Accounts (various years); the 2013 CPPIB Annual Report; calculations by authors.

*Transaction Costs were not separately identified until 2007-08.

**Average assets includes those held by the Government of Canada, in addition to those held by the CPPIB.
This paper has shown that the total costs of running the CPP are considerably higher than just the operating expenses of the CPPIB. First, one has to include the external management fees and the transactions costs for the CPPIB. A broader measure of the costs of the CPP would include the costs of collecting and paying the actual CPP benefits. Even this understates the true burden of the CPP to the Canadian economy, since it does not take account of the cost to employers of complying with CPP rules and regulations. As well, there is no documentation of the cost of designing the CPP, including all the consultations and federal-provincial meetings leading up to the reform of the CPP in the 1990s and recent discussions of its overhaul, which are absorbed by various Ministries of Finance. Finally, the benefits of the CPPIB’s increasingly complex and costly investment strategy have to be weighed against the opportunity cost of a passive investment strategy and the potential costs of investing in more risky assets.

As part of the overhaul of the CPP in 1997, governments agreed to continuously seek ways to reduce the plan’s administrative and operating costs. Given this fundamental directive, it is surprising that the total costs of the CPP are not presented more clearly by both the Government of Canada and the Plan’s Investment Board. Canadians should be informed of the total cost of administering the CPP’s operations and the total costs involved in its increasingly complex investment strategy. Otherwise, the expressed intent to relentlessly search for lower costs will appear to be just another politically-motivated bromide disappearing into the ether of a self-serving bureaucracy.

References


Accounting for the True Cost of the Canada Pension Plan

Philip Cross worked for 36 years at Statistics Canada, the last few as its Chief Economic Analyst. He wrote Statistics Canada’s monthly assessment of the economy for years, as well as many feature articles for the Canadian Economic Observer. After leaving Statistics Canada, he has worked as a contract researcher for a variety of organizations. He has been widely quoted over the years, and now writes a bi-weekly column for the National Post and other papers.

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