EXECUTIVE SUMMARY

Compulsory Government Pensions vs. Private Savings: The Effect of Previous Expansion to the CPP

by François Vaillancourt, Charles Lammam, Ian Herzog, and Pouya Ebrahimi

In recent years, there has been a strong push to expand the Canada Pension Plan (CPP). Ontario has already set out a plan to create an additional mandatory provincial program mirroring the CPP, the Ontario Retirement Pension Plan (ORPP), which is slated for implementation on January 1, 2017. Yet the debate about expanding compulsory public pensions has largely overlooked important consequences for private savings, and thus may have overstated the benefits of such a policy move.

Increasing compulsory savings can have the unintended consequence of reducing the amount that households save privately. Households who are content with their balance between current consumption and saving for the future might respond to increased mandatory savings by reducing voluntary savings, maintaining their overall consumption-saving balance. This means that if governments mandate higher CPP or ORPP contributions, Canadians may simply reduce their private savings in vehicles such as RRSPs and TFSAs. While this trade-off has been highlighted by standard economic theory and international studies, its impact has received little attention in the debate about expanding the CPP or enacting new provincial plans.

This study builds on past Fraser Institute work by empirically examining the extent to which historical increases to CPP contributions affected the private savings of Canadian households. The survey data used accounts for the saving patterns and demographics of Canadian households for select years from 1986 to 2008, spanning a substantial increase to the CPP contribution rate. The analysis focuses on particularly important changes made to the CPP between 1996 and 2004, when the total contribution rate rose from 5.6 percent to 9.9 percent of insurable earnings as part of reforms to improve the program's long term outlook.

The results show that past increases in the compulsory CPP contribution rate were followed by decreases in the private savings rate of Canadian households. This drop in private savings is not explained by changing interest rates or shifts in demographics such as age, income, or home ownership. Specifically, our results associate a 0.895 percentage point drop in the private savings rate of the average Canadian household with each percentage point increase in the total CPP contribution rate, holding other factors constant (the average private savings rate for all households was 7.1 percent in 1996, the year before the CPP reforms).

Breaking down this result into income and age groups shows that this effect is most pronounced among the young (under 30) and smallest for those approaching retirement (50–64). We also find a larger percentage point drop in the private savings rate of lower-income households and practically none for those with higher income. Further analysis based on the empirical results suggests that households may have, on average, substituted between private and public savings on a dollar-for-dollar basis, whereby a one dollar increase in CPP contributions is offset by approximately a dollar decrease in private savings.

The debate about the efficacy of compulsory expansion of the CPP or new provincial plans such as the ORPP should account for the consequence of reduced private savings. Our results suggest that overall retirement savings won't increase to the extent of the increase in compulsory savings, and perhaps won't increase at all. In the end, there will be a reshuffling of retirement savings, with more money going to forced savings and less to voluntary savings. This means the benefits of increasing the CPP or enacting the ORPP must be weighed against the flexibility and choice offered by private savings vehicles such as RRSPs and TFSAs. For instance, voluntary vehicles like RRSPs can be used for buying a home, obtaining skills training, withdrawing in case of a terminal illness, or fully transferring assets to a beneficiary upon death.

The key to providing retirement income through savings is a set of rules that allows for an optimal mix of savings for different people in different stages of life and with different preferences. The benefits to a compulsory expansion of the CPP or of similar provincial policies need to be considered against the costs, which as our analysis suggests will include a reduction in voluntary private savings.

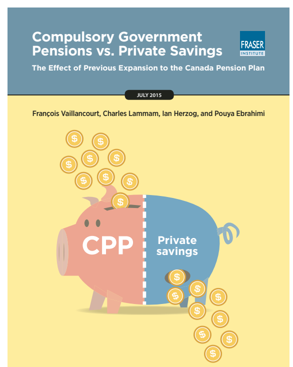

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Figure 1: Combined CPP contribution rate (%), 1986–2015