Reforming Old Age Security: A Good Start but Incomplete

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by Jason Clemens, Milagros Palacios,
and Niels Veldhuis

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Executive summary

In 2012, the federal government implemented changes to Old Age Security (OAS), one of three key income programs for seniors. While the main reform—an increase in the age of eligibility—is a positive first step in reforming programs for seniors in the face of historic demographic change, it is only a first step.

OAS reforms—A summary

The most prominent reform announced in the 2012 Budget concerning OAS is an increase in the age of eligibility to receive full OAS benefits. The announced changes will not affect anyone born before March 1958. Specifically, the age of eligibility will be increased to 67 years of age from its current level of 65 years of age starting in 2023, with the change fully implemented by January 2029.

It is worth noting the modest nature of the two year increase in the age of eligibility. Consider that every year that life expectancy increases, the total benefits paid under senior programs also increase but without any specific action on the part of the government. In other words, these benefit increases occur automatically as a function of increases in life expectancy. If, however, the government had indexed the age of eligibility to life expectancy in say 1966, when the CPP was introduced, the age of eligibility for OAS today would be 74 years of age.

What wasn't included?

Two key issues related to OAS remained untouched and thus unchanged: 1) eligibility for OAS benefits and 2) the OAS clawback.

i) Eligibility

What was not included in the reforms or even in the discussions of reforms was eligibility for OAS. Currently, eligible individual seniors whose income is less than or equal to $70,954 receive the full OAS benefit (2013 income tax year). Income earned beyond this level results in a reduction of OAS benefits at a rate of 15 percent. This means that individual seniors earning income up to $114,640 receive partial OAS benefits. Seniors with income above this level receive no OAS benefits.

It is important to understand that OAS benefits are calculated on an individual basis. This means that two seniors living together can have household income up to $141,908 (2013) and still qualify for full OAS benefits. Put differently, senior couples can earn combined household income up to $229,280 and still receive full to partial OAS benefits.

ii) OAS clawback

Another issue not included in the reform or even discussed was the clawing back of the OAS benefit. The clawback is technically referred to as the Old Age Security Recovery Tax. As noted above, the OAS Recovery Tax is applied to individual senior income above $70,954 (2013) at a rate of 15 percent.

The 15 percent clawback rate applied to OAS benefits has to be understood in the broader context of marginal tax rates. Simply put, when Canadian seniors are making economic decisions such as whether or not to work part-time (or even full-time) or perhaps to invest in a business, they will consider not only their marginal personal income tax rates but also the OAS clawback. In other words, seniors will not only pay their marginal personal income tax rates but will also lose an additional 15 percent of extra earnings through the further clawing back of OAS benefits.

Effective marginal tax rates for seniors with income of $75,000 ranges from a low of 47 percent in Alberta to 54.4 percent in Manitoba. This means that in six of the ten provinces a senior who chooses to work additional hours at this particular level of income will face a marginal tax rate in excess of 50 percent. Most Canadians would agree that such punitive marginal tax rates impose a real barrier for seniors remaining active in the labour market. At a time when more and more businesses are complaining about labour shortages, it seems more than counter-productive to impose such high tax rates on seniors.

The next step in reforming OAS

While a number of challenges remain in reforming Canada's retirement income system to better reflect the demographic changes underway and the preferences of Canadians, the immediate next step available to government is to better prioritize the use of OAS resources.

Changing the point at which OAS benefits begin to be clawed back as well as the threshold at which the benefits are entirely clawed back would free up resources that could be used for a number of alternative purposes.

There are a number of options for changing the clawback thresholds for OAS. This paper relies on an approach that integrates the threshold for OAS with the income thresholds used for the Canada Pension Plan (CPP). The maximum earnings upon which the CPP payroll tax is levied is $51,100 (2013). This threshold provides the starting point ($51,100) at which OAS benefits would be clawed back; down from nearly $71,000 under current rules.

A starting point of $51,100 for clawing back OAS benefits would result in the full elimination of OAS benefits at $94,787 rather than nearly $115,000 under current guidelines (2013), assuming the current clawback rate of 15 percent. The change in the threshold for OAS benefits results in a calculated annual savings for 2013 of approximately $730.4 million. This estimated savings would materially increase as the senior population increases over the next three decades.

An important second reform is also recommended. The federal government should consider reducing the clawback rate in order to reduce the effective marginal tax rates incurred by seniors. Such a change would, however, consume some of the savings generated from the first reform. The exact portion of the savings used for this reform would depend on the revised clawback rate.

How best to use the savings—Other potential reforms to consider

There are a number of additional reforms that should also be considered, which could be at least partially financed by the savings from less OAS spending. The paper provides a brief discussion of several options for consideration.

(i) Augmenting the Guaranteed Income Supplement (GIS)

There are a number of possible ways by which to augment GIS with savings generated from changing the clawback income levels for OAS benefits. There are two changes that should be considered.

The first is to ensure that low-income seniors who rely on GIS are not displaced by the changes to the age of eligibility announced in 2012. The federal government has indicated it will compensate the provinces for transitional costs but has yet to provide details regarding how this will be achieved.

The second priority for savings from OAS changes is a re-examination of the level of GIS benefits provided to single seniors. There has been a concern expressed by many observers that the benefits allocated to single seniors in GIS are insufficient. It's clear that single seniors lack the type of economies of scale that senior couples enjoy. Additional research and investigation into the adequacy of GIS benefits for single seniors is recommended.

(ii) Increasing private savings options and eliminating the tax bias in tax deferred accounts

Some portion of the savings from changing the income thresholds for OAS eligibility could also be used to both increase the ability of Canadians to save for their own retirement and eliminate a tax distortion currently present in tax deferred accounts such as Registered Retirement Savings Plans (RRSPs).

Simply put, some portion of the savings could be used to increase the limits for deferred tax accounts like RRSPs and registered pensions. Additionally, the limit for tax free savings accounts, which are not tax deferred, could also be increased to provide Canadians with greater choices regarding the mix of their savings.

In addition, some savings from the change in the OAS threshold for benefits could be used to deal with a little known tax bias against tax deferred retirement accounts. Currently, contributions to registered retirement accounts like RRSPs are deducted from one's income for the purposes of income taxes, which mean the contributions are made with pre-tax dollars. All withdrawals from such accounts are taxed using personal income tax rates. This means, however, that contributors ultimately pay personal income taxes on all withdrawals from the account, which means they forego the preferential tax rates available for capital gains, eligible dividends, etc. Reforms are needed to standardize the tax treatment of these gains within tax deferred accounts.

Conclusion

While the federal government should be applauded for its willingness to tackle a sensitive and controversial issue, the changes made to OAS are a first step in what needs to be a much larger process.

Introduction

In January 2012, Prime Minister Stephen Harper announced "major transformations" to Canada's Old Age Security (OAS) program in a speech in Davos, Switzerland before the World Economic Forum.[1] This rather unexpected announcement was followed up with action in the 2012 federal budget.[2] Federal Minister of Finance Jim Flaherty announced an increase in the age of eligibility for OAS as well as related reforms as part of the 2012 budget.[3] While the increase in the age of eligibility is a positive first step in reforming programs for seniors in the face of historic demographic change, it is only a first step. Additional reforms are required to protect gains made in eliminating poverty for seniors, permitting workers to adequately save for their own retirement, and achieving balance between seniors dependent on public programs for income and those providing the resources (i.e., taxes) for such support.

This paper begins with a brief overview of the three main public programs designed to provide Canadian seniors with income during their retirement. The second section examines the "sustainability" of OAS and related seniors programs, as well as the arguments both for and against the then-proposed increases in the age of eligibility for the OAS benefit. The third part of the paper looks at aspects of the OAS and other programs that were not reformed with particular attention paid to the status quo regarding eligibility for OAS and the OAS Recovery Tax, more commonly referred to as the OAS clawback. In addition, some of the concerns regarding how the change in the age of eligibility in OAS will interact with other federal and provincial programs are briefly discussed. Finally, section four outlines additional reforms that should be considered with respect to income transfer programs for seniors, the potential savings from such reforms, and how best to use such savings to improve Canada's retirement income system.

1 See, for example, Kennedy and Press (2012, January 26).

2 Canada, Ministry of Finance (2012). Changes to OAS are presented in Chapter 4: Sustainable Social Programs and a Secure Retirement (see: http://www.budget.gc.ca/2012/plan/toc-tdm-eng.html).

3 See Service Canada (2013a) for summary information regarding the changes to OAS.

1) Public retirement benefits in Canada: A primer

(i) Old Age Security

There are three principal public programs in Canada aimed at providing income to seniors. The first program, Old Age Security (OAS),[4] is a general monthly benefit paid to all eligible seniors on an individual basis (not as a household) regardless of previous work experience. In other words, OAS is not tied to employment earnings. The average monthly benefit as of January 2013 was $515 while the maximum benefit in 2013 is $546.[5] The maximum annual benefit available for OAS is $6,553. OAS benefits are paid out of general government revenues.

According to the latest actuarial report of Old Age Security (2012) by Canada's Chief Actuary, 5.3 million Canadians will receive OAS benefits in 2013, representing roughly $33.1 billion in federal expenditures. Figures 1a and b illustrate the actuarial projections for increases in the number of OAS beneficiaries and expenditures starting in 2013 through to 2040.[6] Canada's

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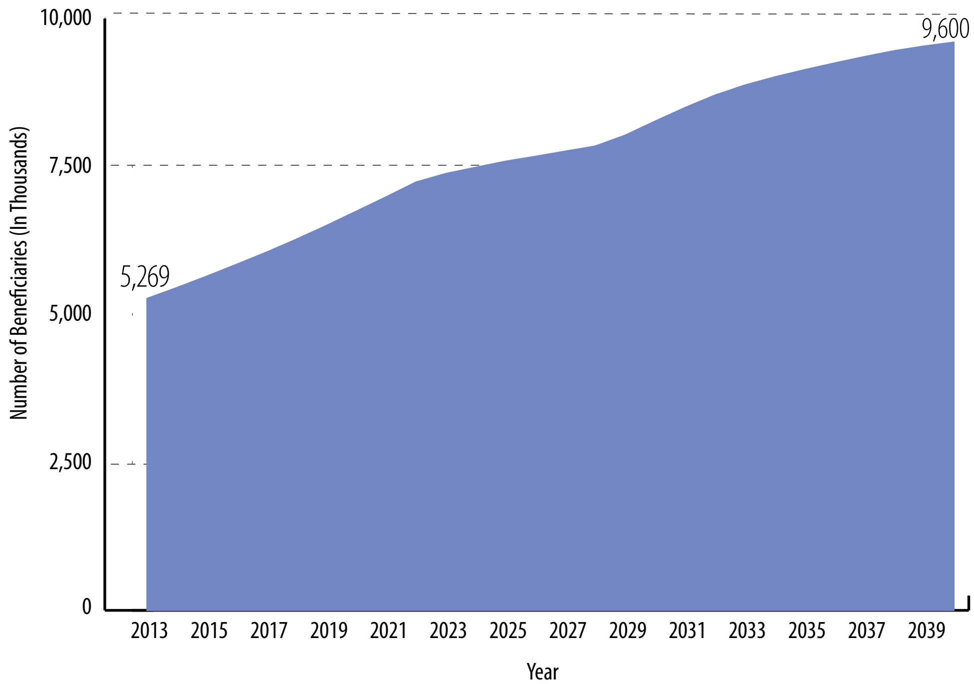
4 See Service Canada, 2013b for a general portal with information about OAS and related programs, including eligibility.

5 These benefit rates apply up to June 2013. For a schedule of payment rates for OAS and GIS for 2012 see Service Canada (2013c). Please note that these rates were provided before the July calculations for 2013.

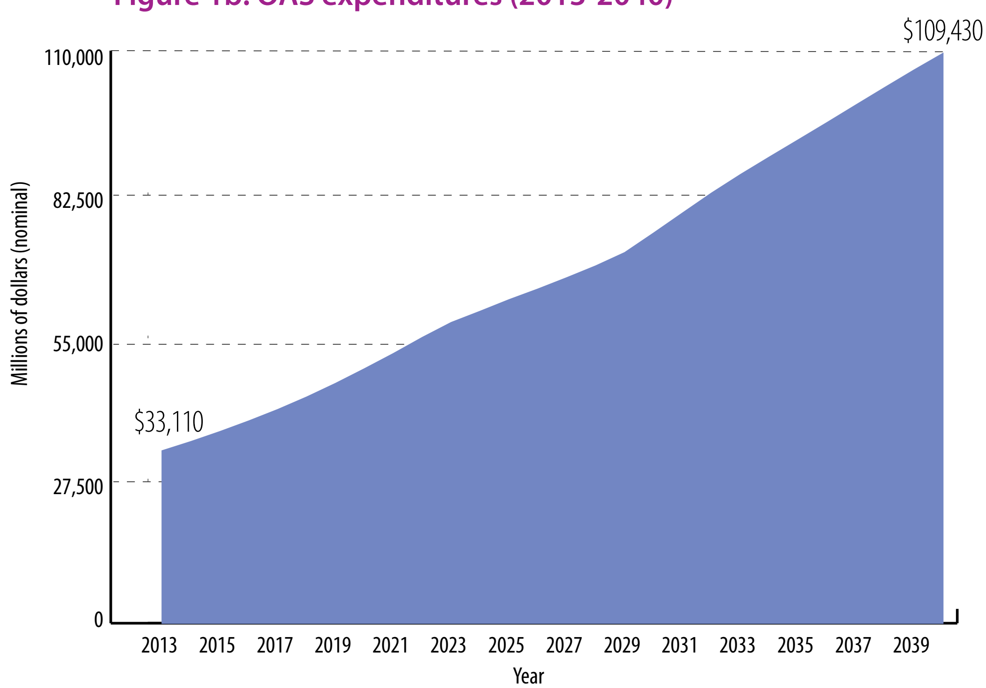
6 The Actuarial Report includes projections to 2050. The estimates for 2040 to 2050 are less detailed than those for the preceding years. This paper focuses on the immediate thirty year estimates while acknowledging that such projections are highly sensitive to the

Figure 1a: Number of OAS beneficiaries (2013-2040)



Note: Expenditures on OAS exclude Administrative expenses.
Source: Office of the Superintendent of Financial Institutions (2012). Actuarial Report (11th): Supplementing the Actuarial Report on the Old Age Security Program. As at 31 December, 2009. Tables 11 and 12. (Issued to the Minister of Human Resources and Skills Development Canada on July 18, 2012). Ottawa, ON: OSFI. Available at http://www.osfi-bsif.gc.ca/app/DocRepository/1/eng/reports/oca/OAS11_e.pdf.

Figure 1b: OAS expenditures (2013-2040)



Note: Expenditures on OAS exclude Administrative expenses.
Source: Office of the Superintendent of Financial Institutions (2012). Actuarial Report (11th): Supplementing the Actuarial Report on the Old Age Security Program. As at 31 December, 2009. Tables 11 and 12. (Issued to the Minister of Human Resources and Skills Development Canada on July 18, 2012). Ottawa, ON: OSFI. Available at http://www.osfi-bsif.gc.ca/app/DocRepository/1/eng/reports/oca/OAS11_e.pdf.

Chief Actuary expects the number of OAS beneficiaries to increase from 5.3 million in 2013 to 9.6 million in 2040, an increase of 82.2 percent. Similarly, the Actuarial Report estimates that spending on OAS will increase from $33.1 billion in 2013 to $109.4 billion in 2040, a nominal increase of 230.5 percent.[7]

(ii) Guaranteed Income Supplement

A critical seniors program linked to OAS is the Guaranteed Income Supplement (GIS). The GIS is paid to low-income seniors whose income is below $16,512. The average monthly benefit for single seniors as of June 2013 was $501 while the maximum benefit payable was $740.[8] Like OAS, GIS is paid out of general government revenues.

Figures 2a and b illustrate comparable data to figures 1a and b for GIS.[9] According to the Chief Actuary, the number of seniors receiving GIS is estimated to increase from 1.9 million in 2013 to 3.4 million in 2040, an increase of 79.7 percent (Office of the Superintendent of Financial Institutions, 2012). The increase in the number of seniors receiving GIS is less than the increase in the number of seniors receiving OAS, which is a positive sign that less

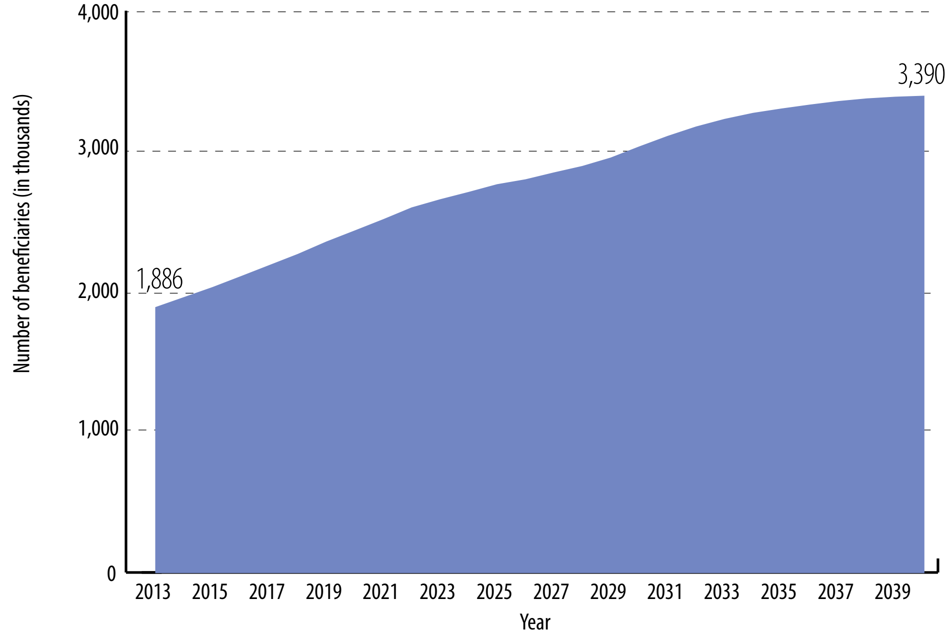
underlying assumptions upon which they are based. Any deviations from the assumptions on GDP growth, population, labour force participation, inflation, interest rates, and income growth will have a material impact on the accuracy of the projections. For instance, the Actuarial Report assumes an inflation rate of 2.0 percent until 2016. Beginning in 2017, the rate is assumed to uniformly increase until it reaches 2.3 percent in 2019. The report also assumes that the main drivers of population growth, fertility and mortality rates, will continue to decline. For more information about the future demographic and economic assumptions used in the Actuarial Report and presented throughout this study, see Office of the Superintendent of Financial Institutions, 2011a, Appendix C.

7 Part 4 of Bill C-38, an Act to implement certain provisions of the budget tabled in Parliament on March 29, 2012 and other measures, amended the Old Age Security Act to gradually increase the age of eligibility for the basic OAS pension and GIS benefits from 65 to 67, commencing April 1, 2023 with full implementation by January 2029 (Canada, Bill C-38). Additionally, the reforms allow individuals the option to defer OAS pension benefits for up to five years, starting July 1, 2013. As a result of these changes, projected total program expenditures are $32 million and $102 million lower in 2013 and 2022, respectively. Meanwhile between 2023 and 2030, the projected total program expenditure will be reduced by $526 million (in 2023) and $10.8 billion (in 2030) as compared if the reform were not implemented. Similarly, by 2030, the projected number of OAS and GIS beneficiaries are about 1 million and 230,000 lower, respectively. See Office of the Superintendent of Financial Institutions, 2012.

8 For a schedule of payment rates for OAS and GIS, see Service Canada, 2013c.

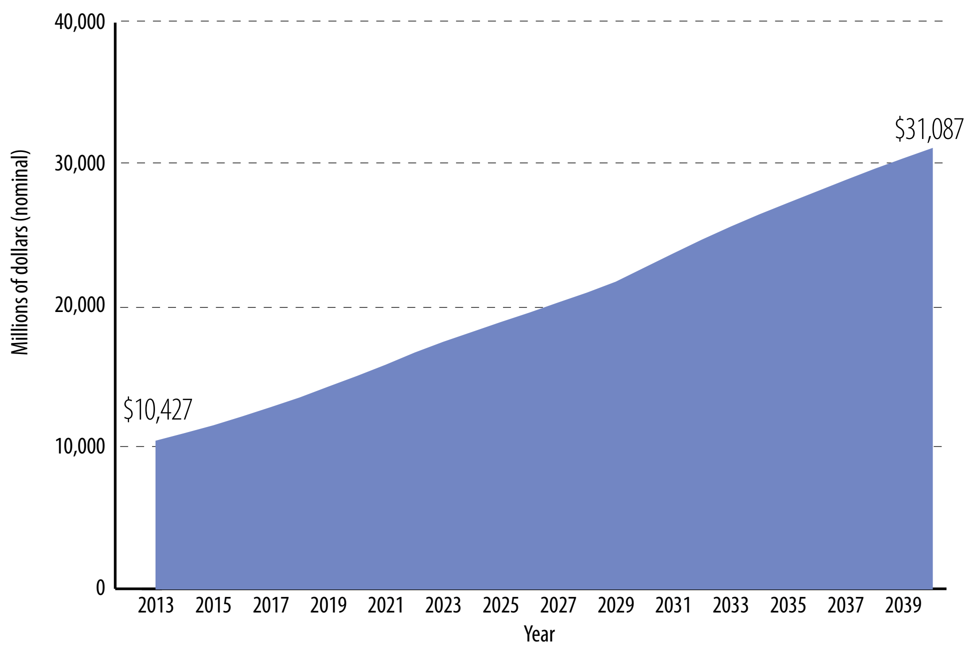
9 The expenditure data presented in figures 2a and b includes spending on the Allowance benefit.

Figure 2a: Number of GIS beneficiaries (2013-2040)



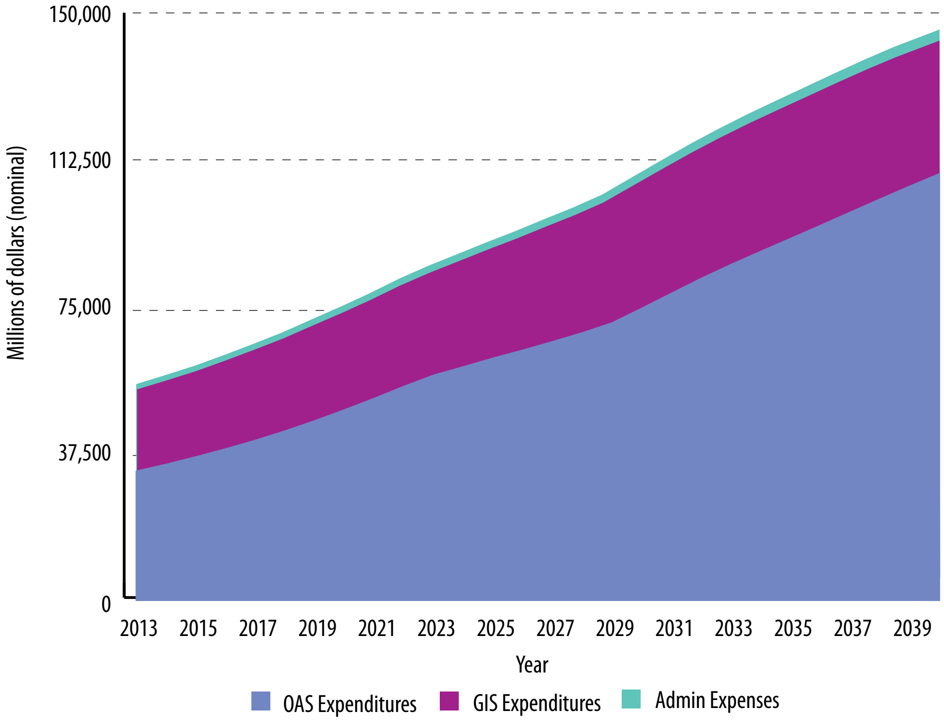
Notes: Expenditures on GIS exclude Administrative expenses. Expenditures on GIS includes spending on Allowances.
Source: Office of the Superintendent of Financial Institutions (2012). Actuarial Report (11th): Supplementing the Actuarial Report on the Old Age Security Program. As at 31 December, 2009. Tables 11 and 12. (Issued to the Minister of Human Resources and Skills Development Canada on July 18, 2012). Ottawa, ON: OSFI. Available at http://www.osfi-bsif.gc.ca/app/DocRepository/1/eng/reports/oca/OAS11_e.pdf.

Figure 2b: GIS expenditures (2013-2040)



Notes: Expenditures on GIS exclude Administrative expenses. Expenditures on GIS includes spending on Allowances.
Source: Office of the Superintendent of Financial Institutions (2012). Actuarial Report (11th): Supplementing the Actuarial Report on the Old Age Security Program. As at 31 December, 2009. Tables 11 and 12. (Issued to the Minister of Human Resources and Skills Development Canada on July 18, 2012). Ottawa, ON: OSFI. Available at http://www.osfi-bsif.gc.ca/app/DocRepository/1/eng/reports/oca/OAS11_e.pdf.

Figure 3: OAS, GIS, and administrative spending (2013-2040)



Notes: Expenditures on GIS exclude Administrative expenses. Expenditures on GIS includes spending on Allowances.
Source: Office of the Superintendent of Financial Institutions (2012). Actuarial Report (11th): Supplementing the Actuarial Report on the Old Age Security Program. As at 31 December, 2009. Tables 11 and 12. (Issued to the Minister of Human Resources and Skills Development Canada on July 18, 2012). Ottawa, ON: OSFI. Available at http://www.osfi-bsif.gc.ca/app/DocRepository/1/eng/reports/oca/OAS11_e.pdf.

numbers of seniors will be experiencing low levels of income, a qualifying condition for receipt of GIS.[10] Total spending on GIS is expected to increase from $10.4 billion in 2013 to $31.1 billion in 2040, an increase of 198.1 percent (Office of the Superintendent of Financial Institutions, 2012). Again, the increase in spending related to GIS is less than the expected increase in spending for OAS.

Figure 3 illustrates the combined nominal expected spending on OAS and GIS as well as administrative costs as calculated by the Chief Actuary between 2013 and 2040. Total spending is expected to increase from $43.7 billion in 2013 to $141.0 billion in 2040 (Office of the Superintendent of Financial Institutions, 2012). This represents a nominal increase of 222.8 percent. As depicted in figure 3, OAS will continue to dominate total spending on

10 According to the assumptions presented in the Actuarial Report, OAS recipient rates are expected to increase gradually from 98.1 percent in 2010 to 99.0 percent by 2025, and to 99.7 percent by 2050. Meanwhile, GIS recipient rates are expected to increase from 33.6 in 2010 to 35.1 percent by 2025, but decrease to 31.6 percent by 2050 (Office of the Superintendent of Financial Institutions, 2011a: 13, table 1).

seniors' programs, representing between 75 and 78 percent of total spending throughout the period 2013 to 2040.

OAS and GIS[11] combined compose the Elderly Benefits expenditures in the federal budget. In 2011-12, the most recent fiscal year[12] for which confirmed financial data is available, Elderly Benefits totalled $38.0 billion, representing 15.6 percent of total government program spending (Canada, Ministry of Finance, 2013: table 4.2.6). Budget 2013 forecasted spending on Elderly Benefits to increase to $51.8 billion by 2017-18, an increase of 36.3 percent in just six years. As a share of program spending, Elderly Benefits are expected to increase to 18.6 percent of total program spending by 2017-18. Indeed, the Chief Actuary expects total spending on Elderly Benefits to reach 23 percent of total federal program spending by 2030.[13] In other words, by 2030 nearly one-in-four dollars of federal program spending will be consumed by the Elderly Benefits program.

Another way by which to gauge the increase in OAS and related spending is by comparing nominal spending with the size of the economy (GDP). Figure 4 illustrates the data presented in figure 3 as a share of the economy. Total spending on OAS is expected to increase rather steadily from 2.47 percent of GDP in 2013 to 2.84 percent of GDP in 2030. It then declines to 2.72 percent by 2040. The Chief Actuary expects it to continue to decline to 2050, when it reaches 2.41 percent of GDP (Office of the Superintendent of Financial Institutions, 2012).

(iii) Canada and Quebec Pension Plans

The final major public program aimed at providing seniors with income in retirement is the Canada Pension Plan (CPP)[14] and its counterpart in Quebec, the Quebec Pension Plan (QPP).[15] Unlike both OAS and GIS, benefits from the CPP (and QPP) are based on employment. Both programs are financed by payroll taxes and contributions are segregated from general government

11 In addition to the OAS and GIS benefits, there are also Allowances and top-ups provided by the federal government. For information on these programs please see Service Canada, 2013c.

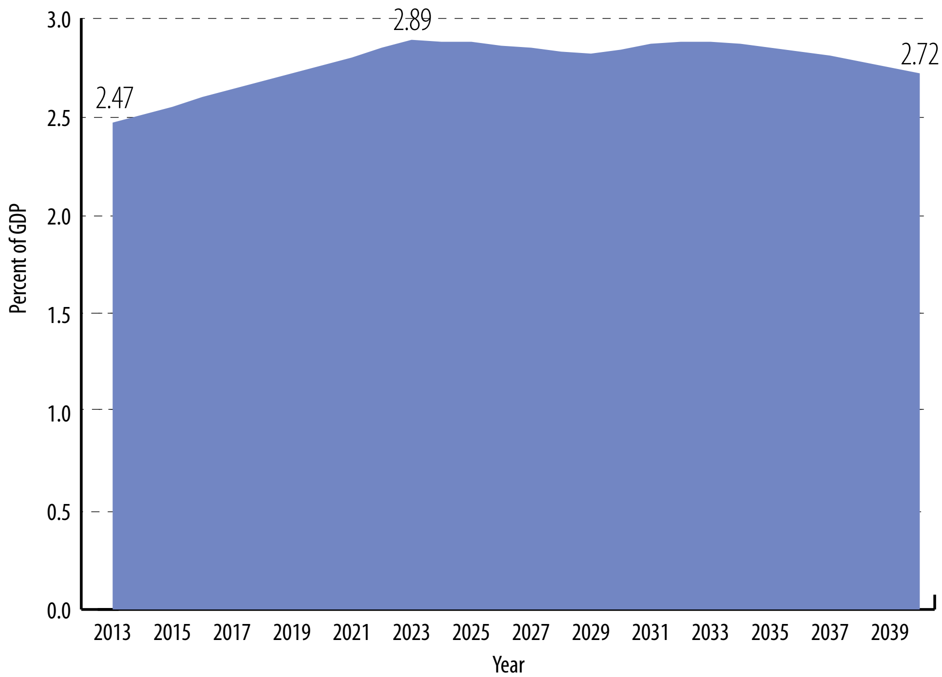
12 Note that the fiscal year used by the Actuary corresponds to a calendar year while the fiscal year for the federal government runs from April to March, which can result in slight reporting differences due to timing.

13 Calculations done by the authors based on Office of the Superintendent of Financial Institutions, 2012, and Canada, Ministry of Finance, 2012: table 6.6.

14 Service Canada maintains a general portal with information about the CPP at http://www.servicecanada.gc.ca/eng/isp/cpp/cpptoc.shtml.

15 In addition to the main benefit based on contributions from employment earnings, the CPP also includes disability benefits, survivor benefits, and a death benefit. For further information please see http://www.servicecanada.gc.ca/eng/isp/pub/factsheets/rates.shtml.

Figure 4: Total OAS spending as a share of GDP (2013-2040)



Note: OAS spending includes OAS, GIS, Allowance, and administrative costs.
Source: Office of the Superintendent of Financial Institutions (2012). Actuarial Report (11th): Supplementing the Actuarial Report on the Old Age Security Program. As at 31 December, 2009. Tables 13. (Issued to the Minister of Human Resources and Skills Development Canada on July 18, 2012). Ottawa, ON: OSFI. Available at http://www.osfi-bsif.gc.ca/app/DocRepository/1/eng/reports/oca/OAS11_e.pdf.

revenues. The average monthly benefit for CPP as of January 2013 was $535 while the maximum monthly benefit was $1,013.[16]

The combination of the OAS and CPP (QPP in Quebec) is designed to replace 40 percent of the Average Industrial Wage. The target rate will vary depending on the level of income and particular circumstances of the senior. For example, these programs will constitute a proportionately smaller share of income for upper-income Canadians than for lower-income seniors, particularly for those eligible for the GIS.

16 Information on benefit rates for the CPP is available at Service Canada, 2013e.

2) Understanding "sustainability"

Much was made and continues to be made about the sustainability of OAS and related programs targeted at seniors. The federal government used sustainability as one of the rationales for introducing the change in age of eligibility. Unfortunately, the government did not define what it meant by sustainability. This vagueness led to a number of reports and commentaries arguing for and against the sustainability of OAS.

The federal government's Budget 2012, for example, included statistics on the declining ratio of workers-to-retirees as well as continuing increases in life expectancy, which increase the lifetime benefit costs for programs like OAS as reasons to justify the proposed changes in OAS age eligibility.

A number of the major banks in Canada commented on the change as part of their evaluations of the 2012 budget. For example, TD Bank Economics commented on the proposed (now confirmed) increase in the age of eligibility for OAS in its analysis of the federal budget:

> In addition to being fiscally prudent in the medium-term, the government is taking action to pursue fiscally sound policies for the long run. The increase in the qualifying age for Old Age Security, the new normal age for retirement among public sector workers and reforms to public sector pensions are good examples of this (TD Economics, 2012).

A major report by noted McGill economist Christopher Ragan suggested that government finances are not sustainable given current policy and anticipated demographic change (Ragan, 2011 and March, 2012). Specifically, the Ragan paper calculated that the status quo policies of 2011, when projected forward, would result in an all-government deficit of 4.2 percent of GDP, representing about $67 billion in 2011 dollars. The deficit was driven largely by the combination of lower rates of economic growth coupled with spending pressures from an aging society, largely in the form of higher spending on health care and benefits for seniors. The result, according to the analysis, would have to be spending cuts, tax increases, increased borrowing, or some combination of the three.[17]

There are also reports arguing that the expected increases in OAS spending are sustainable. For example, the Parliamentary Budget Office (PBO) published a report, which analyzed the overall sustainability of the federal budget, which commented on OAS sustainability:

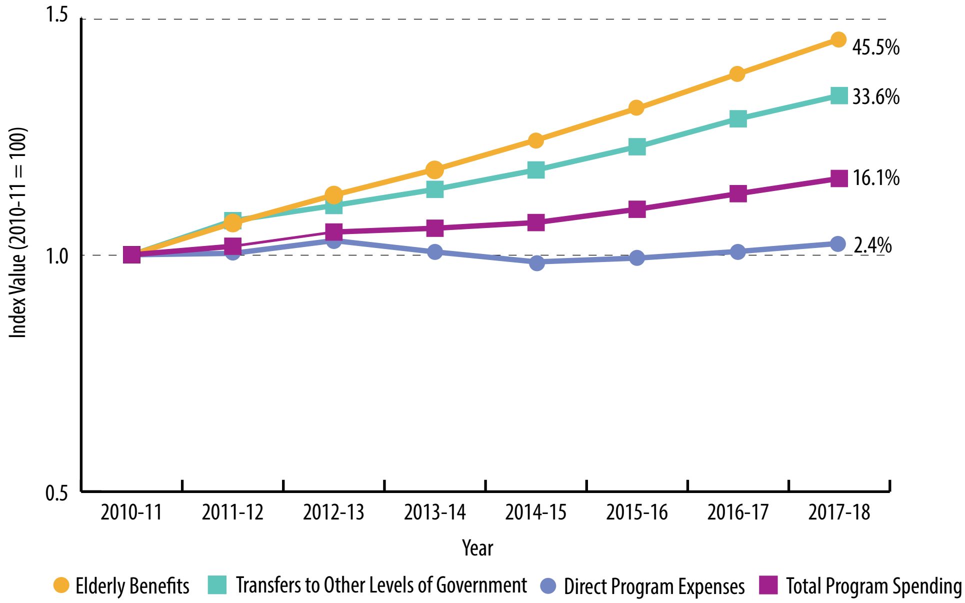
> Following the renewal of the federal CHT [Canada Health Transfer] on December 19, 2011, PBO updated the analysis presented in its September 2011 Fiscal Sustainability Report. The updated analysis indicated that as a result of the change to the CHT (to grow in line with nominal GDP beyond 2016-17 at around 4 percent annually instead of the current 6 percent) the federal fiscal structure was sustainable and had sufficient room to absorb the cost pressures arising from the Old Age Security (OAS) program…While there may be other policy rationales for changing the OAS program, PBO's analysis indicates that the program itself is financially sustainable over the long term within the Government's current fiscal structure, given projected demographic and economic trends (Canada, Parliamentary Budget Office, 2012)

There are clearly conflicting views with respect to the sustainability of OAS and related spending. However, a key problem is that very few, if any, of the reports defined sustainability. The traditional approach to determining sustainability entails measuring whether the current set of policies provide reasonable and adequate resources for the program to continue with current benefit levels and eligibility rules. In other words, can the current program benefits be paid for now and in the future with current and expected resources without change?

Assuming one accepts this traditional test of sustainability, data already presented from the Chief Actuary and the federal budget indicate that OAS and its related programs are not sustainable. The key to understanding the unsustainability of OAS within the current framework is that it will consume a larger share of federal resources in the future. This means that other spending will need to be reduced, taxes will need to be raised, or deficits incurred to finance the increase in spending.

17 The study by Professor Christopher Ragan outlining the coming fiscal challenges due to demographic change and lower rates of economic growth did not include specific recommendations. However, the Macdonald-Laurier Institute published a subsequent series of essays by leading Canadian thinkers on ways to deal with the coming demographic deficit (see Crowley and Clemens, 2012).

Figure 5: Index of comparative growth in select spending (2010-11 = 100)



Sources: Government of Canada, Ministry of Finance (2012). Budget 2012: Jobs, Growth, and Long-Term Prosperity. Table 6.6. Ottawa, ON: Ministry of Finance. Available at http://www.budget.gc.ca/2012/plan/toc-tdm-eng.html; calculations by the authors. Government of Canada, Ministry of Finance (2013). Budget 2013: Jobs, Growth, and Long-Term Prosperity. Table 4.2.6. Ottawa, ON: Ministry of Finance. Available at http://www.budget.gc.ca/2013/doc/plan/budget2013-eng.pdf; calculations by the authors.

There are several ways by which to assess the potential for OAS expenditures to crowd out other federal program spending. One approach is to simply calculate the share of total spending represented by OAS, which was discussed previously.

A second approach to understanding the proportional spending expected for OAS and GIS (Elderly Benefit) is by examining growth rates in different types of spending. Figure 5 illustrates the growth in different types of federal spending between 2010-11 and 2017-18, using 2010-11 as a base year. Spending on the Elderly Benefit (which includes both OAS and GIS) will increase by 45.5 percent between 2010-11 and 2017-18. In comparison, total program spending by the federal government, which includes OAS, is expected to grow 16.1 percent over this period (Canada, Ministry of Finance, 2012: table 6.6; calculations by authors). Direct departmental spending by the federal government is expected to increase marginally by 2.4 percent. Increases in OAS and GIS spending along with increases in transfers to other levels of government (33.6 percent increase) will consume ever larger shares of federal program spending while direct departmental spending by the federal government will represent less proportional spending over time.

A final method by which to assess spending is to examine the share of the economy consumed by OAS and GIS, which is illustrated in figure 4. The data presented in figure 4 from the actuarial report indicates that OAS and related spending will increase from 2.47 percent of GDP in 2013 to a peak of 2.89 percent in 2023 (Office of the Superintendent of Financial Institutions, 2012).

Opponents of the change in the age of eligibility for OAS indicated that a less than 1.0 percentage-point increase in the cost of OAS as a share of GDP is more than manageable.[18] The implication of such an argument is that the government should simply operate in deficit for an extended period of time to absorb the cost increase. The danger of this type of approach is well documented in the Ragan study previously referred to in this paper. One of many tangible risks is that the underlying assumptions regarding the cost and available revenues could turn out to be overly optimistic and deficits are larger than expected, which results in a larger accumulation of debt and accordant interest costs. This is a higher risk approach to financing costs associated with the baby-boomers and an aging society. More importantly, for the discussion of sustainability, such an approach implicitly accepts the fact that expected resources will not be sufficient in the future to finance status quo benefits since deficit-financing is required. In other words, such an argument accepts the fact that expected resources are insufficient to finance expected benefits, which is the core test of sustainability.

Adopting a principle that governments should basically operate in balance over the business cycle means that the increases in OAS and related programs, which everyone agrees are forthcoming, will have to be financed by either higher taxes or less spending in other areas. Indeed, to some extent we are already seeing the effects of this crowding out. For example, the federal government reduced spending in a number of program areas in the most recent budget even though overall spending increased (figure 5). Increases in transfers to individuals and provinces overwhelmed the decreases in departmental spending resulting in the overall increase. For those implicitly calling for other spending reductions or tax increases in order to finance increasing expenditures on seniors, it is imperative that they specify what other spending would be cut or taxes increased to finance these expenditures.

18 For example, in a presentation to the Senate Committee on National Finance on June 7, 2012, CAW economist Jim Stanford indicated that "between now and then, the impact of the aging of society on OAS expenditures is modest. The projections in the Chief Actuary's report suggest an increase in expenditures equal to 0.6 percent of our GDP versus the levels of that program today, and then the expense of the program relative to GDP begins to decline after that point, sometime in the early 2030s. The federal government's fiscal capacity to manage that temporary and modest bulge in expenses associated with this program is more than adequate. Canada's federal debt as a share of GDP today is low, both historically and internationally" (Canada, Senate Committee).

3) OAS reforms: A summary

The most prominent reform announced in the 2012 Budget concerning OAS (and thus GIS) is an increase in the age of eligibility to receive full OAS benefits. The announced changes will not affect anyone born before March 1958.[19] Specifically, the age of eligibility will be increased to 67 years of age from its current level of 65 years of age starting in 2023, with the change fully implemented by January 2029.[20]

It is worth noting the modest nature of the two year increase in the age of eligibility. Consider that every year that life expectancy increases, the total benefits paid under seniors programs also increase but without any specific action on the part of the government. In other words, these benefit increases occur automatically as a function of increases in life expectancy. If, however, the government had indexed the age of eligibility to life expectancy, in say 1966 when the CPP was introduced, the age of eligibility today for OAS would be 74 years of age (calculations by authors).

Alternatively, assume that in 1980, when it became clear that increases in life expectancy would affect the future viability of seniors' programs, the government made a decision to maintain 10 years of benefits for seniors' programs based on life expectancy in 1980. That would mean an age of eligibility today of roughly 70 years of age (calculations by authors). An increase from 65 to 67 looks modest when compared to the adjustments that would have occurred had the age of eligibility been linked or indexed to life expectancy.

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19 For a detailed table containing the affects for those born between 1958 and 1962 please see *A Strong Retirement Income System for Canadians* at Canada, Ministry of Finance (2012): chapter 4 (http://www.budget.gc.ca/2012/plan/chap4-eng.html#a6).

20 A number of industrialized countries, including Australia, Germany, Ireland, Italy, Japan, the Netherlands, Spain, the United Kingdom, and the United States enacted similar changes to increase the age of eligibility for public retirement income programs.

One important aspect of the announced reforms, which has not received much attention, is the ability, which began in January 2013, to defer OAS benefits for up to five years and receive an actuarially-adjusted benefit afterwards. The deferral option is voluntary and similar to the deferrals permitted for CPP benefits.[21]

What wasn't included?

Two key issues related to OAS remained untouched and thus unchanged: (1) eligibility for OAS benefits and (2) the OAS clawback.

i) Eligibility

Currently, eligible individual seniors whose income is less than or equal to $70,954 receive the full OAS benefit (2013 income tax year). Income earned beyond this level results in a reduction of OAS benefits at a rate of 15 percent. This means that individual seniors earning income up to $114,640 receive partial OAS benefits. Seniors with income above this level receive no OAS benefits.[22]

It is important to understand that OAS benefits are calculated on an individual basis. This means that two seniors living together can have a household income up to $141,908 (2013) and still qualify for full OAS benefits.[23] Put differently, senior couples can earn combined household income up to $229,280 and still receive full to partial OAS benefits.[24]

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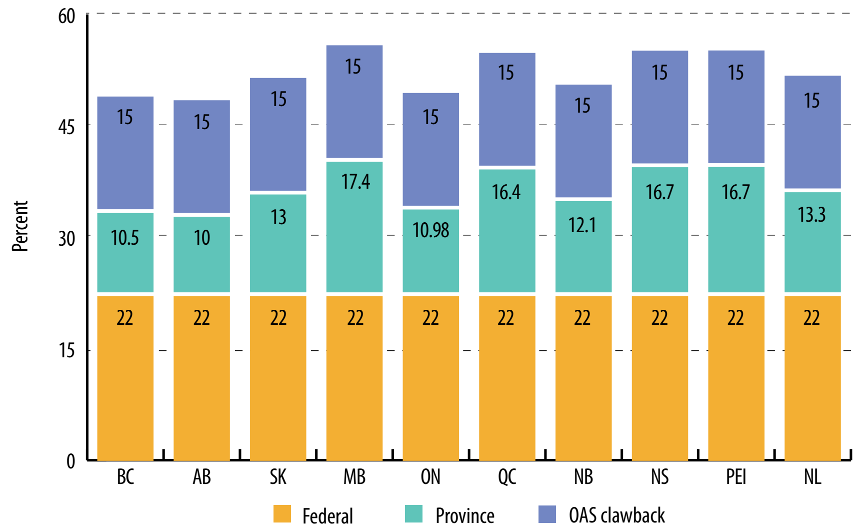
21 For more information about the voluntary deferral of the Old Age Security pension, see Service Canada (2013f).

22 Service Canada, 2013g (http://www.servicecanada.gc.ca/eng/isp/pub/factsheets/oastax.shtml) has details regarding the Old Age Security Recovery Tax, which is the mechanism by which OAS benefits are clawed back.

23 Professor Chris Sarlo uses an adult equivalent transformation dividing the household's total (after-tax) income by the square root of household size. The square root rule is one of the most common equivalency scales. It is designed to account for economies of scale in living together (e.g., four people do not need four times the income of one person to have the same living standard as that one person). For instance, equivalency scales assume that two people living together need 1.4 times the level of income of a single person to support the same standard of living (Sarlo, 2009).

24 In addition, seniors have a number of tax planning strategies available to them to enable them to plan their income so as to maintain OAS benefit eligibility. For example, seniors below age 71 who have room in their RRSP plans can make contributions equal to their OAS benefits, which lowers their taxable income sufficiently to remain eligible for OAS benefits.

Figure 6: Marginal tax rates by province including the OAS clawback (2012)



Sources: Federal and provincial budgets (2012); Service Canada Guidelines on the OAS Recovery Tax (2013); calculations by the authors.

ii) OAS clawback

Another issue not included in the reform or even discussed was the clawing back of the OAS benefit.[25] The clawback is technically referred to as the Old Age Security Recovery Tax. As noted above, the OAS Recovery Tax is applied to individual senior income above $70,954 (2013) at a rate of 15 percent.

The 15 percent clawback rate applied to OAS benefits has to be understood in the broader context of marginal tax rates.[26] Figure 6 illustrates the marginal tax rates faced by seniors in Canada with income of $75,000 for the 2012 tax year. Simply put, when Canadian seniors are making economic decisions such as whether or not to work part-time (or even full-time) or perhaps to invest in a business, they will consider not only their marginal personal income tax rates but also the OAS clawback. It's not just that seniors will pay their marginal personal income tax rate but that they will lose an additional 15 percent of extra earnings through the further clawing back of OAS benefits.

In practice, and as illustrated in Figure 6, this means effective marginal tax rates for seniors range from a low of 47 percent in Alberta to 54.4 percent in Manitoba when the OAS clawback is added to the marginal personal income tax rates in effect at $75,000 in income. Put differently, in six of the ten provinces, a senior who chooses to work additional hours at this

25 For information on the OAS clawback, see Service Canada, 2013g (http://www.servicecanada.gc.ca/eng/isp/pub/factsheets/oastax.shtml).

26 For a thorough review of the economics of marginal tax rates, see Murphy, Clemens, and Veldhuis (forthcoming).

particular level of income will face a marginal tax rate in excess of 50 percent. Most Canadians would agree that such punitive marginal tax rates impose a real barrier for seniors remaining active in the labour market. At a time when more and more businesses are complaining about labour shortages, it seems more than counter-productive to impose such high tax rates on seniors.

Ambiguities remain

Finally, there are a number of ambiguities that exist with respect to the changes made to the age of eligibility for OAS and GIS. For example, the federal government indicated that it will compensate the provinces for costs associated with transitioning the GIS, which targets low-income seniors for benefits. However, the mechanism for compensating the provinces and the calculation determining costs remain ambiguous. Indeed, there is a likelihood that there will be no net savings from the changes implemented by the federal government for seniors receiving GIS if the provinces simply fill the void. In other words, if the provinces introduce programs to provide seniors with proximate OAS and GIS benefits from age 65 to 67 then the reforms have simply shifted the costs from one level of government to another.

In addition, how the change in eligibility will interact with other public programs like CPP, provincial programs, private savings, and federal and provincial regulations covering savings and pensions is still unclear. These details are yet to be finalized or, in some cases, have not even been discussed. The effectiveness of the Canadian retirement income system is dependent on the interactions of these various programs and regulations. It is essential that they are adequately and thoughtfully coordinated.

4) The next step in reforming OAS

While a number of challenges remain in reforming Canada's retirement income system to better reflect the demographic changes underway and the preferences of Canadians, the immediate next step available to government is to better prioritize the use of OAS resources. Recall that OAS is paid from general revenues. Currently individuals are eligible to receive full OAS benefits on income up to almost $71,000 per year and benefits are not fully clawed back until annual income reaches nearly $115,000. Further, OAS benefits are calculated on an individual basis, which means senior households can have double this level of income and receive full or partial benefits.

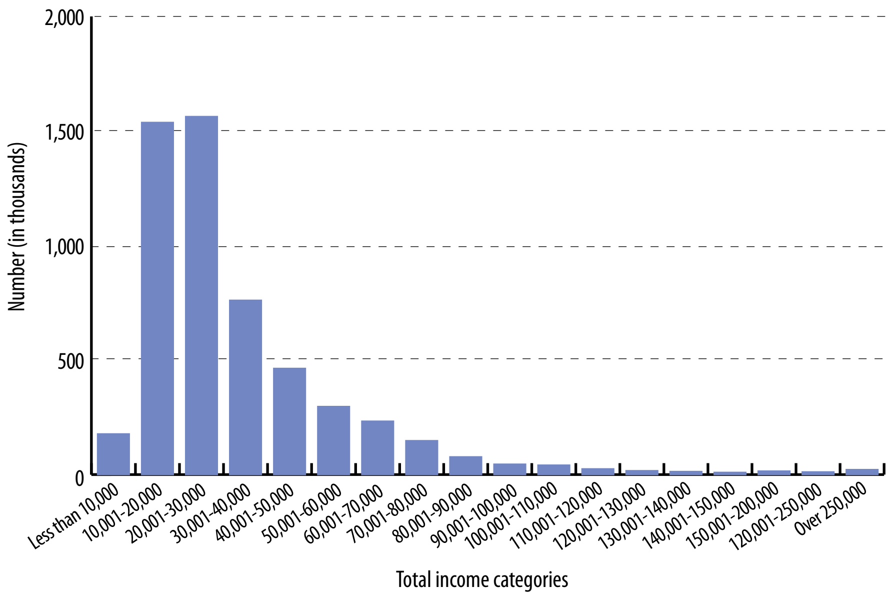
Changing the point at which OAS benefits begin to be clawed back as well as the threshold at which the benefits are entirely clawed back would free up resources that could be used for a number of alternative purposes.

Prior to discussing potential savings from changing the income thresholds for OAS, it is important to review some basic statistics on seniors and OAS. Figure 7 illustrates the number of seniors (2013) in various income categories. This provides a rough depiction of the level of potential savings available. It's easy to see from figure 7 that more than half of all seniors have a total annual income of less than $30,000. Specifically, 60.0 percent of seniors reported income in this range. These seniors would include those eligible and receiving GIS.[27] Almost 8 percent of seniors (7.8 percent), on the other hand, reported income (individually) at or above $70,000, which is roughly the point at which the OAS clawback begins.

Similarly, figure 8 depicts the amounts paid in OAS benefits by income group, using the same categories used in figure 7. Again, one observes that

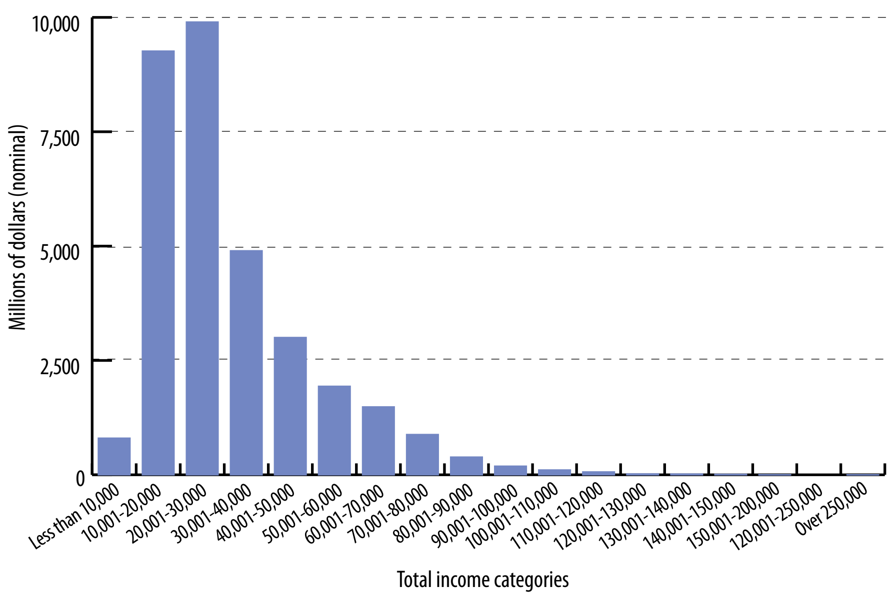
27 The most recent Actuarial Report corroborated these results when it concluded that in 2012 some 35.8 percent of OAS recipients also received GIS benefits (Office of the Superintendent of Financial Institutions, 2011b: table 2).

Figure 7: Number of seniors by income category (2013)



Source: Calculations were completed by the authors using Statistics Canada's SPSD/M (Version 20.0, database year 2008).

Figure 8: OAS benefits by income category (2013)



Source: Calculations were completed by the authors using Statistics Canada's SPSD/M (Version 20.0, database year 2008).

the majority of OAS benefits are paid to those with earnings below $30,000 per year (60.6 percent). However, there are sufficient OAS benefits paid to seniors earning higher levels of income to allow for reforms to generate meaningful levels of savings.

There are a number of options for changing the clawback thresholds for OAS. This paper relies on an approach that integrates the threshold for OAS with the income thresholds used for the Canada Pension Plan. The maximum earnings upon which the CPP payroll tax is levied is $51,100 (2013).[28] This threshold for CPP contributions is also instrumental in determining maximum benefits. This threshold provides the starting point ($51,100) at which OAS benefits would be clawed back; down from nearly $71,000 under current rules.

A starting point of $51,100 for clawing back OAS benefits would result in the full elimination of OAS benefits at $94,787 rather than nearly $115,000 under current guidelines (2013), assuming the current clawback rate of 15 percent.[29]

This change in the threshold at which the clawback rate is applied generates two sources of savings. The first is simply that the clawback rate is applied at lower levels of income. In addition, however, it also means the income at which partial benefits are still received once the clawback rate is applied is lower than under current rules. Using Statistics Canada's Social Policy Simulation Database Model (SPSD/M), the change in the threshold for OAS benefits results in a calculated annual savings for 2013 of approximately $730.4 million. These estimated savings would materially increase as the senior population increases over the next three decades.

An important second reform is also recommended. The clawback of OAS benefits results in higher marginal effective tax rates for seniors wishing to remain active in the labour market. Put simply, seniors that remain working pay their current marginal income tax rates and forfeit 15 percent of their OAS benefits (see figure 6). The federal government should consider reducing the clawback rate in order to reduce the effective marginal tax rates incurred by seniors. Such a change would, however, consume some of the savings generated from the first reform. The exact portion of the savings used for this reform would depend on the revised clawback rate.

28 The Canada Revenue Agency announced the maximum pensionable earnings for the CPP in November of 2012 (Canada Revenue Agency, 2012).

29 The calculation for determining the income level at which OAS benefits are completely clawed back is relatively straightforward. The clawback on OAS benefits is 15 percent. When income above the threshold at which the OAS clawback begins—roughly $71,000—reaches an additional $43,687 the benefits have been eliminated; calculated based on 15 percent of $43,687, which equals the annual maximum OAS benefit ($6,553).

This could be done in one of two ways. First, the government could simply reduce the claw back rate, to perhaps 10 percent or even 5 percent. This would reduce the effective marginal tax rate incurred by seniors and extend the range of income over which partial OAS benefits are paid.

This latter point is worth further explanation. Recall that under current rules the 15 percent clawback begins on income at roughly $71,000, which results in the full elimination of OAS benefits at approximately $115,000 of income. Changing the clawback rate means that the income level at which OAS benefits are fully eliminated will increase beyond the current threshold of roughly $115,000.

A second method by which to determine a reduced clawback rate is to target the income threshold at which the government wishes OAS benefits to be fully eliminated. This becomes a simple mathematical equation whereby the government says the clawback begins at $51,100 and ends at $X, and then determine the clawback (tax) rate that eliminates the benefit between these two values.

Reducing the clawback rate from its current level of 15 percent will encourage seniors to remain in the labour force, which is part of the government's broader vision for seniors' policy.[30] In addition, it mitigates the lower income threshold at which OAS benefits will begin being clawed back by providing greater incentives to remain active in the labour force.

Additional reforms

There are other reforms that could in part be financed by the expected savings in OAS from changing the eligibility thresholds discussed previously. A brief discussion of additional reforms to consider is outlined below.

(i) Augmenting the Guaranteed Income Supplement (GIS)

There are a number of possible ways by which to augment GIS with savings generated from changing the clawback income levels for OAS benefits. There are two changes that should be considered.

The first is to ensure that low-income seniors who rely on GIS are not displaced by the changes to the age of eligibility announced in 2012. The federal government indicated it will compensate the provinces for transitional costs but has yet to provide details regarding how this will be achieved.

30 This will result in cost increases in senior program spending for the federal government, but it would be mitigated somewhat by the amount of taxes garnered from encouraging seniors to remain in the labour force.

Savings from the changes in OAS eligibility could be used to finance such a transition program.

The second priority for savings from OAS changes is a re-examination of the level of GIS benefits provided to single seniors. There has been a concern expressed by many observers that the benefits allocated to single seniors in GIS are insufficient. It's clear that single seniors lack the type of economies of scale that senior couples enjoy. An example of these economies of scale is rent or housing costs more broadly. Simply put, two seniors living together will share the costs of housing and thus substantially reduce their individual costs compared to a single senior living in otherwise similar circumstances. Additional research and investigation into the adequacy of GIS benefits for single seniors is recommended. However, such a review must balance the desire to aid low-income seniors against providing reasonable benefits based on the cost of living.

(ii) Increasing private savings options and eliminating the tax bias in tax deferred accounts

Some portion of the savings from changing the income thresholds for OAS eligibility could also be used to both increase the ability of Canadians to save for their own retirement and eliminate a tax distortion currently present in tax deferred accounts such as Registered Retirement Savings Plans (RRSPs).

Simply put, some portion of the savings could be used to increase the limits for deferred tax accounts like RRSPs and registered pensions. Additionally, the limit for tax free savings accounts, which are not tax deferred, could also be increased to provide Canadians with greater choices regarding the mix of their savings.

In addition, some savings from the change in the OAS threshold for benefits could be used to deal with a little known tax bias against tax deferred retirement accounts. Currently, contributions to registered retirement accounts like RRSPs are deducted from one's income for the purposes of income taxes, which mean the contributions are made with pre-tax dollars. Contributors to such accounts are deferring their tax on the underlying income into the future when the income and earnings are withdrawn from the account. All withdrawals from such accounts are taxed using personal income tax rates. Herein lies the problem that needs to be resolved.

Earnings from investments, like capital gains, dividends, and interest income are all taxed at preferential rates to reflect double taxation of corporate earnings and the economic benefits of investing and savings. Using the current top marginal federal income tax rates, the following rates apply to different sources of income:

- Personal Income: 29.0 percent
- Capital Gains: 14.5 percent
- Dividends : 19.29 percent[31]
- Interest Income: 19.58 percent

Individuals investing outside of tax deferred accounts like RRSPs or prepaid tax accounts like Tax Free Savings Accounts (TFSAs) enjoy these preferential (lower) tax rates on capital gains, dividends, and interest income. Specifically, individuals investing in these non-tax advantaged accounts enjoy lower rates as outlined above depending on the nature of the investment income.

Individuals who invest in TFSAs contribute earnings after tax but then pay no tax on the earnings in their account and incur no taxes when they withdraw funds from the accounts.

Contributors to tax deferred accounts, like RRSPs, on the other hand, forego these tax benefits on investment earnings because all withdrawals from RRSPs and other tax deferred accounts are fully taxed at personal income tax rates. The solution is to mirror the treatment used in the TFSAs. Specifically, withdraws from tax deferred accounts should pay normal personal income taxes on the contributions made but no taxes on the earnings accumulated in the account. The costs of such a change are currently unknown and would more than likely exceed the total savings calculated for changes to OAS eligibility. Research regarding the cost of fixing the tax bias present in tax-deferred accounts is recommended.

31 Please note that this assumes dividends are eligible for the tax credit. There are dividends paid that are deemed ineligible and taxed at the normal personal income tax rates.

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Prof. Jean-Pierre Centi

Prof. John Chant

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Prof. Herbert G. Grubel

Prof. James Gwartney

Prof. Ronald W. Jones

Dr. Jerry Jordan

Prof. Ross McKitrick

Prof. Michael Parkin

Prof. Friedrich Schneider

Prof. Lawrence B. Smith

Dr. Vito Tanzi

Past members

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Prof. James M. Buchanan* †

Prof. Friedrich A. Hayek* †

Prof. H.G. Johnson*

Prof. F.G. Pennance*

Prof. George Stigler* †

Sir Alan Walters*

Prof. Edwin G. West*

* deceased; † Nobel Laureate