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# Pensions



# Under Attack

What's behind  
the push to privatize  
public pensions

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# Summary

## Why are public pensions under attack?

Canada's aging population has raised cries of alarm and panic from some quarters. Critics warn of a "demographic time bomb" waiting to explode and an age war over pensions as the baby boom generation starts to retire in the next decade. Because the population is aging, we are told, there will be fewer people of working age to support those who have retired and become "dependent." Younger people will resent paying the cost of supporting the growing older generation, so the argument goes. The answer, according to some people, is to get rid of public pension programs like the Canada Pension Plan and force people to contribute to their own personal savings plans instead.

The fact is that public spending on income security for seniors in Canada is modest by international standards and is expected to peak at levels well below those anticipated by other western countries in this century. Public pensions have reduced poverty and inequality among seniors in Canada. And while the percentage of older people in the population is increasing, the percentage of young people has been dropping. By 2031, when the so-called demographic time bomb is supposed to explode, Canada's "total dependency ratio" - the ratio of the young and old "dependants" to the population of working age - will still be lower than it was in 1951.

In addition, as seniors form an increasing percentage of the population, they will account for an increasing percentage of all taxpayers. The baby boomers have been described as "the trillion dollar generation" and they will

be much better off in retirement than today's generation of seniors. They will also pay an increasing share of the amounts collected by various levels of government in different kinds of taxes and user fees that will help pay for services to the elderly such as pensions, health care and long-term care. In other words, higher total amounts paid in taxes by seniors themselves will be able to finance a significant part of the cost of the programs that the older generation will require.

Recent Canadian studies have also demonstrated that, with relatively modest economic growth over the next few decades, Canada can "afford" its aging population - even taking into account increased public spending on health care and pensions as the population ages. And the OECD says that if public spending on the old in Canada is to maintain its share of GDP as the population ages, the average annual growth rate required between 1980 and 2040 is only 1.05%.

So why the panic? What's behind the attack on pensions? Who stands to gain if governments renege on their commitment to social security and public pensions, leaving the coming generation of seniors to fend for themselves? Is there a hidden agenda here?

## The push for privatization as the answer to an aging population

If there really is a demographic time bomb waiting to explode, and if the countries of the western world face a crisis of population aging, how would it help to get rid of public pension plans? How would replacing social insurance pension programs like the CPP with mandatory or even voluntary savings

schemes help societies deal with the needs of an aging population? There's no clear answer to this.

The advocates of privatization of public pensions do not say what would happen to the incomes of future seniors under a system of mandatory savings plans.

They have argued that the public costs of an aging population just cannot be sustained. When the population is aging, they say, pay-as-you-go public pension plans such as the CPP require unacceptable transfers from younger generations to the old. Of course, they don't talk about other inter-generational transfers – for example, the cost of education or the financial support families give their children - which represent transfers from older people to younger.

They claim public pensions plans like the CPP are unfair to young people, who would get a much better return if they contributed to an individual savings account for themselves rather than to the public pension program. But this ignores the fact that individual savings accounts, which depend on individual investment expertise and the vagaries of the stock market don't guarantee any pension at retirement. Fees and commissions also reduce the proportion of the individual's contribution that will actually generate a pension, as other countries that have tried this system have discovered.

Under a system of individual savings accounts, people would end up with lower pensions if they had periods out of the work force because they were ill or unemployed; if they had extended periods of further education and training; or if they took time out of the paid work force to raise children. Most of these situations are accommodated in the CPP without penalizing the individual.

The CPP is not a personal savings plan like a mutual fund or an investment portfolio. It is a social insurance program that pools the risks

of providing for the loss of income that individuals face when they retire or become disabled. An investment portfolio or mutual fund can't provide the additional benefits available through the CPP such as inflation indexed pensions, disability coverage, survivor benefits and benefits for the dependent children of disabled or deceased contributors.

It is inevitable that as the elderly form a much higher percentage of the population, more of the economy's total resources will have to be directed to them. Whether that's done through public pension plans or private savings makes little difference to the total amount of resources that must be allocated to older people. Claims on national income by the elderly can only be reduced if their numbers are reduced – perhaps through later retirement – or their relative incomes can be reduced. No matter how pensions are financed – whether through pay-as-you-go public pension plans, general tax revenues, or fully funded private savings arrangements - they must be paid out of current incomes.

**But if the economy is growing and productivity is improving - as they almost certainly will over the long term - increased claims on the national income by retirees should not result in a reduction of the claims of younger Canadians.**

## **Pinochet and the Chicago boys privatize Chile's pension system**

Privatization of public pensions in Chile was implemented under the Pinochet dictatorship in 1981, with the help of economists from the University of Chicago - known colloquially as "the Chicago boys" - who pushed the Chilean economy down the free enterprise road with deregulation, privatization of public institutions, and pro-market social and economic policies. Virtually overnight and without any public consultation, Chile replaced its public pension plan with a forced savings scheme. It became the darling of right-wing

governments and think tanks around the world and was held up by the World Bank as a model for other governments to copy. In Canada, for example, the former Reform Party advocated the abolition of the CPP and its replacement with a mandatory savings scheme of “Super-RRSPs” based on the Chilean model.

But Chile’s system of mandatory private savings accounts can hardly be called a pension scheme, since there is no pooling of risk, which is the fundamental characteristic of a true pension plan. The entire risk of providing for retirement is borne by individuals. Workers must contribute 10% of their monthly earnings into an account with a private investment fund to cover old age pensions, and an additional 3% of earnings to cover disability and survivor pension benefits. There is also a mandatory health insurance premium of 7% of earnings. In other words, total mandatory contributions to these private funds - most of which are run by foreign financial institutions - amount to 20% of earnings and there are no matching employer contributions.

Experts who have looked at Chile’s mandatory private savings scheme have raised serious concerns about it, including the high cost of the scheme; the low coverage and the large number of vulnerable workers who are excluded; the inadequate benefits provided by the scheme; and the systemic bias against women. Low-income workers can’t afford the high contributions and many are in default. It has been estimated that for the average worker, fees, commissions and other charges consume well over one third of contributions. By way of comparison, the cost of running the CPP (before the recent reforms) is 1.8% of the contribution revenue.

## **Margaret Thatcher brings opting out to Britain’s pension system**

Privatization of public pensions in Britain was implemented under the government of

Margaret Thatcher in the mid-1980s. However, rather than replacing the public pension program with a mandatory private savings scheme along the lines of the Chilean system, the Thatcher government, decided to allow individuals to opt out of the public earnings-related system and from workplace pension plans, provided they could demonstrate they had an approved personal pension.

Personal pensions were individual savings plans, sold mainly by insurance companies and very similar to Canada’s RRSPs. Aggressive marketing by the insurance companies persuaded two million people to opt out of the public earnings-related pension plan in favour of individual savings accounts, even though the pensions many of them will receive at retirement will be less than they would have received under the public pension plan. People were also persuaded to opt out of good defined benefit workplace pension plans in favour of inferior personal savings accounts where no pension was guaranteed. The scandal that followed, euphemistically known as “the mis-selling of personal pensions,” resulted in insurance companies being fined an estimated £11 billion or about \$23.3 billion at current exchange rates.

Analysts note that the personal pensions that many individuals have chosen in place of the public earnings-related plan, are based on uncertain investment returns and are subject to very high set-up and administration charges, often inappropriate sales tactics, and very low paid-up values if contributions into the plans lapse prematurely. As well, the evidence suggests that very few personal pensions scheme members are likely to maintain their membership of the scheme for long enough to build up an adequate pension.

It has been estimated that between 40 and 45% of the value of individual accounts in the UK is consumed by various fees and costs. Yet advocates of privatization of public pensions in Canada – including the Reform/Alliance Party, and the province of Alberta - are now

suggesting people be allowed to opt out of the CPP and have their mandatory contributions directed to their RRSPs or some other type of personal savings scheme instead.

## Does Social Security have a future in the U.S.?

In the United States, almost everyone acknowledges that Social Security has been an enormous success in providing the elderly, the disabled, and survivors with a modest basic income. Two-thirds of retirees receive more than half their total income from Social Security. Without this program, the incomes of approximately 16 million people - about half of all retirees - would fall below the official poverty thresholds. Until recently, no politician would dare say anything against Social Security, so popular was the program.

But just lately, Social Security has been losing some of its lustre - thanks to a concerted effort by right-wing think tanks such as the Heritage Foundation and the Cato Institute, ably assisted by a compliant media that has swallowed their privatization message hook, line and sinker. The campaign has received generous funding from Wall Street firms which stand to benefit if Social Security contributions are directed to private financial institutions.

The idea that Social Security is broke - or will be bankrupt any day now - has become so much a part of the conventional wisdom that almost no one even questions it. So effective has the right-wing message been that one expert says apocalyptic predictions about Social Security now represent the accepted opinion of the bulk of the American population. There are clear parallels with the attack on the CPP in Canada and with the widespread - but erroneous - belief that the CPP is broke.

The reality, as it turns out, is that the Social Security Trust Fund is in surplus and is expected to remain that way for at least the next

35 years, by which time the baby boom generation will have retired. The surplus, which currently stands at about US\$124 billion, has been accumulating since 1983, when the Social Security payroll tax was increased. And it will help finance the baby boomers' retirement, which is why the program will not have any trouble meeting its obligations when the boomers are retiring.

Nevertheless, there is now strong pressure to privatize this public pension system. For example, George W. Bush, in his campaign for the presidency, proposed allowing workers to divert part of their Social Security payroll tax - possibly two percentage points - into their own individual savings accounts.

It would appear that Bush's plan - like all similar privatization proposals - was based on the assumption high stock market returns will continue indefinitely. It appears no estimates have been made about what percentage of contributions to individual accounts would be consumed by fees and commissions. Nor has the Bush plan taken into account transition costs involved in moving to the new system. According one estimate, Bush's privatization plan would cost something like US\$900 billion over the first ten years. Transition costs this high would result because the Social Security system would have to simultaneously pay out current benefits, while privatization drained over 16% of the money coming into the system - assuming that two percentage points of the current 12.4% contribution rate would be diverted to the individual accounts.

Not only would average Social Security benefits have to be cut relative to current law, but workers would have to shoulder substantially increased risk under individual accounts - a typical outcome when public pension programs are replaced with individual savings accounts, even when such privatization consists of the kind of limited opting out that the Bush proposal envisages.

## Replacing the Canada Pension Plan with individual accounts

In Canada, advocates of privatization have used tactics that are strikingly similar to the kind of strategies being used by advocates of privatization south of the border. The key to getting radical changes adopted, of course, is creating the crisis mentality. If people can be convinced our public pension program is in crisis, they will be much more amenable to making major changes.

Corporate funded think tanks and right-wing commentators have put forward a number of different schemes to privatize of the CPP by converting it to a system of mandatory individual savings accounts, or by allowing people to opt out of the plan and have their mandatory contributions directed to their individual savings accounts. While initially most proposals seemed to favour the Chilean model, in recent years, the British system of opting out seems to be the preferred option.

The Reform Party, in a 1998 booklet on pension reform, claimed that privatization based on individual accounts was working successfully in other countries, including Chile, the UK and Australia. A closer look at those countries reveals that is not the case. The Alberta government, under its then Treasurer Stockwell Day, threatened to take Alberta out of the CPP unless federal and provincial finance ministers agreed to adopt several Alberta proposals, one of which was to allow individual to opt out of the plan and have some part of their contributions directed to their individual accounts.

But opting out raises the same kinds of concerns as complete abolition of the CPP

- There would be huge transition costs because some way would have to be found to pay for the accumulated benefits of people who chose to opt out of the plan.

- Vulnerable workers may be pressured to opt out – as they were in Britain - even though it would not be in their interests to do so.
- The high cost of individual accounts would reduce the proportion of contributions available to generate a pension, probably leaving individual without adequate pensions at retirement and therefore increasing the number of people who would have to rely on a minimum government guarantee through OAS or GIS.
- Opting out could seriously undermine the viability of the public plan itself. Based on the British experience, those most likely to opt out would be higher-income workers with secure jobs. If contributions from these workers were diverted to their private individual savings accounts, contribution revenues from those left in the plan might be inadequate to pay the promised benefits.
- Privatization through individual accounts or opting out would introduce inequalities. For example, Alberta's proposal to withdraw "surplus" funds from the plan and allow individuals to invest them privately for their own benefit would also contravene the principle of pooling risks through social insurance.
- It would weaken public policy levers that can be used to redistribute income and reduce inequality. Recent Canadian studies indicate the important contribution made by the public pension programs – and particularly the CPP – to reducing poverty and inequality among seniors. Reducing the role of government to one of simply providing social assistance for those most in need, while encouraging market place solutions for income security and maintenance, would likely lead to an increase in rates of poverty and income inequality among future generations of Canadian seniors.
- It would weaken support for the public pension plan. The more people who opt out of the public pension plan, the more

collective responsibility and social solidarity would be weakened. It might then become a simple matter to abandon the public earnings-related plan completely, forcing low-income workers to rely on means-tested benefits from the first tier of the pension system - always assuming they can qualify.

## The bottom line on privatization of public pensions in Canada

So far, policy makers in Canada have rejected calls to abolish the CPP and replace it with a mandatory system of individual savings accounts. And Stockwell Day, as Treasurer of Alberta, was unable to convince the other finance ministers to agree to a limited form of opting out of the public plan. Polls show strong support for the continuance of the CPP as a public pension plan. But there is no doubt that pressure for privatization will continue.

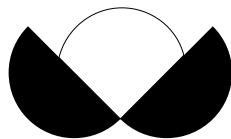
Significantly, none of the advocates of privatization claims that it would ensure adequate incomes for the seniors of the future. In fact, even the World Bank admits that “mandatory savings schemes can still leave considerable old age poverty.” Pensions generated from such schemes may fall below subsistence levels because of inflation or unexpectedly low returns. And low-income workers may never accumulate enough in their pension accounts to support themselves in old age, the Bank notes.

Advocates of individual accounts have tried to coat their views with a veneer of economic respectability, but empirical studies suggest that choice of a pension regime in itself has little impact on savings, investment or growth. However, it can change markedly the distribution of income and wealth. Privatization of public pensions would jeopardize the ability of the state to reshape income inequalities in later life.

Those who want to replace the CPP with a system of individual savings accounts – whether that takes the form of mandatory private savings plans or simply allowing people to opt out of the CPP if they wish to – are clearly following their own political and ideological agenda. It’s clear that by presenting the situation in terms of crisis and conflict, radical solutions may be more likely to find public acceptance.

We should recognize these threats for what they are. They represent an attempt to justify reducing the role of government and eliminating collective responsibility for our aging population under the guise of preventing intergenerational conflict. Many of those who advocate privatization through individual accounts have a thinly-disguised self interest in the outcome of this debate. They would like to see the mandatory contributions of workers and their employers directed to private financial markets where fees, commissions and other charges can be levied on them – reducing the portion of workers’ contributions that can be used to generate a pension.

Canada has already taken action to address the concerns raised by a pay-as-you-go pension plan in the face of population aging. A wide range of further acceptable options is available to policy makers, if necessary, without resorting to privatization and individual accounts. Canada’s retirement income system already has a reasonable balance of public and private arrangements and it has done a good job of reducing poverty and inequality among seniors. If we are really concerned about protecting the financial security of future seniors and ensuring them an adequate income in retirement, we must resist the attack on public pensions. Our retirement income system is worth fighting for.



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