Intelligence MEMOS

From: William B.P. Robson

To: Bill Morneau, Minister of Finance

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Re: **The "Factor of Nine" Crushes Retirement Saving Opportunities – Let's Pension it Off**

Ottawa should raise contribution limits for savers in RRSPs and defined-contribution pension plans. In a C.D. Howe Institute paper, I outlined how current limits are outdated, unfair, and put savers in RRSPs and defined-contribution plans at a major disadvantage.

People are living longer and—even more importantly—yields on investments suitable for retirement saving are very low. These changes have raised the cost of obtaining a given level of retirement income.

The core of the problem is the Factor of Nine, a little-known, outdated "equivalency test" for savings in various retirement saving plans. First adopted in 1990, the Factor of Nine uses a hypothetical defined-benefit pension plan in which saving 9 percent of annual earnings will let a person buy a retirement annuity equal to 1 percent of pre-retirement income. The *Income Tax Act* permits a member of a defined-benefit pension plan accrue a maximum annuity of 2 percent of final earnings tax-free in the year of accrual, which, over 35 years, would yield a pension equal to 70 percent of pre-retirement earnings. The Factor of Nine limits holders of RRSPs or defined-contribution plans to contributions worth up to 18 percent of their earnings a year (9 x 2 percent).

While intended to let them achieve an equivalent outcome, this limit badly damages their hopes of achieving the kind of retirement security members of defined-benefit pension plans common in Canada's public sector enjoy.

For one thing, the hypothetical plan underlying the factor is offers less generous benefits than the plans that dominate Canada's defined-benefit pension landscape – so it is a poor benchmark for fairness. Worse, a quarter-century after its adoption, the Factor of Nine is badly outdated. Ongoing improvements in life expectancy and lower yields on retirement-appropriate assets mean that people must save at least twice as much to replace pre-retirement earnings than the Factor of Nine presumes.

Moreover, savers in defined-contribution pensions and RRSPs typically incur higher risks and higher costs than defined-benefit plan savers. RRSPs and defined-contribution plan cannot pool longevity risk across cohorts like direct-benefit plan participants can. Market downturns are also more harmful to defined-contribution plans since savers cannot contribute extra funds to cover past capital losses: indeed, capital losses incurred by a defined-benefit plan must be offset by plan sponsors. All these considerations would justify more generous tax treatment of retirement saving in these plans - not the less generous treatment dictated by the Factor of Nine.

Three types of reforms could alleviate these problems:

- Updating the Factor of Nine's underlying assumptions to reflect current economic and demographic realities; specifically, allowing a higher tax-deferred saving limit, raising the threshold from 18 percent to 30 percent or more.
- Levelling the playing field for savers catching up on contributions later in life, or for savers with differences in pension plan design.
- Replacing the current annual saving limits with flexible tax-deferral regimes: either index unused contribution room for inflation or, more transformatively, establish an inflation-indexed lifetime tax-deferred savings limit.

Defined-contribution plan participants and RRSP savers should enjoy the same opportunity for pension wealth as their defined-benefit plan and public-sector plan counterparts. All Canadians should have the ability to accumulate sufficient savings for retirement, and unfair tax-treatment should not stand in their way.

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