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*Boston College*

*Year 1999*

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The Politics of Pension Reform in  
Canada and the United States

R. Kent Weaver

**THE POLITICS OF PENSION REFORM IN CANADA AND THE  
UNITED STATES**

R. Kent Weaver\*

CRR WP 1999-04

November 1999

Center for Retirement Research at Boston College

550 Fulton Hall

140 Commonwealth Ave.

Chestnut Hill, MA 02467

Tel: 617-552-1762 Fax: 617-552-1750

<http://www.bc.edu/crr>

\*R. Kent Weaver is a Senior Fellow at the Brookings Institution. The research reported herein was performed pursuant to a grant from the U.S. Social Security Administration (SSA) funded as part of the Retirement Research Consortium. The opinions and conclusions are solely those of the author and should not be construed as representing the opinions or policies of SSA or any agency of the Federal Government or of the Center for Retirement Research at Boston College.

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#### **Center for Retirement Research at Boston College**

550 Fulton Hall  
140 Commonwealth Ave.  
Chestnut Hill, MA 02467  
phone: 617-552-1762 fax: 617-552-1750  
e-mail: [crr@bc.edu](mailto:crr@bc.edu)  
<http://www.bc.edu/crr>

#### *Affiliated Institutions:*

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Cutting pensions for the elderly is a difficult task for any government.<sup>1</sup> The elderly are a large, politically active group, and they are viewed sympathetically by the rest of the electorate. In pension programs that are based on a system of contributory social insurance, a sense that benefits have been "earned" adds to recipients' perception of entitlement and inviolability of prior commitments. Moreover, even those who are too young to receive old age pensions currently may view themselves as being indirectly hurt by cutbacks, either because it will lower their benefits in the future, or because it will force them to give additional help to elderly relatives. Yet reform of public pensions has been very much on the agenda in both Canada and the United States.

The first section of this paper outlines the common pressures that have given rise to pension reform initiatives in the United States and Canada, and discusses how differences in political institutions and policy legacies that might lead to different policy outcomes. The middle two sections review the experiences of the two countries with pension retrenchment. The final section reflects on and tries to draw lessons from these experiences about the political limits on pension reform specifically and loss-imposition generally in the two political systems.

### ***PRESSURES FOR CHANGE***

The enormous blame-generating potential of pension-cutting initiatives suggests that politicians will undertake such initiatives only with great reluctance. Although their pension systems are structured differently,<sup>2</sup> the Canadian and U.S. governments, along with governments in most other Western industrialized countries, confront countervailing pressures that have placed pension reform—including pension reductions—on the agenda in recent years. First, aging populations have caused both governments to face rapidly increasing pension expenditures. This pressure has been exacerbated by the maturation of contributory pension programs (Social Security in the United States, the Canada/Quebec Pension Plan in

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<sup>1</sup> See John Myles and Jill Quadagno, "Recent Trends in Public Pension Reform: A Comparative View," pp. 247-271, and Paul D. Pierson, "The Politics of Pension Reform," pp. 273-293, in Keith G. Banting and Robin Boadway, eds., *Reform of Retirement Income Policy: International and Canadian Perspectives*, Kingston, Ontario: Queens University School of Policy Studies, 1997; R. Kent Weaver, "The Politics of Pension Reform: Lessons from Abroad," in R. Douglas Arnold, Michael Graetz, and Alicia Munnell, eds., *Framing the Social Security Debate: Values, Politics and Economics*, Washington, D.C.: Brookings Institution Press, 1998, pp. 183-229.

<sup>2</sup> For an overview of differences between the Canadian and U.S. welfare states, see Keith Banting, "The Social Policy Divide," pp. 267-309 in Keith Banting, George Hoberg and Richard Simeon, eds., *Degrees of Freedom: Canada and the United States in a Changing World*, Montreal and Kingston: McGill-Queens University Press, 1997

Canada), causing a larger share of their population to become eligible for payments from inadequately-funded contributory pension systems. Public pension programs in both countries have increasingly been criticized for putting government spending in a “fiscal straightjacket” that makes it difficult to shift spending priorities, especially toward spending more on children (who have substantially higher poverty rates than the elderly in both countries) and for contributing to budget deficits and unfunded pension promises whose costs will be borne by the next generation of workers.

A second and closely related pressure faced by governments in both countries through most of the past twenty-five years has been high budget deficits and tremendous resistance to increased taxes that limit alternatives to expenditure reductions in pension programs. At the end of the 1990s, budget deficits were supplanted by budget surpluses that changed the pension policymaking calculus yet again.

A third source of pressure is more long-term: the aging of the “baby boom” generation means that pension systems will undergo even more strain after 2010 as the baby-boomers begin to retire. This is particularly a problem in Canada, where the onset of the baby boom after World War II was faster and more immediate.<sup>3</sup> It has also fuelled critiques that the lower returns on contributory pensions likely to be incurred by younger workers are fundamentally unfair—a critique that has the potential to transform pension politics from one in which short term retrenchment and fundamental restructuring generate only diffuse benefits (and thus have no allies) to a zero-sum intergenerational conflict in which the interests of the young are pitted against the interests of the elderly and the near-elderly.<sup>4</sup>

Fourth, the increasing generosity of pension programs in both Canada and the United States since the 1970s have contributed to a situation in which overall poverty rates among the elderly are as low or lower than those rates among the general population.<sup>5</sup> Indeed, the growth of contributory, earnings-related public pensions in both countries and a near-universal Old Age Security program in Canada have meant that substantial pension benefits are received by persons who are relatively well-off and do not “need” them.

Fifth, conservative groups in both countries increasingly criticized contributory pension schemes as inefficient mechanisms that subsidize government deficits (by allowing governments to borrow money cheaply), while stifling investment and providing an inadequate return on workers’ contributions. The perception that workers could do better if their pension contributions were investment in equities rather than lent to government was also fuelled by an enormous run-up in stock prices on North American markets in the 1990s. Conservatives have called for at least partial replacement of government-run contributory pension systems by personal pensions in which individuals rather than governments make investment decisions, and benefits are determined by the return on those investments rather than a collective “defined benefit” based on earnings history. Both countries have large private pension sectors, and the growth of individually managed,

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<sup>3</sup> David Walker, “Discussion” in R. Douglas Arnold, Michael Graetz, and Alicia Munnell, eds., *Framing the Social Security Debate: Values, Politics and Economics*, Washington, D.C.: Brookings Institution Press, 1998, pp. 272-279 at p. 272.

<sup>4</sup> On the constraints on generational politics in the U.S., see Hugh Hecl, “Generational Politics,” pp. 381-411 in Palmer, Smeeding and Torrey, eds., *The Vulnerable*, Washington, D.C.: The Urban Institute, 1988.

<sup>5</sup> On declining poverty rates among the elderly in Canada, see Keith G. Banting and Robin Boadway, “Reforming Retirement Income Policy: The Issues,” pp. 1-26 in Banting and Boadway, eds., *Reform of Retirement Income Policy: International and Canadian Perspectives*, Kingston, Ontario: Queen’s University School of Policy Studies, 1997.

tax-subsidized retirement savings programs (Individual Retirement Accounts in the United States and Registered Retirement Savings Accounts in Canada) helped to legitimize “individual account” plans as an alternative to the government managed, historically Pay-As-You-Go, contributory pension systems operating in Canada and the U.S.<sup>6</sup>

Finally, policymakers in both countries, but especially in the United States, have grown concerned about the cost of old-age pensions provided to immigrants (who frequently come into the country under family reunification programs to join relatives who entered earlier), some of whom do not enter the country until they are at or near pensionable age.

### *Options for Change*

Politicians have, in short, faced strong pressures to impose some of pain on pension recipients and taxpayers. As shown in Table 1, the repertoire of potential responses to these pressures for pension change in the two countries has three broad components, each with distinctive political dynamics and challenges for policymakers concerned with avoiding blame. A first possible response is cuts in benefits and or eligibility, such as increases in the retirement age, cuts in indexation of benefits for inflation, and targeted reductions in benefits to upper-income recipients. Because these changes are most clearly targeted on a particular group (present or future pensioners), they have the greatest potential to spark opposition and political retribution. Thus we should expect to see policymakers attempt to reduce their blame-generating potential by, for example, delaying the onset of such changes for several years into the future, phasing them in gradually, or targeting them on politically weak clientele (e.g., non citizens). Existing beneficiaries may be “grandfathered,” that is, protected from any cutbacks.

Second, governments may seek to inject more revenue into the pension system. For example, both payroll tax rates and the tax base (the share of payroll that is subject to taxation) may be increased. This diffuses rising pension costs more broadly across the population—a potential advantage if the cost increases are low, but a potent liability if they are not, or if opposition to any tax increase is high. Again, we would expect policymakers concerned with minimizing the political costs of imposing pain to try to make such effects more obscure by delaying them, phasing them in, etc.

A third family of pension reforms are broader efforts to restructure existing tiers of pension programs, such as the merger or elimination of existing tiers or major changes in their structure (e.g., turning tax deductions for pension contributions into tax credits). Governments may also phase out existing tiers over time: for example, replacing a country-wide “defined benefit” pension, in which benefits are based on workers’ earnings history, with a “defined contribution” pension, in which workers each have their own individual pension account, and final benefits depend on the return on investments made with that account’s funds over time. As with the other cuts, politicians may try to any pain associated with those changes less noticeable by phasing changes in slowly and or applying them only to future beneficiaries.

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<sup>6</sup> On this point, see in particular Steven M. Teles, “The Dialectics of Trust: Ideas, Finance and Pension Privatization in the US and the UK,” paper presented at the Annual Research Conference on the Association for Public Policy Analysis and Management, October 29-31, 1998.

### *Constraints on Change*

Common pressures may nevertheless have differential effects cross-nationally if the balance of those pressures is different, or if those pressures are mediated by different program structures, political institutions, cultures, or political forces. One important mediating factor is the role of political institutions. In particular, we might expect that Canada, with its concentration of power in the executive, would enjoy more success in pension retrenchment initiatives than the separation of powers system in the United States, at least during periods when there is a single party majority government in the Canadian House of Commons. This difference is likely to be reinforced by strong party discipline in Canada, which may give an individual MP protection from his constituents for voting for unpopular measures and encourage voters to consider a party's entire record in voting decisions. In the U.S., on the other hand, candidate-centered elections reinforced by negative "sound-bite" advertising discourage legislators from casting any votes that may come back to haunt them later. A corollary to this argument is that governments with massive legislative majorities (or in the U.S., massive majorities in both chambers of the Congress and control of the presidency) is more likely to take loss-imposing actions than one with an insecure majority. As Pierson and Weaver noted in an earlier three-nation study of pension retrenchment, however, the advantage that Westminster-style parliamentary systems enjoy in concentrated power may at least partially offset by concentration of accountability: voters know that it is the governing party that is imposing losses, and those in power know that they know it, and may therefore to be reluctant to undertake initiatives that are very likely to incur retribution at the next election.<sup>7</sup>

A second institutional difference that may also lead to Canada-U.S. differences concerns the electoral cycle. In the United States, all members of the House of Representatives and one third of all Senators are elected every two years. Thus voters have to have very short memories if a loss-imposing action is going to adopted by Congress without incurring any retribution at the polls. In Canada, on the other hand, general elections for the House of Commons must be called only once every five years, although by tradition, they occur after about four years. This should afford a greater window of opportunity for loss imposition in pension retrenchment.

A third institutional difference concerns federalism. Both the U.S. and Canada are federal states, but structured very differently: Canada has fewer first-level sub-national units, with a broader and more constitutionally-protected jurisdictions; their leaders are much more active on the national political stage. Overall, the political science literature suggests that federalism tends to inhibit welfare state growth,<sup>8</sup> but the effects clearly are not unidirectional, and depend both on the specifics of program structure and federal arrangements. Three specific hypotheses about federalism (and policy feedbacks) in mature welfare states seem appropriate. First, pension programs that are entirely within provincial jurisdiction, and entirely financed by the provinces/states, are likely to be especially meager, and subject to retrenchment initiatives, as sub-national governments seek to avoid becoming "welfare magnets" in a process that leads to a "race to the bottom." Second, programs that are primarily financed by one level of government but delivered by the other are also likely to be especially vulnerable to cuts, as the financing level of government may feel, if it is pressed

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<sup>7</sup> Pierson and Weaver, "Imposing Losses in Pension Policy."

<sup>8</sup> See for example Keith Banting, *The Welfare State and Canadian Federalism*.

by high budget deficits, that it can cut expenditures while the level of government delivering the benefits is likely to incur most of the blame. Finally, pension programs that require changes to be approved by both levels of government are likely to encounter what Fritz Scharpf has labeled the “joint decision trap” and thus be especially impervious to change, especially to retrenchment.

A second critical set of influences on the prospects for pension reform are what Paul Pierson has called “policy feedbacks”—the policies already in place and the political support coalitions that tend to grow up around and defend them.<sup>9</sup> As Pierson has shown in the case of the U.K., for example, contributory pension systems are more likely to be highly resistant to cutback when they are “mature”—when large numbers of pensioners have begun to draw significant benefits from them—than beforehand. Programs in which benefits are indexed for inflation are harder to cut than unindexed programs, where benefits can be eroded over time simply by doing nothing. And pension programs that are funded exclusively by payroll taxes may become more susceptible to cutbacks when expenditures exceed revenues: the unavailability of an “out” through general revenues creates an action-forcing mechanism for either benefit and eligibility cuts or payroll tax increases.

### ***PENSION REFORM IN THE UNITED STATES***

The United States has a two-tiered system of public old-age pensions for its residents. By far the larger of the two is Old Age and Survivors Insurance (OASI), more commonly known as Social Security. Social Security is a contributory system financed entirely by payroll taxes, paid equally by employers and employees. Any excess of revenue over contributions are held in a “Trust Fund” that invests only in U.S. government securities. Benefits are loosely linked to a worker's earnings (and therefore contributions) history, with low-wage workers receiving a higher return on their contributions than high-wage workers.

Social Security depends entirely on payroll tax contributions and interest earned on trust fund surpluses to finance benefits: with a few exceptions, general government revenues are not used to pay benefits, and cannot be injected into the system to pay for any spending shortfalls without changing the basic Social Security legislation. These attributes of OASI have lent weight to critics charges by critics of the programs that Social Security is more akin to a Ponzi scheme—holding nothing but government IOUs and the power to levy taxes to pay future claims on the program. Social Security has historically operated on a “pay-as-you-go” basis (i.e., current workers’ contributions are used to pay the benefits of current beneficiaries) rather than building up, as most private-sector pension plans do, adequate reserves to pay the expected pension liabilities of current workers. This funding mechanism has meant that Social Security is vulnerable to potential funding crises-- shortfalls of revenues relative to current expenditure requirements-- that serve as an “action-forcing mechanism” putting expenditure reductions or tax increases (or both) on government’s agenda, and that give proponents of expenditure reductions critical leverage to force spending cutbacks.

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<sup>9</sup> Paul Pierson, *Dismantling the Welfare state? Reagan, Thatcher and the Politics of Retrenchment*, Cambridge: Cambridge University Press, 1994.

In addition to Social Security, old-age pensions in the United States are funded by a means-tested program, Supplemental Security Income (SSI), which also provides benefits to low-income disabled and blind persons. SSI is financed from general government revenues. The federal government provides a basic benefit, which some states (sixteen in 1998) supplement. Benefit levels for both Social Security and SSI have been indexed for inflation since 1975. SSI benefit payments to the aged (including state supplements) totaled \$4.51 billion in 1996.<sup>10</sup> Because SSI earnings and asset tests are quite severe, and benefits are quite low (a maximum of \$484 for a single person and \$726 for a couple in 1997) only 6.2 percent of the U.S. elderly received SSI payments in 1996.<sup>11</sup>

In addition to the legacy of past policy structures, the political limitations on pension reform in the United States over the past quarter century have also been heavily constrained by specific political configurations: in particular, divided government (majorities in at least chamber of Congress by a political party different from that of the President) has been in effect for all but six years of this period (1997-80 under Carter; 1993-94 under Clinton). Thus at least some degree of bipartisanship is needed to enact any major pension reform proposal. But it is an issue on which the gulf between the parties has generally been quite wide. Equally important, it is an issue that has enormous potential for generating blame against any politicians who are seen as favoring benefit cuts. Thus not only is the basis for bipartisan compromise fragile (and for bipartisan consensus, non-existent), but each party (and especially the Republicans) fears that taking the initiative for reform is likely to result in political pot-shots rather than concessions by the other party. As we will see, the experience of several rounds of Social Security policymaking reinforced rather than weakening this atmosphere of mistrust between the parties.

#### ***Initial Retrenchment Efforts in the United States***

Repeated crises in the Social Security trust fund and overall budgetary pressures led to numerous attempts to introduce Social Security cutbacks beginning in the late 1970s.<sup>12</sup> Unlike Canada, where the

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<sup>10</sup> Social Security Administration, *Social Security Bulletin Annual Statistical Supplement, 1997*, p.288.

<sup>11</sup> The maximum annual income levels at which persons can still be eligible for SSI are \$6,048 for an individual and \$8,952 for a couple receiving only Social Security Income, and \$12,636 for an individual or \$18,444 for a couple receiving only wage income. See House Ways and Means Committee, *1998 Green Book*, pp. 268-269,278,307

<sup>12</sup> On this period in both the United States and Canada, see Paul D. Pierson and R. Kent Weaver, "Imposing Losses in Pension Policy," pp. 110-150 in R. Kent Weaver and Bert A. Rockman, eds., *Do Institutions Matter?: Government Capabilities in the U.S.*

centralization of political authority means that battles over pensions have stemmed from a few clear governmental initiatives, political struggles over pension cutbacks in the United States have been more frequent and have emerged from a variety of sources in Congress and the executive branch, but have enjoyed a lower success rate. The most important Social Security cutback initiatives took place in 1977, the spring of 1981, and 1983. Only the first and last of these resulted in major changes. There were also abortive initiatives in 1979, the autumn of 1981, 1985 and 1987.

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*and Abroad*, Washington, D.C.: The Brookings Institution, 1993 and Paul Pierson and Miriam Smith, "Shifting Fortunes of the Elderly: The Comparative Politics of Retrenchment," pp.21-59 in Theodore R. Marmor and Timothy M. Smeeding and Vernon L. Greene, eds., *Economic Security and Intergenerational Justice: A Look at North America*, Washington, D.C.: Urban Institute Press, 1994. On the United States, see Paul Light, *Still Artful Work: The Continuing Politics of Social Security Reform* (New York: McGraw-Hill), 1995.

An impending Social Security trust fund crisis prompted the Carter administration's initial Social Security initiative, in the fall of 1977. This crisis resulted from a combination of stagflation that lowered revenue inflow to the fund and a faulty method used to adjust workers' wage histories for inflation (and thus establish their initial benefit) that gave newly retiring workers unexpected windfalls and rapidly depleted the OASI trust fund. Although there was strong agreement that some changes needed to be made, neither the administration nor the Congress was willing to impose substantial short-term losses on persons already receiving benefits. Instead, policymakers relied almost exclusively on injecting new revenues into the system to produce short-term improvements in the program's financial status. These came in the form of both increases in payroll taxes and the wage base (the amount of wages subject to the Social Security tax). These increases were phased in after the next election to reduce political blame.<sup>13</sup> Long-term savings were produced largely by reducing the initial benefit of most future beneficiaries. The reforms were not widely perceived as imposing losses because they were portrayed by sponsors as restoring the always-intended benefit levels. But policymakers did not attempt to retroactively lower the real purchasing power of workers who had already retired or those who were about to become eligible to retire. Instead, policymakers attempted to lower the visibility of the benefit cuts by phasing in the corrected formula for initial benefits in over five years beginning with workers who turning 62 in 1979. In short, Congress attempted to correct a serious program flaw in a way that minimized blame by not cutting the benefits of those who were most likely to notice and by delaying almost all benefit cuts until after the next election. The Carter administration sought additional Social Security cuts in 1979, but President Carter sought to distance himself from his proposals even before they were issued as part of his fiscal year 1980 budget, and no action resulted.

When the Reagan administration came into office in 1981, administration officials sought further cuts in OASI for several reasons. First, the 1977 changes had proven insufficient to make the OASI trust fund solvent; it was once again in danger of running dry as early as 1982. Additional funding problems faced the system in the long term as the "baby boom" generation retired in the 21st century. Second, because Social Security comprised about one-sixth of all federal outlays, it was an obvious target for an administration hoping to cut taxes without creating large deficits. Third, many Republicans felt that the role of the government in the social sector was already too large, and saw Reagan's election as an opportunity to change it.

However, many of these same Republicans were convinced that major cuts in Social Security were

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<sup>13</sup> For a detailed discussion of the 1977 legislation, see Joseph Califano, *Governing America: An Insider's Report from the White House and the Cabinet*, New York: Simon and Schuster, 1981, chapter 9, Martha Derthick, *Policymaking for Social Security* (Washington, D.C.: Brookings), 1977, chapter 19, and John Snee and Mary Ross, "Social Security Amendments of 1977: Legislative History and Summary of Provisions," *Social Security Bulletin*, vol. 41 (March 1978).

politically suicidal. President Reagan had complicated the already difficult task of cutting Social Security by promising in the 1980 presidential campaign that the program was part of a "social safety net" of programs that would be exempt from cuts; thus proposing cuts could lead to charges that the administration was not only hurting the elderly but violating a promise. And when considered along with the president's tax cut proposals, which were heavily weighted towards the better off, cuts in Social Security could provide an opening for charges that the administration lacked a fundamental sense of "fairness."

The new administration initially proposed only minor changes in Social Security, notably elimination of the minimum benefit for workers with a very low contributions histories and benefits for college student survivors of Social Security-insured workers. Congressional Democrats quickly seized on the minimum benefit issue,<sup>14</sup> seeking to create a public image of the administration as heartless and "unfair," tarnish the President's growing reputation as the invincible master of Congress, and perhaps derail some of the administration's domestic cuts.<sup>15</sup>

The major Social Security drama of Reagan's first two years, however, resulted from the efforts of OMB Director David Stockman to find immediate spending cuts to diminish the growing gaps between the administration's promise of a balanced budget and his own private forecasts of mounting deficits. Seeking those cuts, Stockman sold a Social Security reform package to the President in the spring of 1981 that contained a large dose of immediate political pain,<sup>16</sup> including a three month delay in cost-of-living adjustments and a change in calculating future retirees' initial benefits that would eventually lower the "replacement rate" (percentage of prior earnings replaced by Social Security benefits) from 42 percent to 38 percent. It also lowered future payroll taxes. The most controversial cut, however, was a proposal to reduce severely (from 80 to 55 percent of full benefits) and almost immediately (in January 1982) benefits for future early retirees. Because a large proportion of recipients take early retirement, the plan to cut these benefits without any phase-in sparked especially intense opposition. The package immediately generated enormous criticism from congressional Democrats, and the American Association of Retired Persons and other groups in the "elder lobby" promised to mobilize their huge memberships to fight the cuts.<sup>17</sup> Even conservative

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<sup>14</sup> *Congressional Record*, vol 127, no. 5, March 30, 1981, pp. 5697,5700. The administration's defenders in Congress argued that Social Security recipients who were truly needy could receive means-tested SSI benefits instead, but this did little to assuage public fears. See Senator Robert Dole's statement in the *Congressional Record*, vol. 127, pt. 5, July 21, 1981, pp. 16556-16559. In fact, some recipients of the Social Security minimum benefit would not be eligible for SSI, notably early retirees between the ages of 62 and 65, widows and widowers between ages 60 and 65, and recipients who met the income but not the assets test for SSI.

<sup>15</sup> A compromise was eventually reached on the minimum benefit, continuing it for all recipients who became eligible before the end of 1981. Again, political pressures pointed towards a solution which exempted current beneficiaries from losses.

<sup>16</sup> David A. Stockman, *The Triumph of Politics: Why the Reagan Revolution Failed*, New York: Harper and Row, 1986, chapter 7.

<sup>17</sup> David E. Rosenbaum, "First Major Cuts in Social Security Proposed in Detailed Reagan Plan," *New*

Republicans complained that the decision to begin the early retirement changes almost immediately would upset the plans of older workers who had anticipated retirement under existing rules.<sup>18</sup>

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York Times, May 13, 1981, p. A29; Warren Weaver, Jr., "Coalition Plans Drive Against Move to Trim Social Security Benefits," New York Times, May 14, 1981, p. B15.

<sup>18</sup> See for example the statement of Rep. Carroll Campbell (Rep S.C.) in the *Congressional Record*, May 13, 1981, p. H2174, and Stockman, *The Triumph of Politics*, pp. 190-191.

As criticism mounted, the White House sought to distance the President even further from the proposals, and to declare its openness to alternative proposals.<sup>19</sup> When it was clear that the White House was backing away, the administration's defenders on Capitol Hill deserted completely: Senator Robert Dole, the Republican chairman of the Senate Finance Committee, proposed a resolution condemning immediate cuts in early retirement benefits. It passed by a 96-0 margin.

The cuts that were enacted in the 1981 budget reconciliation bill cut outlays by only about two percent in the 1981-1984 period.<sup>20</sup> Most of the cuts enacted in the reconciliation bill did not significantly affect the core retirement and survivors benefits.<sup>21</sup>

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<sup>19</sup> See Warren Weaver, Jr., "Eased Stand Hinted on Social Security," New York Times, May 29, 1981, p. A13.

<sup>20</sup>These figures are for OASI and Social Security Disability Insurance together. In addition, revenues to OASI and SSDI were expected to rise by \$828 million in fiscal year 1984 as a result of extending payroll taxes to the first six months of sick pay. See U.S. House of Representatives, Committee on Ways and Means, *Background Material and Data on Programs within the Jurisdiction of the Committee on Ways and Means*, 1988 Edition, Committee Print WMCP 1100-29, 100th Congress, 2nd session, March 24, 1988, pp. 24-25.

<sup>21</sup> The major exception was the repeal of the Social Security minimum benefit for both current and future recipients, which became the subject of several bitter rounds of blame-generating between the administration and congressional Democrats in the summer and fall of 1981. About 55 percent of the cuts in the reconciliation bill came from a phaseout of benefits to college student survivors of insured

The cuts enacted in the 1981 reconciliation bill clearly were not enough to solve Social Security's financial problems, but neither the President nor congressional Democrats wished to take the lead in proposing painful solutions. President Reagan's advisors convinced him to propose a COLA delay in a new round of budget cuts announced in September, but this time the White House was more cautious: it floated the proposed cuts a week in advance. When it became clear that a COLA delay would not gain the support of Republicans in Congress, the administration dropped the idea.<sup>22</sup>

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<sup>22</sup> On the administration's deliberations see Stockman, The Triumph of Politics, pp. 304-317; "Action," New York Times, September 21, 1981, p. A21, and Tolchin, New York Times, September 22, 1981, p. A1.

While the political dangers of proposing benefit cuts were evident, awareness of looming trust fund deficits forced a response. Both sides in the dispute eventually agreed to entrust Social Security's financial problems to a bipartisan commission which was to report after the 1982 elections. Although the commission almost came to an impasse, it did provide a political cover allowing negotiators for the president and congressional Democrats to come to an agreement that was eventually approved, with some additions, by Congress.<sup>23</sup> Because both parties shared responsibility for reaching the agreement, the potential for blame was minimized, and thus the ability of the various participants to stick to the agreement was maximized.

The 1983 legislation made major changes in Social Security on both the tax and benefit sides. But again a lot of attention was paid to minimizing blame. In the short term, the most important change was a six month delay in inflation adjustments for benefits. Because the period for calculating inflation adjustments was also changed, the result was that current (but not future) beneficiaries had their benefits permanently cut by the amount of inflation in that period. Nominal benefits were not cut, however. In addition, the benefits of high income beneficiaries of OASI and SSDI became subject to income taxation for the first time.<sup>24</sup> The number subject to this tax will expand incrementally (because the income limits were not indexed): only about one-sixth of Social Security recipients were subject to the tax in 1989; almost one quarter were affected by 1997.<sup>25</sup>

The most dramatic long-term change imposed by the 1983 legislation will be a gradual increase in the standard retirement age (the age at which full OASI benefits are received) from 65 to 67. This increase is phased in gradually, beginning in the year 2000 and ending in the year 2021. Workers can continue to retire at age 62, with an greater actuarial reduction in their benefits. Although the reform was treated as a change in eligibility rules, its actual impact is likely to be a sizable reduction in benefits, unless future retirees retire later than current ones.<sup>26</sup> However, the long delay between 1983 passage of the social Security rescue package

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<sup>23</sup> For a detailed discussion see Paul Light, *Still Artful Work*.

<sup>24</sup> Individuals with incomes of less than \$25,000 and couples with incomes less than \$32,000 remained exempt from taxation. The justification for taxing one-half of benefits is that individuals pay income tax on their share of social security contributions at the time of the contributions, but the employer's share of contributions is not taxed.

<sup>25</sup> U.S. House of Representatives, Committee on Ways and Means, *Background Material and Data on Programs within the Jurisdiction of the Committee on Ways and Means*, 1989 Edition, Committee Print WMCP 101-4, 101st Congress, 1st session, March 15, 1989, p. 26; U.S. House of Representatives, Committee on Ways and Means, *1996 Green Book: Background Material and Data on Programs within the Jurisdiction of the Committee on Ways and Means*, Committee Print WMCP 104-14, 104th Congress, 2nd session, November 4, 1996, p. 42.

<sup>26</sup> Most social security beneficiaries already retire before age 65. The estimated savings of the 1983 reforms were based on the assumption that individuals would not delay their retirement as a result of the changes but instead accept reduced benefits. Between 1980 and 2030, replacement rates for a 65 year-old retiree are projected to fall from 68.1% to 49.4% for low earners, 51.1% to 36.7% for average earners and 32.5% to 24.2% for high earners. See House Ways and Means Committee, *1998*

and its initial “bite,” along with its gradual phase-in, lessened near-term blame associated with the cuts. Few workers are likely to pay attention to retirement age increases taking place twenty to forty years in the future.

The 1983 Social Security rescue package dramatically altered the short- and medium-term financial condition of OASI. Current OASI trust fund revenues are higher than current expenditures. The fact that the trust funds are currently growing—helping to reduce the overall federal budget deficit for 15 years after 1983, and producing the federal budget surpluses of 1998 and beyond—made it politically very difficult to either raise Social Security taxes or cut benefits in the short term.

Continued concern over the budget deficit and the recognition that large expenditure reductions were unlikely without a contribution from Social Security led Republican politicians to return repeatedly to pension cutbacks in the final years of the Reagan and Bush administrations. Each attempt confirmed Social Security's reputation as the "third rail" of American politics. In 1985, for example, Senate Republican leaders took the lead in endorsing a one-year COLA freeze as part of a budget package. Although the proposed budget passed the Senate 50-49 on a straight party line vote, its meager prospects for adoption collapsed completely when President Reagan cut a deal with Democratic House Speaker O'Neill that preserved Social Security in return for higher defense authorizations.<sup>27</sup> The "Black Monday" stock market collapse of October 19, 1987 led to renewed deficit reduction negotiations between the administration and Congress. However, President Reagan's politically wary decision to announce that Social Security cutbacks were "off the table" before negotiations began essentially made it impossible to put them back on the table after the negotiations got under way unless Democrats agreed to provide political cover by sharing the blame-- a politically implausible event. The 1987 "budget summit" ultimately settled for a minimal package of new revenues and spending cuts, with Social Security left untouched. The 1990 budget summit in the Bush administration also left Social Security untouched.

Several lessons emerge from these initial rounds of retrenchment. First, politicians are well aware of the blame-generating potential associated with Social Security retrenchment, and do their best to avoid it. Social Security cutback initiatives have been most successful when they occur in the context of an imminent trust fund crisis, when they gain the support of both the President and key congressional leaders, and when they are directed at narrow and politically weak clienteles rather than all retirees. Efforts to use cuts in Social Security benefits and eligibility in the battle to shrink the federal deficit in the absence of a looming trust fund crisis are almost certain to fail, and long-term trust fund shortfalls can be addressed successfully only in the context of a short-term funding crisis.

### ***Reforming U.S. Pensions in the Clinton Years***

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<sup>27</sup> Many House Republicans also opposed the 1985 Senate COLA freeze proposal. See Dan Balz and Ronald Brownstein, *Storming the Gates: Protest Politics and the Republican Revival*, Boston: Little, Brown, 1996, pp. 129-130. For details of the 1985 and 1987 budget rounds and the role of Social Security in those negotiations, see Pierson and Weaver, "Imposing Losses in Pension Policy," pp. 122-124.

As noted above, the 1983 Social Security rescue package, combined with generally positive economic performance and favorable demographic trends (the baby boom generation began entering its peak earning years) meant that there would be no short-term funding crisis in Social Security program to act as an action-forcing mechanism for retrenchment initiatives in the 1990s.<sup>28</sup> Indeed, the Old Age and Survivors Insurance trust fund had a surplus of \$51.5 billion in fiscal year 1996, with surpluses projected by the Congressional Budget Office to reach a staggering \$184.7 billion—and OASI trust fund balances an even more staggering \$2.038 trillion— by 2008.<sup>29</sup> The 1983 reform package was supposed to make the system actuarially sound for 75 years, but 1999 projections suggest that it will run out of money by the year 2034 (trust fund expenditures will begin to exceed outlays in the year 2014). After 2034, income to the trust fund will only be about 72 percent of what is necessary to meet obligations.<sup>30</sup>

Clearly politicians in the United States have been extremely reluctant since 1983 to do anything that might leave their fingerprints on a bill that could later be portrayed by political opponents as a cut in Social Security. There are at least two potential ways around this problem. First, they could delegate decision-making to non-elected bodies and limit their own discretion to overturn the decisions of those bodies, as they have done in the case of the military base-closing commissions. Second, politicians could legislate automatic triggers that would take place in the future: for example, across the board cuts in all entitlement programs that would be triggered by deficits above specified targets in future years.<sup>31</sup>

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<sup>28</sup> See R. Douglas Arnold, "The Politics of Social Security," *Political Science Quarterly*, vol. 111, no. 2 (1998) pp. 213-240.

<sup>29</sup> U.S. House of Representatives, Committee on Ways and Means, *1998 Green Book*, Committee Print 105-7, May 19, 1998, pp. 62-63.

<sup>30</sup> Reported in Social Security Board of Trustees, *1999 Annual Report*, March 30, 1999. These projections are slightly more optimistic than those in the 1994-96 Advisory Council on Social Security, *Report*, vol 1. *Findings and Recommendations*, Washington, D.C.: The Council, 1997, p. 163, based on higher than expected economic growth.

<sup>31</sup> See R. Kent Weaver, "Setting and Firing Policy Triggers," *Journal of Public Policy*, 9,3 (1989) pp. 307-336.

In practice, neither has been viable. Congress generally delegates real power to commissions—for example, saying that their recommendations go into effect automatically unless Congress can muster a majority against them—only on issues like military base closings and congressional pay where all the major actors in the legislative and executive branches are agreed on the broad outlines of a solution but need a political cover to work out the details and take the political heat.<sup>32</sup> But on Social Security, there is no such agreement on the basic dimensions of a solution, and thus not even a hint of willingness to submit its future to a commission with binding decision-making power. President Clinton did appoint a commission to study Security and other entitlement issues in 1993 (a price extracted by Senator Bob Kerrey for his vote in favor of Clinton's budget package), but the commission had only the power to make recommendations, and it ended up being so divided that it was unable even to agree on a package of recommendations.<sup>33</sup>

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<sup>32</sup> See R. Kent Weaver, "Is Congress Delegating Too Much Power to Commissions?," *Roll Call*, 1989.

<sup>33</sup> On the Kerrey commission, see Jeff Shear, "The Untouchables," *National Journal*, July 16, 1994, pp. 1681-1685; George Hager, "Entitlement Reform Panel Convenes in Pessimism," *Congressional Quarterly Weekly Report*, June 18, 1994, pp. 1583-1584; George Hager, "Commission Moves Carefully on Entitlement Cuts," *Congressional Quarterly Weekly Report*, August 13, 1994, p. 2318; Andrew Taylor, "Consensus Elusive for Panel in Plan to Cut Benefits," *Congressional Quarterly Weekly Report*, December 10, 1994, p. 3504; Jon Healey, "Entitlement Panel Wraps Up Without Agreeing on a Plan," *Congressional Quarterly Weekly Report*, December 17, 1994, p. 3564.

Use of automatic triggers to produce program cuts has been even more of a political non-starter. Far from agreeing to put in place mechanisms that might lead to Social Security cuts at some future point, American politicians have done just the opposite: they have either explicitly excluded Social Security from such mechanisms, or they have refused to adopt those mechanisms when there was even a hint that they might lead to Social Security cuts. The former can be seen in the case of the Gramm-Rudman-Hollings deficit reduction mechanism adopted in 1985: Social Security (and several other entitlement programs) was specifically exempted from any automatic cuts. And fear that a Balanced Budget amendment might lead to cutbacks in Social Security in the future was used by President Clinton and by wavering Senators as political cover to justify votes against the Balanced Budget Amendment to the U.S. constitution—killing it by the narrowest of margins in the Senate—in both 1995 and 1997.<sup>34</sup>

It is not surprising, therefore, that the decade after passage of the 1983 Social Security rescue package saw virtually no legislation on the issue. The only significant exception was a provision adopted as part of President Clinton's 1993 budget package that made 85 percent of benefits taxable for beneficiaries at the upper end of the income scale. But this provision affected relatively few Social Security recipients.<sup>35</sup>

The story was initially the same after Republicans gained control of Congress in 1994. House Republicans, having learned from the Reagan experience with Social Security retrenchment initiatives, and seeking to avoid proposals that did not enjoy popular support, explicitly excluded Social Security cutbacks from their "Contract with America" campaign pledge in the 1994 congressional election.<sup>36</sup> The major Social Security pledge included in the Contract was a liberalization of the earnings test that lowers Social Security benefits for senior citizens with significant earnings. Even as congressional Republicans endorsed very unpopular (and ultimately unsuccessful) Medicare and Medicaid cuts in the fall of 1995 in an effort to make their deficit and tax reduction promises "add up," they resisted Social Security cuts. The Clinton-Republican budget agreement of 1997 also excluded Social Security cuts.

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<sup>34</sup> See for example Clay Chandler, "Playing the Social Security Card," *Washington Post*, February 24, 1997, p. A8, David E. Rosenbaum, "Dancing the Balanced-Budget Waltz," *New York Times*, February 28, 1997, p. A24.

<sup>35</sup> For details, see House Ways and Means Committee, *1994 Green Book: Overview of Entitlement Programs: Background Material and Data on Programs within the Jurisdiction of the Committee on Ways and Means*, WMCP 103-27, Washington, D.C: Government Printing Office. 1994, pp. 30-34.

<sup>36</sup> Balz and Brownstein, *Storming the Gates*.

**CUTTING IMMIGRANT BENEFITS:** Indeed, the major Republican initiative on retirement benefits during the 1995-96 “Gingrich Revolution” concerned benefits received by non-citizens under the relatively small and heretofore largely uncontroversial SSI program. There is little dispute that non-citizens who are legal permanent residents and contribute to social insurance programs such as Social Security, Medicare and Unemployment Insurance should be eligible for benefits on the same basis as citizens.<sup>37</sup> Controversy over the means-tested SSI program increased in the early 1990s, however, as solid quantitative evidence began to emerge in government studies that non-citizens, especially refugees and elderly persons admitted to the United States as part of family reunification policies, were heavy users of means-tested benefits.<sup>38</sup> In the Supplemental Security Income program, non-citizens increased from 7 percent of aged recipients in 1983 to 30.2 percent of recipients in 1994.<sup>39</sup>

The political calculus for politicians who consider cutting benefits to aged immigrants is tricky one, however, in ways that the new Republican majority in Congress after the 1995 election may not have fully thought through. On the surface, cutting benefits to non-citizens seems like a politically easy decision. Non-citizens can’t vote, so they can’t punish electorally politicians who cut their benefits. But the situation is more complicated in two ways. First, most non-citizens are related to persons who *are* citizens of the United States and therefore can vote. These voters may punish politicians who cut their relatives’ benefits, especially if they themselves have to pick up the costs formerly borne by government. Second, many persons who receive means-tested benefits or may receive them in the future are *eligible* to become citizens, and will do so if they have incentives to do it. The naturalization process in the United States is not entirely costless in terms of time, anxiety, and identity, however, and new citizens may also be inclined to punish politicians who forced them to go through this process. Moreover, politicians from states with heavy concentrations of immigrants (notably California, which is home to 40 percent of immigrants receiving federal benefits) are well aware that if federal benefits are cut off, additional burdens are almost certain to be transferred to state and local governments in their home jurisdiction.<sup>40</sup>

Cutting benefits to non-citizens nevertheless seemed a *relatively* attractive option for politicians in the era of the Budget Enforcement Act of 1990, where every expansion in entitlement program expenditure must be offset either by a tax increase or by a cut in some other program. The Clinton administration used cuts in immigrant benefit in 1993 to finance an extension of Unemployment Insurance benefits in 1993. It also planned to sue cuts in benefits to non-citizens to finance a portion of its failed 1994 welfare reform

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<sup>37</sup> Illegal aliens are, with very few exceptions, barred from receiving federally-financed benefits (see House Ways and Means Committee, *1996 Green Book*, pp. 1301-2, 1353-59), although the courts have ruled that they cannot be barred from most *state*-financed programs, most importantly public education.

<sup>38</sup> See House Ways and Means Committee, *1998 Green Book*, pp. 138-1399. In the 1980s, Congress added provisions to three major programs (Supplemental Security Income, Aid to Families with Dependent Children, and Food Stamps) “deeming” a portion of sponsors’ income to be available to non-citizens in calculating non-citizens’ income eligibility for public assistance for a period of three years (later extended to five years for SSI). Most Medicaid recipients become eligible as a result of qualifying for AFDC or Supplemental Security Income, and thus are indirectly affected by deeming provisions.

<sup>39</sup> House Ways and Means Committee, *1996 Green Book*, p. 1305

<sup>40</sup> William Claiborne, “California Faces New Welfare Reality,” *Washington Post*, August 2, 1996, p. A9.

proposal.<sup>41</sup>

The new Republican majority that took over control of Congress in 1995 proposed far more ambitious cuts in eligibility for immigrants than the Clinton administration had dared. House Republicans' Contract with America proposed barring resident non-citizens from virtually every federal means-tested program, including SSI and Medicaid. Their aggressive stance on benefits to non-citizens reflected a coming together of several forces, notably (1) a strong desire to reduce federal spending; (2) a desire to send a very strong signal to potential immigrants that while they were welcome to come to the United States to work, they should not view it as a free retirement home; and (3) a belief that immigrants to the United States should express their commitment to this country by becoming citizens.

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<sup>41</sup> See R. Kent Weaver, *Ending Welfare As We Know It*, Washington, D.C.: The Brookings Institution, forthcoming, chapter 8.

In the final legislation passed as part of the 1996 welfare reform bill, non-citizens retained eligibility for many educational, child nutrition and job training programs. But the legislation barred most non-citizens from receiving Supplemental Security Income and Food Stamps until they became citizens. Moreover, the bill's SSI retrenchment provisions took effect almost immediately, and did not exempt current recipients.<sup>42</sup>

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<sup>42</sup> States also gained an option to exclude "qualified aliens" already in the country from receiving payments under the new Temporary Assistance to Needy Families and Medicaid (except for treatment of emergencies) programs. Immigrants who enter the country after enactment of the legislation face a five year waiting period for Medicaid and TANF. Future sponsor affidavits of support were made legally enforceable, and extended "sponsor deeming" provisions for program eligibility were also added for future immigrants to the United States that take affect once the five year waiting period has expired. Refugees are exempted from both the Food Stamp/ SSI ban and the state option to deny TANF and Medicaid for their first five years in the United States, and other exemptions were made for veterans of the U.S. military and persons with a substantial (10 years) work history in the United States. For details of program provisions, see House Ways and Means Committee, *1996 Green Book*, pp. 1353-59; Jeffrey L. Katz, "Welfare Overhaul Law," *Congressional Quarterly Weekly Report*, September 21, 1996, pp. 2696-2705, at pp. 2701-2702; David A. Super, Sharon Parrott, Susan Steinmetz and Cindy Mann, *The New Welfare Law*, Washington, D.C.: Center on Budget and Policy Priorities, August 14, 1996, chapter 4). Separately passed legislation also imposed minimum income qualifications on persons seeking to sponsor a family member for immigration (Dugger, 1997). Overall, immigrant provisions constituted 44 percent of the seven-year expenditure cutbacks in the legislation (Congressional Budget Office (1996) Letter from Congressional Budget Office Director June O'Neill to Jacob Lew, Acting Director, Office of Management and Budget, August 9, Summary Table 2).

The immigrant provisions of the welfare reform act proved to be highly controversial, and became one of the Clinton administration's top targets for revisions to the law.<sup>43</sup> The Balanced Budget Act of 1997 restored SSI benefits to those who had been receiving them at the time that the 1996 welfare law was passed: a limited backtracking on SSI consistent with the blame-avoiding principle that taking benefits away from those who already have them is most likely to spark retribution.<sup>44</sup>

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<sup>43</sup> Judith Havemann and Barbara Vobejda, "President's Budget Draft Would Restore Some Aid Cut by Welfare Law," *Washington Post*, February 5, 1997, p. A6. In addition, Republican governors who had helped to shape and had endorsed the welfare reform bill pressed for reconsideration of immigrant benefit provisions that they felt would impose a severe burden on their states. They backed down under pressure from Republican leaders in Congress, who resisted major changes in those immigrant benefit provisions, in large part because they produced such a large share of the expenditure reductions in the act. On conflict between congressional Republicans and Republican governors, see Judith Havemann, "GOP Governors Ask Congress to Revisit Law Ending Some Immigrant Benefits," *Washington Post*, January 25, 1997, p. A8; Havemann, "GOP Governors Reject Reopening of Welfare But May Seek Some Aid," *Washington Post*, February 2, 1997 p. A7.; Dan Balz and Judith Havemann, "Governors Seek to Ease Group's Partisanship," *Washington Post*, February 2, 1997 p. A6.; Dan; Robert Pear, "Governors Limit Revisions Sought in Welfare Law," *New York Times*, February 3, 1997, p. A1.

<sup>44</sup> For a review of legislative changes in SSI made between 1993 and 1997, see House Ways and Means Committee, *1998 Green Book*, pp.318-325.

Throughout most of President Clinton's first term in office, efforts to address Social Security's long-term funding problems remained largely stymied by politicians' reluctance to agree to restrictive changes in Social Security in the absence of a funding crisis. A number of proposals were offered to address the long-term funding shortfall in Social Security. For example, former Congress Secretary Peter Peterson proposed means-testing Social Security benefits for Social Security recipients with incomes above \$35,000 per annum, as well as a further increase in the normal retirement age (to age 68) and requiring the elderly to pay taxes on a portion of their Medicare benefits.<sup>45</sup> However, these proposals, remained on the margins of political discourse in the United States.

**CUTTING INDEXATION.** In the second Clinton administration, two proposals have dominated the Social Security discussion agenda in the United States: adjustment of benefit indexation mechanisms, and some combination of investment of Social Security funds in equity markets, possibly combined with creation of individual investment accounts. The first proposal, adjustment of benefit indexation, reflects a widely shared perception among economists that the Consumer Price Index (CPI), which is used to make annual adjustments in Social Security benefits, overstates inflation. The reasons are fairly technical, involving the difficulty in measuring price increases that reflect improvements in quality (faster computers and cars with more safety equipment, for example) and substitution by consumers of less expensive substitutes (apples for bananas, for example) when the price of goods rise.

In principle, a lowering of the value of the CPI combines elements of both the "automatic triggers" and "delegation to experts" paths around the political sensitivity of Social Security cuts. It provides an opportunity to lower outlays without direct intervention by politicians, and with the eminently reasonable justification that it is not in fact a benefit cut at all, but simply a more accurate calculation that will keep the real value of benefits intact rather than falsely inflate them. If there were a methodology for reforming the Consumer Price Index that all experts and interests agreed upon, and that experts in the Bureau of Labor Statistics could simply implement as a technical improvement in the index, then reform of the CPI (and cutbacks in Social Security benefits) might be politically attainable. But there is no agreement on a methodology, or even on how much the CPI overstates inflation. That means that if the CPI is to be changed in the short term, politicians must get involved, legislating a "best guess" adjustment in the CPI. The politics of Social Security cutbacks are so extraordinarily sensitive that a downward adjustment of benefits requires the political equivalent of a virgin birth: no politician wants to claim, or to be labeled by his or her political enemies, as the father of this baby. In the negotiations in the spring of 1997 between the President and congressional leaders over a potential budget deal, both parties sent signals that they would consider agreeing to a downward adjustment in the CPI, but only if the other side would agree simultaneously, so that they could not be assigned paternity for the idea during a later election campaign.<sup>46</sup> As budget negotiations neared completion in the spring of 1997, Senate Majority Leader Trent Lott seems to have decided that Republicans would ultimately take the blame for cutting inflation adjustments if they were included in a budget agreement,

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<sup>45</sup> Peter G. Peterson *Facing Up: How to Rescue the Economy from Crushing Debt and Restore the American Dream*, New York: Simon and Schuster, 1993.

<sup>46</sup> On the President's calculus in refusing to agree to an independent commission to settle CPI revisions, see Clay Chandler and Eric Pianin, "President Won't Back CPI Panel," *Washington Post*, March 13, 1997 p. A1; George Hagar, "GOP Demands New Clinton Budget As CPI 'Magic Bullet' Misfires," *Congressional Quarterly Weekly Report*, March 15, 1997, pp.619-620.

so he took them off the table.<sup>47</sup> The achievement of a federal budget surplus beginning with the 1998 federal fiscal year has at least temporarily put cuts to the CPI used to index Social Security benefits on the back burner: the political risks associated with such cuts in a period in which Social Security contributions are fueling budget surpluses is too great.

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<sup>47</sup> See Eric Pianin, "Lott Rejects Lower Social Security Adjustment As Part of Budget Deal," *Washington Post*, April 29, 1997, p. A; Richard W. Stevenson, "Lott Now Opposes Change in Inflation Adjuster," *New York Times*, April 29, 1997 p. A16..

***THE PRIVATIZATION DEBATE.*** Controversy continues over another Social Security reform proposal, however: investment of Social Security trust funds in the stock market.<sup>48</sup> The appeal of this reform is in large part that it appears to offer the equivalent of a free lunch to politicians: because the stock market over the long run offers a higher rate of return on workers' contributions than the current policy of investing payroll tax contributions in government bonds, taking advantage of this higher rate of return could lower the long term shortfall in the Social Security trust fund when the baby boom generation retires, and thus lessen the need to cut benefits or eligibility.

Some form of investment in the stock market has enjoyed growing support in the 1990s, especially in the business and conservative policy communities. Organizations like the Cato Institute and the Committee for Economic Development have called for varying degrees of "privatization" of Social Security through mandatory contributions to personal pensions.<sup>49</sup> Senators Kerrey and Danforth called for mandatory personal pensions in the report of the Bipartisan Commission on Entitlement and Tax Reform.<sup>50</sup> The 1994-96 Advisory Council on Social Security, which issued its report in early 1997, was unable to agree on a single plan to harness the stock market to save Social Security, however. Instead, the Council split into three groups, none of which was able to muster a majority. One group, most strongly tied to the current system, urged a series of incremental reforms plus a potential investment of a portion of Social Security contributions be invested by government in broad-index stock market funds beginning in the year 2010. A second group favored an increase in payroll taxes, with the new funds being invested by individuals in one of several choices through pooled accounts held by government. The third, most radical, plan would convert the current Social Security system into a flat-rate pension and divert a larger share of payroll tax contributions into individual accounts that could be invested in a broader array of investment vehicles. Each of the plans would make a variety of additional changes in the retirement age and other aspects of Social Security, but it is their investment aspects that have garnered the most attention, and constitute the biggest change from the status quo.

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<sup>48</sup> 1994-96 Advisory Council on Social Security, *Report*, vol 1. *Findings and Recommendations*, Washington, D.C.: The Council, 1997.

<sup>49</sup> Committee for Economic Development (1996) *Fixing Social Security*, New York: CED

<sup>50</sup> Bipartisan Commission on Entitlement and Tax Reform, *Final Report to the President*, Washington, D.C.: Superintendent of Documents, 1995.

Disagreements about which of these approaches to take reflect not only different values, but different assessments of risks and willingness to accept that risk-- or assign it to individual Social Security recipients. Would moving investment away from government bonds, for example, cause an increase in interest rates and an increase in the federal deficit? What would happen to retirees who lost money on investments in their personal accounts, and what safeguards should be put in place to minimize those losses? How would the creation of individualized Social Security accounts financed by a payroll tax increase affect individuals' other savings? And how might Social Security funds invested in the equity of companies affect the federal government's willingness to undertake regulatory decisions that impose losses on those companies.<sup>51</sup> The uncertainties posed by these unresolved issues translate into big political risks for politicians. It is thus no surprise that no single solution emerged, and that the positions taken by participants were heavily influenced by political posturing.

In the debate over Social Security privatization, conflict has centered in part on the distributional consequences of those reforms for particular groups. Privatization advocates have attempted to undermine public support for the program by showing that particular groups either have shared poorly under the current system or were likely to do so in the future, thus allowing them to generate blame against politicians who fail to support privatization proposals. Defenders of the status quo, on the other hand, have attempted to rebut those charges and show that they would do more poorly under individual accounts. Privatizers have in particular focused on the lower returns to contributions by younger workers, arguing that Social Security is a "bad deal" for this group. They have also argued that African-Americans, because they have shorter average life-spans, receive lower returns on their contributions.<sup>52</sup>

Critics of privatization have responded in a variety of ways. They have, for example, argued that while it is true that African-Americans' lower life expectancy lowers their return on Social Security contributions, both the Social Security benefit formula that disproportionately benefits workers with lower lifetime earnings and higher than average receipt of survivors' benefits and Social Security Disability insurance benefits by African-Americans causes that group to reap disproportionate benefits from Social Security.<sup>53</sup> Critics of individual accounts have also argued that because of stock market volatility, individuals who retire a few years apart after contributing over their working lives to a broad stock index fund could end up with dramatically different earnings replacement rates—and those who pulled out their funds in a stock market trough would end up with very inadequate benefits.<sup>54</sup>

The course of the debates in the late 1990s over equities investment and creation of personal accounts for Social Security has been heavily influenced by the political maneuverings of Bill Clinton. The

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<sup>51</sup> Jeffrey L. Katz, "Fierce Debate Looms as Congress Turns to Social Security Rescue," *Congressional Quarterly Weekly Report*, January 11, 1997, pp. 127-132.

<sup>52</sup> W. Beach and Gareth Davis, *Social Security's Rate of Return*, Heritage Foundation Center for Data Analysis, 1998.

<sup>53</sup> *Social Security and Minorities: Current Benefits and Implications of Reform*, Testimony of Cynthia M. Fagnoni, Director, Income Security Issues, Health, Education and Human Services Division, General Accounting Office before the Subcommittee on Social Security, House Committee on Ways and Means, GAO/T-HEHS-99-60, February 10, 1999.

<sup>54</sup> See testimony of Gary Burtless for the Task Force on Social Security Reform, House Budget committee, May 11, 1999.

President clearly saw a long-term solution to Social Security financing as one of the few issues on which he could leave a positive legacy to dispel his impeachment-tarnished image. In his 1998 State of the Union Speech, Clinton called for “Saving Social Security First”—deferring any tax cuts or expenditure increases until a Social Security rescue package was adopted, with a year-long dialogue on Social Security reform leading to development of a consensus reform package. Republicans (correctly) interpreted this as an effort to forestall Republican to defer Republican pressures for a major tax cut without going out on a political limb by putting forward his own proposal.

1998 also saw an evening out of the debate over privatization, which proponents had previously dominated. Both the AFL-CIO and the American Association of Retired Persons became more forceful in their defense of the existing Social Security system.<sup>55</sup> The Century Foundation (formerly the Twentieth Century Fund) began a project to disseminate research and opinion pieces that called privatization into question.

In the latter months of 1998, President Clinton sent conflicting signals about whether or not he would accept some degree of Social Security privatization through a “carve-out” of existing Social Security payroll taxes revenues for individual accounts. The proposal he put forward in his January 1999 State of the Union address was a political masterstroke.<sup>56</sup> In it, he proposed to reserve 62 percent of the Social Security surplus anticipated over the next fifteen years to bolstering the Social Security (Old Age Survivors Insurance) trust fund). Approximately one-fifth of this amount would be devoted to invested in equities—collectively rather than individually—through a mechanism insulated from government influence. Thus returns on trust fund revenues would be raised at least modestly, but the size of the investment would also be modest enough to lessen fears about government control of the economy. In addition, another 11 percent of the surplus was to be reserved for government subsidies to new “Universal Savings (USA) Accounts”—new retirement savings accounts through which the federal government would match individual retirement savings accounts, with extra benefits for low income workers. These accounts would help individuals prepare for retirement based on personal choice and individual accounts, as privatizers prefer. They have one fundamental difference from Privatizers’ plans, however: they would not take money out of existing payroll taxes or be part of the basic OASI system. Thus they would not require cutting the existing “defined benefits” of the OASI system, and government commitments could be scaled back when government budget surpluses shrink.

Also influencing the course of the debate were changing projections about when the OASI funding crisis would hit. For most of the last quarter of the twentieth century, the Social Security Administration’s projections of when the OASI trust fund would run out of money had proven too optimistic. After each legislative change, the date when the trust fund was expected to be empty would quickly begin moving forward. But in 1997, this began to reverse: with a better than expected economy, the anticipated trust fund crisis moved further way (from 2029 in 1997 to 2034 in 1999), lessening the already weak sense of system crisis. (Indeed, critics of privatization charged that the Social Security system’s trustees, all Clinton administration officials, had changed assumptions about future wage growth in their 1999 report to make the

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<sup>55</sup> See Robert Kuttner, “Growing Doubts About Privatizing Social Security,” *Boston Globe*, August 16, 1998.

<sup>56</sup> See Executive Office of the President, *Budget of the United States Government, Fiscal Year 2000*, p. 41.

funding crisis appear in 2034 rather than 2039).<sup>57</sup>

Overall, the promise of substantial change in social Security prior to the presidential election in the year 2000 has declined substantially. Although President Clinton has sought to maintain sufficient flexibility that he could sign almost any piece of legislation, the positions of congressional Republicans and Democrats remain far apart, leading Republicans to fear that any Social Security initiative on their part could lead them to a political trap. The idea that individual accounts invested in the stock market could constitute a “free lunch” for politicians has dissipated.

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<sup>57</sup> Mark Weisbrot, “Social Security: Can the Trustees Be Trusted,” Knight-Ridder Media Services, May 19, 1999.

Three possible avenues of possible compromise remain (barely) open. First, the option of investment of Social Security trust funds in the stock market could almost certainly win support from Democrats, but it is unlikely that congressional Republicans would agree to it. Alan Greenspan, the powerful and widely-respected chairman of the Federal Reserve Board, has also been a highly vocal critic of government investment in equities markets. Greenspan argues that no mechanisms to insulate investment managers from political pressures would be adequate.<sup>58</sup> Critics of privation have challenged this position, citing the experience of the Thrift Savings Plan (for federal employees) and state employee plans.<sup>59</sup> Second, a proposal along the lines of the president's could possibly be sold as a compromise that preserves the integrity of the current system while providing for individual accounts, but Republicans are likely to see it as moving far enough toward a privatized system—and unlikely to want to cede the President all the political credit for a Social Security reform package. Finally, it is possible that Democrats might agree to a small carveout of the existing Social Security accounts, with an equal or larger increase in the payroll tax also devoted to individual accounts. But it is highly unlikely that Republicans would agree to any tax increase, especially if they feel that they have a chance of getting a better deal if a Republican president is elected in the year 2000.

#### ***REFORMING PUBLIC PENSIONS IN CANADA***

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<sup>58</sup> For Greenspan's views, see Richard W. Stevenson, "Fed Chief Warns of Painful Choices on Social Security," *New York Times*, January 29, 1999, p. A1.

<sup>59</sup> For a review of the literature concluding that government investment of Social Security funds could be adequately shielded from political interference, see Alicia H. Munnell and Annika Sunden, "Investment Practices of State and Local Pension Funds: Implications for Social Security Reform," paper presented at the first annual conference of the Retirement Research Consortium, May 20-21, 1999, Washington, D.C.

Canada currently has a public pensions system with three main tiers of cash benefits, rather than the two-tier system as in the United States.<sup>60</sup> Moreover, the history of its pension system—and therefore the legacy of that history for future choices is quite different. Canada began with federal subsidies to the provinces for means-tested pensions in 1927. This was supplanted in 1951 by Old Age Security (OAS), which until changes made in 1989 was a universal program providing a flat amount to all Canadians aged 65 and over. The 1989 changes reduced, and in some cases eliminated, OAS benefits to upper income Canadians. A second, income-tested tier is made up of the Guaranteed Income Supplement (GIS), created in 1965, and the Spouses Allowance (SPA), created in 1975 (unlike SSI in the United States, however, there is no asset test for any of these programs). These programs supplement OAS payments to low income senior citizens and their near-senior spouses. OAS, GIS and SPA are all financed out of general revenues, and together provide an income guarantee higher than the Supplemental Security Income floor in the United States.<sup>61</sup> As of 1997, about 38 percent of OAS pensioners also received at least some GIS payments.<sup>62</sup>

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<sup>60</sup> In Canadian discourse, the quasi-universal OAS and income-tested GIS and Spouse's Allowance are all referred to as a single tier or "pillars." In this discussion, I will follow the more conventional practice of separating out universal and income-tested programs as distinct, although integrated tiers.

<sup>61</sup> In January 1999, the maximum OAS monthly rate was \$410.82. The maximum Guaranteed Income Supplement was \$488.23 for a single person and \$318.01 for a single person. The maximum Spouse's Allowance was \$728.83 for a married person and \$804.64 for a single person. (Human Resources Canada, Planning and Strategic Studies, *Statistics Related to Income Security Programs*, December 1998, page a.5) In addition, as of 1997, five provinces and two territories provide income supplements for aged persons with low incomes. (Battle, "A New Old Age Pension," p. 138.

<sup>62</sup> In 1997, a monthly average of 3.589 million persons received OAS benefits, 1.178 million received partial GIS benefits and 186 thousand received full GIS benefits. Another 100 thousand received the Spouse's Allowance. (Human Resources Canada, Planning and Strategic Studies, *Statistics Related to Income Security Programs*, December 1998, page m.2)

The third major cash tier in Canada's retirement income system is the Canada Pension Plan (CPP)—a contributory social insurance plan that pays benefits linked to an individual's contribution history. The normal retirement age for CPP pensions is 65, but early retirement (with a reduction in benefits) is available from age 60.<sup>63</sup> Like Social Security in the United States, the CPP provides a higher return to low-wage workers, but using a different mechanism: contributions are not paid on an initial amount of yearly earnings, the year's basic exemption or YBE (\$3,500 in 1997), but those earnings are counted toward benefit entitlement.

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<sup>63</sup> There is a six percent reduction of benefits for each year below age 65 that a person elects early retirement. Individuals can also elect to delay CPP benefits to any point up to age 70, with a bonus of 6 percent for each year of delay in benefit take-up.

While both OAS and GIS are entirely within federal jurisdiction, Ottawa does not have exclusive decision-making authority over the CPP. Changes in the Canada Pension Plan require approval of a "super-majority" of the Canadian provinces, making it a more difficult target for either expansionary or contractionary pension initiatives than the programs within federal jurisdiction.<sup>64</sup> Provinces can also opt out of the CPP to establish their own plans. Only Quebec has chosen to do so, and a separate Quebec Pension Plan, with contribution and benefit policies generally identical to those of the CPP, operates in Quebec. (Quebec is still included in the "2/3-2/3" formula for changes to the CPP, however). Moreover, as part of the federal-provincial bargaining that was required to allow Ottawa to establish the CPP in 1966, Ottawa agreed to allow the provinces to borrow CPP surpluses as they accrued in the early years of the program at Ottawa's borrowing rate—generally better than most provinces could get on their own in financial markets.<sup>65</sup> Thus the provinces had both a veto power over change in the CPP and a substantive stake in policy: maintaining their privileged access to low-cost capital and delaying as long as possible the need to pay back the principal on the money they had borrowed. The result, as one Canadian observer put it, was that the CPP functioned as "essentially a typical, unfunded 'pay as you go' public pension plan, but one that has been burdened with a secondary role of generating revenue for the participating provinces."<sup>66</sup>

The early programmatic choices made in building Canada's multi-tiered (universal, income-tested, earnings-related) retirement income system have limited the range of later options open to politicians: it is now almost impossible for Canada to start afresh with a dramatically different system of social provision, and almost as hard to delete existing tiers of pensions. For example, targeting inefficiencies in the universal Old Age Security program have long been recognized. But simply abolishing it and relying on the contributory Canada Pension Plan was not an option. Because the CPP was originally designed as a supplement to OAS rather than as a replacement for it, the replacement rate provided by the CPP is very low: roughly 25 percent of earnings, up to a maximum of about 25 percent of the average wage. The inadequacy of the CPP as a

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<sup>64</sup> Changes in the CPP must be approved by two-thirds of the Canadian provinces having two-thirds of the Canadian population. This means that any four provinces or Ontario alone have a veto. In practice, Quebec has a veto over major changes as well, since policymakers want to keep the Ontario and Quebec plans closely integrated. See Keith Banting, "Institutional Conservatism: Federalism and Pension Reform," in Jacqueline Ismael, ed., *Canadian Social Welfare Policy: Federal and Provincial Dimensions*, Kingston and Montreal: McGill-Queens University Press, 1985, pp. 48-74, especially pp. 56-57.

<sup>65</sup> Negotiation with the provinces was required because supplementary benefits (e.g., for widows and survivors) are within exclusive provincial jurisdiction, and thus federal entry required provincial assent to an amendment to the British North America Act. On the negotiations surrounding creation of the Canada Pension Plan, see Richard Simeon, *Federal-Provincial Diplomacy: The Making of Recent Policy in Canada*, Toronto: University of Toronto Press, 1972, chapter 3, and Bryden, *Old Age Pensions and Policy-Making in Canada*, chapter 8.

<sup>66</sup> Bruce Kennedy, "Refinancing the CPP: The Cost of Acquiescence," *Canadian Public Policy*, vol. 15 (1989) p. 34."

stand-alone pension could be addressed by increasing benefits from and contributions to the CPP, but doing so would create a double payment problem—today’s workers would have to pay increased contributions now for themselves plus the cost of the current pension system to current retirees. CPP/QPP benefits, like those for OAS, GIS and SPA are all indexed for inflation. The Guaranteed Income Supplement has also been increased several times on an ad hoc basis, generally in election years: e.g., 1979, 1980 and 1984.

As in the U.S., benefits are also delivered to seniors through the tax system, both directly through the Age Credit and Pension Credit (both were tax exemptions, and therefore regressive in their impact, until 1988), and indirectly, through tax subsidies for contributions to employment based (registered Retirement Plans and personal pension plans (Registered Retirement Savings Plans, or RRSPs). RRs and RRSPs, as in the United States, allow contributors to defer taxation on income until they retire. They primarily benefit middle- and upper-income Canadians, who are more likely to have employer-provided pensions and be able to save for retirement.<sup>67</sup> But they comprise a very large share of retirement income: the Canadian government estimates that (excluding the Age and Pension Credits), tax deferred savings through RRs and RRSPs provided almost 44 percent of government-sponsored retirement income in 1997, compared with 27.5% for OAS and GIS combined, and 28.8 percent for the Canada Pension Plan and Quebec Pension Plan.<sup>68</sup>

### ***Initial Retrenchment Initiatives***

Several efforts to reduce pension costs in Canada took place in the 1980s.<sup>69</sup> The first was part of the Trudeau government's "Six and five" inflation-fighting package enacted in 1982. In that initiative, cost of living adjustments in Old Age Security, as well as previously negotiated public sector wage increases, were limited to a maximum of six percent for 1983 and five percent for 1984. However, increases in the Guaranteed Income Supplement were "super-indexed," i.e., increased more than inflation, to ensure that those at the very bottom of the income scale kept up with inflation. This concession, and the fact that pensioners were not singled out for cutbacks, helped to make the restraint package politically palatable, and it was adopted by Parliament. It ended up having little effect, however, since inflation declined to levels close to the "Six and Five" guidelines.<sup>70</sup>

The next initiative occurred as part of the Mulroney government's attempts to reduce the federal deficit shortly after it came into office with a huge House of Commons majority in 1984. The new Progressive Conservative government wanted to proceed cautiously: the party had been out of power in

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<sup>67</sup> For general background on government pensions in Canada, see National Council of Welfare, *A Pension Primer*, Ottawa: Supply and Services, Summer 1996, and Keith G. Banting, *The Welfare State and Canadian Federalism* (second ed.), Kingston and Montreal: McGill-Queen's University Press, 1987. On the origins of Canadian pension policies, see Kenneth A. Bryden, *Old Age Pensions and Policy-Making in Canada*, Kingston and Montreal: McGill-Queens University Press, 1974.

<sup>68</sup> Government of Canada, *Securing Canada's Retirement Income System*, April 1997, p. 6.

<sup>69</sup> For an overview of changes in Canadian pension programs, see Ken Battle, "A New Old Age Pension," pp. 135-190, and Prince, "Lowering the Boom on the Boomers."

<sup>70</sup> See Ken Battle, "Indexation and Social Policy," *Canadian Review of Social Policy*, Issue No. 16/17, October 1986 and January 1987, pp. 1-20.

Ottawa since 1963, except for a brief minority government under Joe Clark in 1979-80. The major objective of the new Prime Minister, Brian Mulroney, was to fashion a sustained political realignment favoring the Conservatives; attacking popular programs for the elderly is not a good way to promote such a realignment. But Canada's huge federal budget deficit, which reached 8.6% of GNP in the fiscal year ending in March 1985,<sup>71</sup> pushed the new government to consider pension cuts. In doing so, the government initially stumbled badly. News leaked in late 1984 that the government was considering cutting the universal demogrant programs--Old Age Security and Family Allowances--as a way to reduce the deficit and target resources on the needy. The government ultimately retreated from an attack on universality without ever articulating a clear proposal.<sup>72</sup> Indeed, Mulroney backed himself further into a fiscal corner by pledging to maintain universality.

Budget pressures remained strong, however, and the following spring Finance Minister Wilson won Cabinet approval for cutting social spending through an attack on indexing rather than universality. Under the government's proposal, adjustments would only be made in Old Age Security (as well as Family Allowances and income tax brackets) for inflation in excess of 3 percent. Full indexing of the Guaranteed Income Supplement was to be maintained, but since the latter is an add-on to OAS, poor seniors would also have their benefits cut.

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<sup>71</sup> Receiver General for Canada, *Public Accounts of Canada, 1987, volume 1: Summary Report and Financial Statements*, Ottawa: Supply and Services, 1987, p. 1-2.

<sup>72</sup> Michael Clugston, "The Social Welfare Battle," *Macleans*, January 7, 1985, p. 44. A full account of this episode is given in David Bercuson, J.L. Granatstein, and W.R. Young, *Sacred Trust?: Brian Mulroney and the Conservative Party in Power*, Toronto: Doubleday Canada, 1986, chapter 6.

While the idea was that cloaking restraint in the guise of fighting inflation would make it more politically palatable, the Mulroney/Wilson proposal played quite differently from the Trudeau government's "Six and Five" plan. It affected all recipients from the first dollar of inflation, because it did not (contrary to the advice of Finance Ministry public servants) protect the poorest elderly from cutbacks by "super-indexing" the Guaranteed Income Supplement. Moreover, the government's move contradicted Mulroney's campaign pledge to retain full indexation of Old Age Security, leaving him open to criticism not only on the substance of the policy change, but on his honesty and trustworthiness as well.<sup>73</sup>

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<sup>73</sup> See Jeffrey Simpson, "Tangled Up in Pledges," *Globe and Mail* (Toronto), June 6, 1985, p. 6.

Opposition was immediate and intense. The New Democratic and Liberal opposition in the House of Commons severely criticized the cuts on a daily basis. There was also opposition outside the House of Commons. Both the Liberals and the NDP sent task forces across the country to hold hearings on--and publicize opposition to--the cuts. Senior citizens' organizations protested outside the Parliament building and mounted letter-writing campaigns.<sup>74</sup> The Quebec National Assembly unanimously passed a resolution asking the federal government to reconsider; Conservative provincial premiers in the Maritime provinces were critical as well.<sup>75</sup> Even the business community's representatives criticized the cuts.<sup>76</sup> Within three weeks, the Prime Minister was backtracking, saying that the cuts in Old Age Security were only a proposal that would not take until the next year and might never be implemented if the economy performed well.<sup>77</sup> Two weeks later, the Mulroney government retreated completely, announcing that full indexing of Old Age Security (but not Family Allowances and the personal income tax system) would be continued.<sup>78</sup> But the Mulroney government did succeed with a similar reform on two more modest (and far less visible fronts): in converting both the age and pension tax deductions to non-refundable credits in 1988, the former was only partially indexed and the latter was not indexed at all, cutting their real value over time.<sup>79</sup>

After the 1985 OAS debacle, it is not surprising that the Conservatives left that program alone until after they won re-election in 1988, in a campaign that focused almost entirely on the issue of free trade with the United States.<sup>80</sup> Persistent federal budget deficits-- still 4.9% of GNP in the fiscal year ending in March 1988-- caused the issue to be rejoined. In his April 1989 budget, Finance Minister Wilson announced that there would be a special tax (known as a "clawback") of fifteen percent on Canada's universal demogrants (OAS payments and family allowances) for upper income families and individuals. This tax was to be phased

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<sup>74</sup> See Barbara Yaffe, "Wilson Budget 'Stinks,' N.B. Seniors Contend," *Globe and Mail* (Toronto), June 7, 1985, p. 1; Yves Lavigne, "Elderly Urged to End PC memberships as Pension Protest," *Globe and Mail* (Toronto), June 12, 1985, p. 1; and Charlotte Montgomery, "PM Faces Politician's Nightmare Over Canadian Pension Furore," *Globe and Mail* (Toronto), June 20, 1985, p. 5.

<sup>75</sup> See "Budget Worries Maritime Premiers," *Globe and Mail* (Toronto), June 12, 1985, p. 5, and Barbara Yaffe, "Pension Cuts a 'Proposal,' PM Asserts,," *Globe and Mail* (Toronto), June 13, 1985, p. 2.

<sup>76</sup> "Business Joins Outcry about Seniors' Pensions," *Globe and Mail* (Toronto), June 112, 1985, p. 5.

<sup>77</sup> Yaffe, "Pension Cuts a 'Proposal,' PM Asserts," p. 1.

<sup>78</sup> Charlotte Montgomery, "Tories Retreat on De-Indexing Pensions," *Globe and Mail* (Toronto), June 28, 1985, p. 4.

<sup>79</sup> Prince, "Lowering the Boom on the Boomers," p. 214.

<sup>80</sup> Social issues were not entirely absent from the debate, however, as the opposition parties charged that the free trade agreement threatened Canada's social programs. See Christopher Waddell, "Wilson Charges Foes with Lying to Elderly," *Globe and Mail* (Toronto), November 1, 1988, p. A1.

in over three years. The Finance Minister estimated that the OAS clawback, when fully phased in, would initially affect only 4.3 percent of the elderly population, with 1.8 percent of OAS recipients losing their OAS benefit entirely.<sup>81</sup> But since the thresholds at which the clawback begins are only partially indexed (to inflation over three percent, with the potential for additional adjustments on an ad hoc basis), the clawback gradually affected more pensioners. Moreover, the clawback contained a serious inequity: because the clawback was calculated on an individual basis, couples who each had incomes just below the \$50,000 phase-in point could escape the clawback entirely, while those with the same total income contributed by just one of the partners would lose that person's OAS benefit entirely.<sup>82</sup>

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<sup>81</sup>The "clawback" rate of 15 percent on OAS payments initially phased in beginning at a net income of \$50,000, with all OAS benefits taxed back at an income level of \$76,332. See Canada, Ministry of Finance, *Budget Papers*, April 27, 1989, pp. 9-12, and National Council of Welfare, *The 1989 Budget and Social Policy*, Ottawa: Supply and Services, September 1989, pp. 15-20. By 1995, the clawback began at a net income above \$53,215, with all OAS income taxed back at income of \$84,484. National Council of Welfare, *A Pension Primer*, p. 4.

<sup>82</sup> Prince, "Lowering the Boom on the Boomers," p. 215.

Social policy advocates strongly criticized the erosion of universality implicit in the clawback, but this time the Finance Minister did not back down, buoyed by a lack of substantial public protest and the disarray of the opposition parties (both the Liberals and the New Democrats were in the midst of searches for new leaders). The proposals were so complicated, so selective in their short-term impact, and so gradual and uncertain in their long-term effect that it was difficult for the media or interest groups to present them in a way that was intelligible to the public.<sup>83</sup>

### ***Pension Reform in the Chrétien Years***

The Liberal government headed by Prime Minister Jean Chrétien that came to power after the crushing defeat of the Conservatives in the 1993 election was elected on a platform that stressed job creation and made no mention of pension retrenchment. Once elected, however, the new government devoted most of its attention to deficit reduction, propelled toward acting quickly in part by the future liabilities of pension commitments, but even more by a tremendous fear that without major deficit reduction, the financial markets would effectively declare Canada bankrupt.<sup>84</sup> Much of the burden was to be borne by transfers to the provinces in the areas of post-secondary education, social assistance to the poor and (especially) health: sectors where the provinces actually delivered services and hence would have to make the tough decisions—and presumably incur most of the political blame—resulting from federal budget cuts.<sup>85</sup> But this option was not available in the pensions sector, where the federal government financed and administered benefits directly (except for the Quebec Pension Plan).

Government initiatives were heavily constrained by the political calendar, however: a Quebec provincial election was anticipated in the fall of 1994, and if (as expected) the Parti Québécois won, a referendum on Quebec sovereignty would occur within a year after that-- and another federal election

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<sup>83</sup> See Ken Battle, [under the pseudonym Grattan Gray], "Social Policy by Stealth," *Policy Options*, vol. 11 (March 1990) pp. 17-29, and Battle, "A New Old Age Pension," pp. 146-47."

<sup>84</sup> On this period, see Edward Greenspon and Anthony Wilson-Smith, *Double Vision: The Inside Story of the Liberals in Power*, Toronto: Doubleday Canada, 1996.

<sup>85</sup> See Leon Muszynski, "Social Policy and Canadian Federalism: What Are the Pressures for Change?," pp. 288--318, and Miriam Smith, "Retrenching the Sacred Trust: Medicare and Canadian Federalism," pp. 319-337 in François Rocher and Miriam Smith, eds., *New Trends in Canadian Federalism*, Peterborough: Broadview, 1995, and Allan M. Maslove, "The Canadian Health and Social Transfer: Forcing Issues," pp. 283-301 in Gene Swimmer, ed., *How Ottawa Spends, 1996-1997: Life Under the Knife*, Ottawa: Carleton University Press, 1996.

presumably in 1997. That left a very narrow window of opportunity-- after the Quebec referendum but as far as possible away from the next federal election-- for any pension retrenchment initiative.

**THE SENIORS BENEFIT: AN ABORTIVE INITIATIVE.** As part of their drive to reduce deficits, Finance Minister Paul Martin and Finance Department officials led an effort to win the approval of Prime Minister Chrétien and the Liberal Cabinet for a restructuring of OAS and GIS that would reduce pensions to middle- and upper-income recipients, while leaving lower-income recipients slightly better off.<sup>86</sup> They encountered substantial opposition from “social” Liberals, ministers who feared a repeat of Mulroney’s 1984-85 debacle and from the Prime Minister, who worried about its effects on the upcoming referendum on sovereignty in Quebec, where seniors were expected to be a major source of support for the federalist side. Ultimately, Prime Minister Chrétien forced the finance minister to back down on including pension reform in his 1995 budget-- just half a year before the expected Quebec referendum-- but promised that he could include it the following year.<sup>87</sup>

The pension reform announced in the 1996 budget constituted a major restructuring of OAS and GIS. The two programs were to be replaced in the year 2001 by a single integrated “Seniors Benefit”; pension and old age tax credits were to be eliminated at the same time. The basic effect of the changes would have been to start phasing out pension benefits (except the CPP/QPP) at lower income levels, and at a faster rate, than under the current system.<sup>88</sup> Effects would be particularly strong for couples, since the Seniors Benefit would be calculated on the basis of family income rather than individual income. The result was to be lower pension benefits for middle- and upper-income seniors and their elimination for a larger group than those affected by the current OAS “clawback.” The changes were supposed to produce substantial savings for the federal government--\$200 million in its first year and \$2.1 a year by 2011.<sup>89</sup> By the year 2030, the new Seniors Benefit was expected to save 10 percent (about \$7 billion) over the cost of the existing programs.<sup>90</sup> The political palatability of the proposal was increased by some changes made in the plan in the weeks before it was unveiled: existing senior citizens-- and those over age 60 as well-- would remain under the existing system as long as they lived if they chose not to switch to the new system. The government claimed that 75 percent of senior citizens (and 90 percent of single senior women, who tend to have the

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<sup>86</sup> See Michael J. Prince, “Lowering the Boom on the Boomers: Replacing Old Age Security with the New Seniors Benefit and Reforming the Canada Pension Plan,” pp. 211-234 in Gene Swimmer, ed., *How Ottawa Spends 1997-98, Seeing Red: A Liberal Report Card*, Ottawa: Carleton University Press, 1997, and Greenspon and Wilson-Smith, *Double Vision*, especially chapter 16.

<sup>87</sup> Edward Greenspon, “Martin Chose Lesser of Two Evils,” *Globe and Mail* (Toronto), July 29, 1998, p. A4. The 1995 Budget did enunciate a set of five principles to be followed in pension reform, initiatives, however, including maintenance of benefits for low-income seniors, full indexation of benefits, using family income in income testing OAS, increased benefit progressivity, and cost control. See Battle, “A New Old Age Pension,” pp. 151-171

<sup>88</sup> For an overview, see National Council of Welfare, *A Guide to the Proposed Seniors Benefit*, Ottawa: Supply and Services, Summer 1996.

<sup>89</sup> National Council of Welfare, *A Guide to the Proposed Seniors Benefit*, p. 23.

<sup>90</sup> Shawn McCarthy, “Martin Backs Off Seniors Plan,” *Globe and Mail* (Toronto), July 29, 1998, p. A1.

lowest incomes) would be as well off or better off than under the old system.<sup>91</sup> Thus the government sacrificed immediate budget savings for increased political viability for the proposals and their long-term savings.

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<sup>91</sup> Government of Canada, *Budget Plan 1997, Building a Future for Canadians*, February 18, 1997, p. 117.

In short, the Seniors Benefit proposal contained numerous elements—significant lead time before going into effect, a lengthy phase-in, “grandfathering” of the aged and near-aged, and minimal sweetening of benefits for the lowest income seniors—designed to diffuse opposition and political blame. The Liberals’ proposed changes to old age pensions also continued several elements of what Canadian social policy critic Ken Battle has called ‘the politics of stealth’ begun under the Mulroney government that increased their political viability. First, they were announced not in “election campaigns or in public discussion papers where they would be subject to scrutiny and debate, but rather in...budgets as part of a long list of policy measures that were imposed largely without debate.”<sup>92</sup> Inclusion in the budget both lowered their visibility and made them almost immune from attack or amendment procedurally. Second, the amendments were highly technical and complex, involving interacting effects of several programs, making it impossible for the average voter to understand.<sup>93</sup>

The measures nevertheless did prove very controversial, and the Chrétien government did not take the opportunity to impose the measures immediately as part of its 1996 budget legislation. Action was first postponed until after the spring 1997 federal election.<sup>94</sup> The long delay after announcement of the Seniors Benefit gave ample opportunity for interest group opposition to emerge. Women’s groups criticized the fact that benefits were to be based on family income rather than individual income, meaning steep cuts in benefits for women whose husbands had substantial income but had little of their own. Business groups, retirement planners, and even the Canadian Institute of Actuaries argued that the Seniors Benefits contained severe disincentives for retirement savings. Because middle income seniors would lose twenty cents of Seniors Benefit for every dollar of income that they pulled from Registered Retirement Savings Plans in addition to paying income tax on that RRSP income, senior citizens could end up with higher marginal tax rates after retirement than before—rates over seventy percent.<sup>95</sup>

Even more important than interest group opposition was growing public awareness that the federal budget was headed toward a surplus. Polls conducted for the government showed that there was little public support for cutting pension benefits in the absence of a budget crisis.<sup>96</sup> A deal with the provinces to stabilize the financing of the Canada Pension Plan (discussed below) also undercut the financial urgency of implementing the Seniors Benefit. The political ambitions of Finance Minister Paul Martin did not bode well

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<sup>92</sup> See for example Ken Battle, “The Politics of Stealth: Child Benefits Under the Tories,” pp. 417-448 in Susan D. Phillips, ed., *How Ottawa Spends, 1993-1994: A More Democratic Canada...?*, Ottawa: Carleton University Press, 1993, at p. 439.

<sup>93</sup> A third element of the “politics of stealth”, manipulation of indexation mechanisms, was not used in this case: the level at which “clawback” of the Seniors Benefit begins is more fully protected from inflation than the OAS clawback phase-in under the current system.

<sup>94</sup> See Shawn McCarthy and Edward Greenspon, “Ottawa Girds for Pension War,” *Globe and Mail* (Toronto), September 8, 1997; Laura Eggertson, “Martin Defends Premium Hike for CPP Security,” *Toronto Star*, October 29, 1997.

<sup>95</sup> Shawn McCarthy, “Martin Backs Off Seniors Plan,” July 29, 1998, p. A1; Alan Toulin, “Martin Scraps Seniors Benefit Plan,” *National Post*, July 29, p. A1; Sean Durkan, “Martin Kills Plan to Cut Pensions,” *Edmonton Sun*, July 29, 1998, p. 24. See also Prince, “Lowering the Book on the Boomers,” pp. 226-229.

<sup>96</sup> Shawn McCarthy, “Ottawa Finds Little Support for New Seniors Plan,” *Globe and Mail* (Toronto) June 30, 1998, p. A3.

for the proposed reform either: Martin was widely seen as the leading candidate to succeed Jean Chrétien as leader of the Liberal Party, and offending senior citizens and other groups arrayed against the Seniors Benefit was not a very good way to boost his prospects. By spring of 1998, the Finance Ministry was outlining alternatives to the Seniors Benefit for Martin.<sup>97</sup> At the end of July, he announced that he was simply canceling it altogether.<sup>98</sup> The lesson, as journalist Edward Greenspon summarized it, is that:

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<sup>97</sup> See Eric Beauchesne, "Martin Ignored Bureaucrats' Advice on Adjusting Pension Plans," *National Post*, May 17, 1999.

<sup>98</sup> Shawn McCarthy, "Martin Backs Off Seniors Plan."

..the postdeficit world is a world of choices, and in scrapping the Seniors Benefit he has made a major spending decision... the next generation of seniors-- the aging baby boomers-- emerge as early beneficiaries of the so-called fiscal dividend.<sup>99</sup>

**IMMIGRANTS AND EMIGRANTS:** While the Seniors Benefit was suffering a slow death, the Chrétien government had much less trouble imposing changes on benefits for immigrants to Canada and Canadians living abroad. In 1996, Canadians living abroad were required to declare their worldwide sources of income rather than just Canadian income, making it harder to avoid the OAS clawback.<sup>100</sup> Also in 1996, as part of the federal budget, benefits to immigrants were cut, although not in as draconian a fashion as in the US. Henceforth, immigrants would be eligible only for one-tenth of the means-tested GIS and Spouse's Allowances for each year of their first decade in Canada, and sponsored immigrants would not be eligible at all for either program for the period of their sponsorship.<sup>101</sup>

**REFORMING THE CPP.** Throughout each of these rounds of retrenchment in the universal Old Age Security program, the Canada/Quebec Pension Plan remained, as Sherlock Holmes put it, "the dog that didn't bark." It was not for lack of problems, however. The CPP shared with the U.S. Social Security system a deteriorating financial condition, shaped in part by declining economic and demographic conditions, a number of benefit enhancements enacted in the 1970s, and a dramatic increase in takeup of disability benefits in the 1980s and 1990s.<sup>102</sup> As a result, cashflow from contributions (i.e., contributions minus

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<sup>99</sup> Greenspon, "Martin Chose Lesser of Two Evils." See also Jeffrey Simpson, "Waving the White Flag," *Globe and Mail* (Toronto), August 5, 1998, p. A14.

<sup>100</sup> OAS benefits are payable to persons living outside Canada for only six months unless that person has lived in Canada for twenty years after reaching age 18, in which case they are payable indefinitely. (Human Resources Development Canada, "Overview of the Old Age Security Program," <http://www.hrdc-drhc.gc.ca/isp/oas/oasind-e.shtml>)

<sup>101</sup> Prince, "Lowering the Boom on the Boomers," p. 218.

<sup>102</sup> Benefit enhancements included full indexation of benefits rather than just for inflation over 2 percent in 1975, dropping

expenditures) turned consistently negative beginning in 1983. In 1993, overall CPP assets began to turn negative (that is, contributions plus interest payments were no longer adequate to pay benefits), meaning that the provinces were beginning to have to repay the principle that they had borrowed from the CPP at favorable rates.<sup>103</sup>

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retirement and earnings tests for persons aged 65 to 69 in 1975, and addition of child-rearing drop-out provisions in 1987. Overall, these benefit enhancements were estimated to add costs of 2.4 percent of contributory earnings to the program. Federal/Provincial/Territorial CPP Consultations Secretariat, *An Information Paper for Consultations on the Canada Pension Plan*, Ottawa: Department of Finance, February 1996, chapter 3.

<sup>103</sup> Assets in the trust fund continued to increase through the end of 1992 because of investment earnings, falling each year after that. See Office of the Superintendent of Financial Institutions, Chief Actuary, *Canada Pension Plan Seventeenth Actuarial Report as at 31 December, 1997*, Ottawa: Office of the Superintendent of Financial Institutions, December 31, 1998, Table II.1.

Despite these financial problems, the difficulty of securing provincial assent helped to keep CPP cutbacks from even getting on the agenda: it doesn't pay to go out in front on an issue where resolution in the absence of a crisis is very doubtful, and where it is almost certain that at least some provincial ministers as well as the federal opposition parties would use the occasion to denounce the federal government in a high-profile setting.<sup>104</sup> Getting agreement on payroll tax increases was difficult, too: they remained flat at 3.6% (shared equally by employers and employees) from 1966 through 1986. Moreover, things were expected to grow steadily worse in the future: the CPP's Chief Actuary estimated in 1995 that the CPP trust fund would be exhausted by the year 2015, and that with an empty trust fund, the contribution rate needed to finance contributions on a pay as-you-go basis would have to reach 14.2 percent by the year 2030.<sup>105</sup> As in the United States, critics also warned that the CPP, as currently constituted, was also grossly unfair to younger workers, and thus ultimately politically unsustainable.<sup>106</sup> Projections for the Quebec Pension Plan were similarly bleak.<sup>107</sup>

Declining trust fund balances, eroding public confidence in the CPP, and growing awareness that a

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<sup>104</sup> On Ottawa's reluctance to proceed in the face of opposition from provincial governments in the 1996-97 round of CPP reform, see Edward Greenspon, "Martin Won't Push Changes to Pension Plan," *Globe and Mail* (Toronto), October 3, 1996, p. A4.

<sup>105</sup> See the discussion in Office of the Superintendent of Financial Institutions, Chief Actuary, *Canada Pension Plan Sixteenth Actuarial Report, September 1997*, Ottawa: Office of the Superintendent of Financial Institutions, September 24, 1997.

<sup>106</sup> See for example William Robson, "The Coming Revolt Against the CPP," *Globe and Mail* (Toronto), December 6, 1996, p. A23. See also Robson, "Ponzi's Pawns: Young Canadians and the Canada Pension Plan," in J. Burbidge, *When We're 65: Reforming Canada's Retirement Income System*, Toronto: C.D. Howe Institute, 1996.

<sup>107</sup> The Quebec Pension Plan's actuary estimated that to maintain current benefits, contribution rates would have to rise .4% per year from 1997 to 2001 and 0.25% per year thereafter until it reached a stable rate of 13% in the year 2023. Régie des rentes du Québec, *For You and Your Children: Guaranteeing the Future of the Québec Pension Plan*, Sainte-Foy, Quebec: Régie des rentes du Québec, 1996, p. 21 and Appendix 2.

failure to address the CPP's problems quickly would lead to soaring contribution rates in the future finally led to an initiative by Ottawa in 1995 to alter the program.<sup>108</sup> Initially, much of the effort was devoted to a behind the scenes effort led by the federal Finance Ministry to bring their counterparts in the provincial capitals on board for the need for change.

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<sup>108</sup> Federal/Provincial/Territorial CPP Consultations Secretariat, *An Information Paper for Consultations on the Canada Pension Plan*, p. 17.

Ottawa and eight of ten provinces reached agreement in 1997 on a package of CPP changes that distributed pain among all parties.<sup>109</sup> (The provinces of British Columbia and Saskatchewan, both governed by the left-of-center New Democratic Party, backed an alternative proposal that would have raised the ceiling on the CPP tax base, resulting in a substantial tax increase for middle- and upper-income workers.<sup>110</sup>) Unlike the planned Seniors Benefit, the Liberal government did not back off these changes, and they went into effect in 1998.<sup>111</sup>

The most visible change in the CPP rescue package—and the one with the biggest fiscal impact—

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<sup>109</sup> Canada Pension Plan, *Securing the Canada Pension Plan: Agreement on Proposed Changes to the CPP*, February 1997.

<sup>110</sup> On the British Columbia government's proposal for an increase in the tax base, see Andrew Petter, "How to Save the Canada Pension Plan," *Globe and Mail* (Toronto), October 3, 1996, p. A21, and Barrie McKenna, "Provinces Block CPP Reform," *Globe and Mail* (Toronto), October 5, 1996, p. A1. Petter was the Finance Minister of British Columbia.

<sup>111</sup> The CPP legislation did run into opposition in Canada's unelected (and therefore usually docile) second chamber, the Senate. Conservative Senators threatened to delay consideration of the bill past the end of 1997, meaning that payroll tax increases scheduled for January 1, 1998 could not be implemented as scheduled. In exchange for getting speedy passage of the legislation, Finance Minister Paul Martin agreed to delay implementation of provisions of the new legislation dealing with the CPP Investment Board until March 31, 1998, giving the Senate Committee on Banking, Trade and Commerce an opportunity to hold a series of hearings on the CPP Investment Board, the proposed Seniors Benefit and RRSPs, and issue a report on the Investment Board. See Laura Eggertson, "Pension Changes Pass Hurdle in Senate," *Toronto Star*, December 17, 1997.

was in payroll taxes.<sup>112</sup> Tax rates on employers and employees will rise from 5.85% to 9.90% (shared equally between the two) over a six year period to finance a move away from Pay-As-You-Go toward partial advance funding of the CPP. As critics on the political right pointed out, this represents a seventy percent increase in the tax rate. In exchange, Ottawa bowed to provincial demands for a cut in the Unemployment Insurance payroll tax, which was running large surpluses.<sup>113</sup>

The CPP payroll tax increase is more rapid than the ones already scheduled under the statute then in effect, but politicians sold it as a measure that would prevent payroll taxes from having to go as high as previously projected if the CPP contribution rate was not changed quickly. Moreover, the initial tax increase was not scheduled to be felt until 1998—after the next federal election.<sup>114</sup> In addition to higher rates, the amount of earnings of low- income workers that is exempt from the CPP payroll tax was frozen at the 1997 level (\$3,500), rather than being indexed for inflation as was the previous practice. As a result, the real subsidy to low-wage earning Canadians will gradually decline, and contributions to the CPP trust fund will grow.

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<sup>112</sup> On the fiscal impact of the 1997 changes, see David W. Slater and William B.P. Robson, *Building A Stronger Pillar: The Changing Shape of the Canada Pension Plan*, Toronto: C.D. Howe Institute, March 1999.

<sup>113</sup> See Barrie McKenna, “Provinces Block CPP Reform.”

<sup>114</sup> In fact, the initial tax increase—from 5.85 to 6.0% of payroll, was retroactive to January 1997, but was not to be paid until income tax time in the spring of 1998. Derek Ferguson, “73% Premium Increases to Save Pensions: Martin,” *Toronto Star*, September 26, 1997. For a schedule of prior and revised payroll tax rates, see Human Resources Development Canada and Finance Canada, *Securing the Canada Pension Plan: Agreement on Proposed Changes to the CPP*, February 1997, p. 7.

Cuts in CPP retirement benefits were, not surprisingly, made much harder for beneficiaries to discern and understand. In consultation documents, bureaucrats suggested a number of options for cutbacks, including as an explicit ten percent cut (from 25 to 22.5%) in replacement rates and increases in the normal and earliest retirement ages.<sup>115</sup> But most of these highly visible cuts with the largest potential savings, including retirement age increases, cuts in the replacement rate, and cuts in indexation, were rejected by the Quebec government in a 1996 discussion paper.<sup>116</sup> Thus the scope for change on the benefit side was dramatically reduced. Benefit cuts in the CPP were, therefore, made largely through technical changes to formulas that are almost incomprehensible to most beneficiaries, such as increasing the years of (unindexed) earnings prior to retirement on which initial retirement benefits are calculated from three to five.<sup>117</sup> Reflecting the familiar principle of “grandfathering” current retirees to lower political opposition from the group with the most intense interest, this group was protected from CPP benefit cuts.

Little noticed at the time the legislation was passed, but potentially of great importance in the longer run, the new CPP legislation also put in place a new “default” or fail-safe procedure for ensuring the long-term financial viability of the CPP. In the future, the chief actuary for the CPP was to prepare estimates of the long-term financial sustainability of the Plan. Over the next year, Ministers from Ottawa and the provinces are supposed to agree on any needed changes to keep the plan viable; if they do not agree, contribution rates will increase automatically to meet half of the anticipated deficiency (phased in over three years), and indexation of the CPP will be frozen for the next three years.<sup>118</sup> This procedure could be overridden by Cabinet order, but it would take affirmative action to do so.

In short, the new statute influenced the future directions of CPP changes in five critical ways. First, it created a strong procedural presumption, and sent a strong signal to beneficiaries and contributors, that the CPP would be kept fiscally sound: its fail-safe trigger kicks in when the long-term viability of the plan is in question, not (as in the 1983 U.S. law) when the plan is in immediate danger of not being able to pay out benefits. Second, unlike in the United States, where contribution increases had essentially been banished from the agenda, contribution increases are likely to play a major role in any future CPP “fix” unless federal and provincial finance ministers can agree on an alternative. Third, it sets up a procedure for sharing the pain of a future CPP fix by dividing it between taxpayers (through contribution rate increases) and beneficiaries

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<sup>115</sup> For a list of proposals and estimates of their likely savings see Federal/Provincial/Territorial CPP Consultations Secretariat, *An Information Paper for Consultations on the Canada Pension Plan*, p. 43.

<sup>116</sup> The Quebec government announced its opposition to these changes in the Quebec Pension Plan. In theory, Ottawa could have implemented major benefit cuts in the CPP anyway if Quebec either went along or was outvoted by other provinces. But a strong desire on the part of all participants to keep the CPP and QPP closely integrated meant that the benefit cuts opposed by Quebec were effectively off the table for both the CPP and QPP once Quebec decided to oppose them. Régie des rentes du Québec, *For You and Your Children: Guaranteeing the Future of the Quebec Pension Plan*, Quebec: Government of Quebec, 1996.

<sup>117</sup> If this policy had been in effect in 1997, the maximum pension benefit would have been twelve dollars a month lower. Human Resources Development Canada and Finance Canada, *Securing the Canada Pension Plan*, p. 10. Cuts were also made in disability benefits.

<sup>118</sup> See “Canada Pension Plan, Chapter C-8, *Consolidated Statutes of Canada*, sections 113-115 and *Statutes of Canada*, Chapter C-40 (Bill C-2), sections 94-6, and Slater and Robson, *Building a Stronger Pillar*, pp. 6-7.

(through benefit freezes). Fourth, the new statute sets up a “clean hands” default procedure that allows losses to be imposed on beneficiaries and contributors without politicians having to do anything—although the concentration of accountability in Canada’s Westminster political system means that it will be difficult for a future Cabinet to avoid blame by refusing to cancel contribution increases and indexation freezes. Finally, by turning the highly inexact science of long-term actuarial projections into a policy trigger for imposing loss-imposing actions, it virtually guaranteed that those projections would be the subject of future [political] conflict.

The CPP reform also contained some modest elements of restructuring. Most notably, CPP investment practices are being changed. Provinces will eventually have to pay higher rates on borrowings.<sup>119</sup> CPP funds will be invested in a broader range of securities, including equities, with these investments managed by an independent twelve-person board. But like other Canadian pension funds, eighty percent of CPP investments will have to be located in Canada.

### ***IMPLEMENTING THE NEW CPP LAW***

As suggested above, the role given to the CPP Chief Actuary’s report in triggering painful increases in contribution rates and indexation freezes have indeed made those reports the subjects of political contention. Shortly before the first Chief Actuary’s report was due under the new law, the Chief Actuary was fired. The fired Chief Actuary, Bernard Dussault, charged that he had been pressured by Finance Ministry officials to change his assumptions after preliminary estimates suggested that a small (0.1% of payroll) increase in the contribution rate would be needed to keep the CPP solvent in the long term. The Chrétien government argued strongly, if not very convincingly, that Dussault’s firing had nothing to do with his conclusions.<sup>120</sup> The consultant commissioned to complete Dussault’s report—using a set of conclusions that were questioned by some critics as too optimistic—produced a report showing that the system was in fact

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<sup>119</sup> Provinces will have to pay their own market rate of interest rather than Ottawa’s, but they were given the option of rolling over their current CPP borrowings for another 20 year term.

<sup>120</sup> See Laura Eggertson, “Firing of CPP Watchdog to Be Probed,” *Toronto Star*, September 23, 1998; Ian Jack, “Don’t ‘Embarrass’ Martin: Fired Actuary Says Boss Twice Asked Him to Alter CPP Numbers,” *National Post*, October 1, 1998, p. 3; Ian Jack, “Actuary Was Asked to Look at ‘Alternative’ CPP Analysis,” *National Post*, December 3, 1998; Ian Jack, “Federal Auditor Plans to Keep Sharp Eye on CPP,” *National Post*, January 8, 1999, p. C3.

slightly (0.1% of payroll) overfinanced.<sup>121</sup> But provincial officials expressed fears that manipulation of the Chief Actuary's findings could mean that they were not getting accurate information about the financial status of the CPP.<sup>122</sup>

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<sup>121</sup> Superintendent of Financial Institutions, Chief Actuary, *Canada Pension Plan Seventeenth Actuarial Report as at 31 December, 1997*. For a critique of the assumptions used in the report, see Slater and Robson, *Building a Stronger Pillar*.

<sup>122</sup> Ian Jack, "Provinces' Concerned' at CPP Actuary's Firing," *National Post*, October 3, 1998, p. 7.

Political conservatives in Canada remain dissatisfied with the 1997 CPP reform package, arguing that it will produce an inadequate return on contributions for future generations of contributors. The provincial government of Alberta has called for a new round of CPP reform, which might include moving some current benefits outside the CPP structure, individual accounts, and possibly some form of opt-out for employers who provide benefit plans as generous as those in the CPP.<sup>123</sup> Alberta's Treasurer (the equivalent of Finance Minister), Stockwell Day, has even broached the possibility of Alberta leaving the CPP and setting up its own plan on the Quebec model as a "last resort" to prod his federal and provincial counterparts into taking further action on CPP reform. This is likely an idle threat, since it would require Alberta to come up with an estimated \$45 billion (Cdn.) to pay for its share of the unfunded CPP liability that the CPP's new Chief Actuary estimated at around \$430 billion (Cdn.).<sup>124</sup> Day's strong position against any further CPP payroll tax increases, and in favor of considering an increase in the retirement age and some benefit cuts, suggests that the future of CPP politics may look increasingly like that in the United States, both in terms of the range of options on the table and the procedural tendency toward stalemate.<sup>125</sup> But the very different default procedure in place still makes payroll tax increases more likely than they are south of the 49th Parallel.

Pressure for additional CPP change has also come from the Reform Party, the Official Opposition in the federal House of Commons. Reform has called for replacing the CPP with mandatory private pensions, and more recently for an opt-out from the CPP to individual pensions on the British model.<sup>126</sup> But neither Alberta nor Reform has spelled out how it would handle the "double payment problem" if younger workers withdrew in large numbers from the CPP. Neither, in any case, has strong leverage to get its proposals on the agenda.

### ***REFLECTIONS ON PENSION REFORM POLICYMAKING***

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<sup>123</sup> See Stockwell Day, "Next Steps to CPP Reform," Government of Alberta, Treasury, June 15, 1998; Government of Alberta, Treasury, *Budget 99: The Right Balance*, March 11, 1999, pp. 195-198.

<sup>124</sup> Sean Durkan, "Alberta Ready to Quit CPP," *Edmonton Journal*, June 16, 1998, p. 7.

<sup>125</sup> Jill Mahoney, "Alberta Issues Warning Over CPP," *Globe and Mail* (Toronto), January 23, 1999, p. A4; Canadian Press, "Federal Willingness to Reform CPP Impresses Alberta's Day," *Lethbridge Herald*, January 23, 1999, p. 5.

<sup>126</sup> Reform Party of Canada, *Blue Sheet: Principles and Policies of the Reform Party of Canada, 1998-99*, Neville Nankivell, "Reforms New Strategy Reopens Serious Debate About CPP's Future," *Financial Post*, June 6, 1998, p. 21.

This review of pension reform policy in the U.S. and Canada over the last fifth of the twentieth century suggests both cross-national similarities and differences in three critical aspects of pensions policy: retrenchment, financing and programmatic restructuring. It also suggests some interesting conclusions about the role of political institutions, policy legacies and other factors in shaping these similarities and differences.

### *Reflections on Outcomes*

**RETRENCHMENT:** Retrenchment initiatives in the United States (1) came onto the “action agenda” of changes given serious consideration by policymakers more frequently, and (2) originated from a greater variety of sources, but (3) had a lower success rate than in Canada. But there are also striking similarities in the repertoire of techniques used by politicians in Canada and the United States to avoid accountability and blame when they did cut pension expenditures.<sup>127</sup> Grandfathering current beneficiaries, who were most likely to notice and mobilize against losses, was used in both Canada and the United States. In both countries, tinkering with benefit indexation mechanisms proved politically risky, and indexation mechanisms for persons who have already retired survived multiple rounds of retrenchment largely intact. Cost savings in both countries were achieved through highly technical changes to benefit formulas that were hard for beneficiaries to understand. In both countries, trust fund crises served as an “action-forcing mechanism” that put retrenchment on the agenda in contributory pension plans, although those crises were more immediate in the U.S. case than in Canada. Trust funds also helped to define the range of acceptable solutions in both countries: changes had to be made that experts would certify as moving funds close to actuarial balance in both the short and long terms.

There have also been important similarities in the targets of cutbacks. Cuts in cash pension benefits in both countries have been targeted especially (through taxation of OASI benefits in the U.S. and the OAS clawback in Canada), although not exclusively, on upper-income beneficiaries. In both countries, changes targeted at higher income retirees were partially offset by changes to tax-subsidized defined contribution plans that primarily benefit people with higher incomes. In Canada, efforts to impose across the board cuts (notably through indexation changes) were defeated, while some broad-based cuts in the U.S., notably the long-term increase in the normal retirement age, were adopted. Both the GIS in Canada and SSI in the United States, have, with the exception of benefits for immigrants, been very resilient in avoiding retrenchment initiatives; indeed, such initiatives have rarely even made it to the agenda. Indeed, the rank ordering of vulnerability to cutbacks appears to be, in declining order, universal pensions (Canada only), contributory pensions, income-tested pensions (except for immigrants).<sup>128</sup> Indeed, the two countries’ experience appears to reverse the conventional wisdom that income- or means-tested welfare state programs are more resistant to retrenchment initiatives than universal ones. The lesson appears to be that the public and politicians in both

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<sup>127</sup> On techniques for obfuscating losses in entitlement programs, see R Kent Weaver, “Controlling Entitlements,” pp. 307-341 in John E. Chubb and Paul E. Peterson, eds., *The New Direction in American Politics*, Washington, D.C.: The Brookings Institution, 1985, and Pierson, *Dismantling the Welfare State*, chapter 1.

<sup>128</sup> See the discussion and data in Banting, “The Social Policy Divide”

countries feel a commitment to preventing severe poverty among a group that is seen as deserving and is not expected to work.

In addition to upper-income recipients, the other group that has been targeted for benefit cuts in both countries is immigrants, especially recent immigrants. There appears to be a common perception in both countries that elderly and near-elderly persons admitted under family reunification programs should be primarily the responsibility of their relatives rather than government. In the United States, Republicans have given this the added element of citizenship as a demonstration of commitment to U.S. values, which has so far been lacking in Canada.

There have also been some important differences in pension retrenchment outcomes, however. In particular, Canadian officials have been able to enact significant retrenchment in the absence of an immediate trust fund crisis, while U.S. officials—with the exception of the cuts to upper income Social Security recipients enacted in 1993 and to non-citizen recipients in 1996—have not.

**PENSION FINANCING:** Differences between the two countries with respect to financing pension systems have been even more striking than those for retrenchment. Major increases in the CPP contribution rate were enacted in Canada in 1997, albeit from a lower base than in the U.S. Payroll tax increases have been virtually banished from the agenda in the United States since the early 1980s. While the need to secure intergovernmental agreement long served to prevent changes in CPP tax rates, once an agreement was reached, there was little public protest or mobilization against the agreement-- it was treated as a fait accompli. These differences on the revenue side have several roots. One is certainly the immediacy of a CPP funding crisis, whereas that crisis was thirty years in the future in the United States. A second reason is the Republican control of the congressional control of the congressional policymaking process in the U.S.: with opposition to any tax increase a bedrock issue for most Republicans, there was little incentive for any political actor to suffer the political costs of proposing a Social Security payroll tax increase when there was virtually no chance that it would be adopted. A third difference is that the intergovernmental bargaining process in Canada provided both a *\_backroom process\_* for negotiating such an agreement and a mechanism for legitimizing it, while Canada's parliamentary institutions meant that it was almost certain to be adopted once an agreement was reached.

**RESTRUCTURING:** There are also significant differences between the two countries in the extent to which their pension systems have been restructured. In both countries, the basic structure of cash pension tiers has remained intact. The weight of past programmatic choices makes it politically almost impossible for countries to start afresh with a dramatically different system of social provision, and almost as hard to delete existing tiers of pensions. In the United States, very heavy reliance on a single system of contributory Old Age and Survivors Insurance has reinforced the initial decision to provide higher replacement rates to those with lower earnings histories; failure to do so would put very heavy pressure on the SSI system. Canada has ended the universality of Old Age Security by income-testing it at the upper end of the income scale, a move that mirrors the actions of many European countries as their contributory pension schemes have matured.

Canada has enjoyed greater success than the U.S. in a second element of restructuring: moving from lending solely to governments toward collective investment in equities markets. Both governments were attracted to equities investments for essentially the same reason: it appeared to offer a "free lunch" of higher returns on trust fund balances, and thus less need to incur blame by cutting benefits or raising payroll taxes. In Canada, however, the decision to invest a modest share of CPP funds in the stock market was undertaken

with relatively little controversy. In the United States, on the other hand, whether to allow collective investment has been a major divisive issue, and has not yet been settled.

### *Explanations*

Some of the patterns outlined above are consistent with the hypotheses outlined at the beginning of this chapter about the politics of concentrated loss-imposition on a specific, geographically diffused group, while others are not. With respect to retrenchment in eligibility and benefits, for example, the larger number of retrenchment initiatives in the U.S., the greater variety of sources, and their lower success rate all reflect the greater diffusion of power in U.S. political institutions. But the fact that even in Canada, the federal government has backed down from pension retrenchment initiatives, suggests that there is indeed a significant gap between the theoretical capacity of Westminster-style parliamentary systems to impose losses and the political practicality of reelection-seeking governments in those systems actually doing so. The results also cast doubt on the suggestion that Canada's federal government will enjoy greater loss-imposition capacity because of the longer electoral cycle. The reason seems fairly straightforward: it is not just elections where MPs' own seats are at stake that are considered relevant to policy decisionmaking in Canada. Looming provincial elections (especially those in Quebec) and referenda on Quebec sovereignty also cast long shadows on pension policy, and most other policy sectors, in Canada.

The effects of federalism on pension policy are quite complex. The fact that most major pension programs are run by the federal governments in both countries has almost certainly helped to prevent a race to the bottom and helped to protect them against the cuts found in other sectors (notably with the CHST in Canada) in which the federal government cuts transfers to sub-national governments who actually deliver benefits, assuming that the latter will bear the brunt of the blame for those cutbacks. Canada's peculiar system of governance for the CPP/QPP, on the other hand, is more mixed. It almost certainly helped delay agreement on cutbacks and contribution increases until the late 1990s. But as noted earlier, once an agreement was reached--between governments, behind closed doors-- it both legitimized that agreement and made it almost impossible to overturn.

A third and quite different effect of federalism can be seen in comparing Canadian and U.S. policies toward collective investment in equities markets. Here, the experience of the Quebec Pension Plan in investing in equities markets appears to be somewhat analogous to that of Saskatchewan in health insurance. In both cases, a provincial government acted as an innovator for reasons idiosyncratic to that province (a social democratic concern for universal health care in Saskatchewan, a commitment to promoting Quebec business in Quebec), but those innovations were ultimately emulated by the federal government. In short, federalism can bequeath a more varied set of policy legacies from which policymakers can learn than in a more centralized system-- especially where underlying patterns of political cleavage also encourage spatial differences in policy choices.

Policy feedbacks are at least as important as political institutions in explaining both cross-national similarities and cross-national differences in pension reform choices, however. The policy feedbacks take several forms, and are sometimes intertwined with institutional effects. Clearly, as Paul Pierson has suggested, mature contributory pension schemes are extremely difficult to dislodge. Only the most radical of pension reformers have favored actually phasing out Social Security in the United States, although many favor lowering its role relative to that of individual portable pensions. But they are also vulnerable to trust fund crises unless there is a mechanism for injecting general revenues into those funds. Universal pensions, both

Canada's OAS and those in other major countries, have become more vulnerable to cutbacks as contributory earnings-related pensions have become more ubiquitous, the phenomenon of the affluent elderly becomes more common, and high marginal tax rates on those with high incomes have been scaled back in many nations.

The ubiquity of indexation in cash pension programs, both immediately before the onset of huge pressures for retrenchment and at the end of the century, undercut our ability to draw conclusions about the relative hardness of indexed and unindexed benefits. But they do suggest quite clearly that indexation of benefits once payment to retirees has begun that is almost impossible to undo. Indexation is both less inevitable, and less impregnable, however, when its effects are less visible: in the income limits for taxation of Social Security, for example, or the Year's Basic Exemption for onset of Canada Pension Plan contributions.

The intertwining of institutional and policy feedback effects is clearly evident in the experience of Quebec Pension Plan investments in equities markets making the issue less sensitive than in the United States than in Canada. Indeed, Finance Minister Paul Martin explicitly acknowledged the Quebec Pension Plan's investment policies as a positive model for the CPP.<sup>129</sup> In the U.S., on the other hand, resistance was enhanced by (1) the greater hopes of advocates that they could enact a greater transformation of the system toward individual accounts, and (2) the opposition of a powerful political actor, Fed Chairman Allan Greenspan, to such investments.

A final explanatory factor that appears to be important in explaining Canada-U.S. differences in outcomes is the ideology of governmental elites—in particular, the role of Republicans in the U.S. both in banishing Social Security payroll tax increases from the U.S. agenda and in creating a much higher level of controversy over government investment in equities markets. The ability of conservatives to do so, however, has almost as much to do with institutions as it does with ideology: the greater institutional leverage they have enjoyed within the U.S. system of checks and balances has been fundamental to their success. The U.S. may eventually follow the Canadian path on collective equity investments, especially if conservatives decide that moving to individual accounts is not politically feasible and can be reassured about insulation of those accounts from government interference. But the road to that decision will have been much more rocky.

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<sup>129</sup> Martin said, "I have always been an apostle of the Caisse de depot and I think having a Canadian Caisse de depot to manage the savings of Canadians is very important" Ferguson, "73% Premium Increases to Save Pensions: Martin."

TABLE 1. A REPERTOIRE OF PENSION REFORM INSTRUMENTS

BROAD APPROACH TO PENSION REFORM	EXAMPLES OF SPECIFIC REFORMS	BLAME-REDUCTION STRATEGIES
Cut pension benefits or eligibility	<ul style="list-style-type: none"> <li>• Reduce initial pension benefits of retirees</li> <li>• Reduce inflation adjustments in pension benefits of existing retirees</li> <li>• Raise “normal retirement age” for receipt of full pension benefits</li> <li>• Increase penalties for early retirement</li> <li>• Increase years of employment history (or residency) used in calculating initial pension benefit</li> <li>• Reduce benefits for upper-income retirees</li> </ul>	<ul style="list-style-type: none"> <li>• Delay onset of cuts until after next election (or longer)</li> <li>• Phase in pension cuts gradually and/or disguise them by manipulating indexation formula</li> <li>• disguise pension cuts as adjustments in arcane program formulae</li> <li>• Target cuts on politically weak or disorganized groups</li> </ul>
Increase revenue inputs to pension system	<ul style="list-style-type: none"> <li>• Increase payroll tax rates or tax base</li> <li>• Inject general government revenues into contributory pension system</li> <li>• Include groups who were previously exempt from pension payroll taxes (e.g., civil servants)</li> </ul>	<ul style="list-style-type: none"> <li>• Delay onset of initial payroll tax increases until after next election (or longer)</li> <li>• Phase in payroll tax increases gradually</li> <li>• Imposes payroll tax increases on employer rather than employees, weakening public awareness of tax increases</li> </ul>
Restructure existing pension programs	<ul style="list-style-type: none"> <li>• Eliminate universal pension tiers</li> <li>• Mandate employer-provided pensions as partial or full replacement for government-</li> </ul>	<ul style="list-style-type: none"> <li>• Grandfather current retirees and the near-elderly into current system, or allow them to choose</li> </ul>

	provided pension tiers	
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