Canada's Pension Predicament:

The widening gap between public and private sector retirement trends and pension plans

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January 2007

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Introduction

In 1970, one in five Canadians were over the age of 50. By 2008, it is projected that one in three Canadians will fall into this category[1]. Canada's aging demographic situation is becoming more and more important. In terms of public policy development, the implications of our aging population span over a wide variety of issues, which include retirement and pensions.

Although there has been increased attention on this issue over the past decade there is not an abundance of research or data available on pensions in Canada. The likely cause for the increased interest in this issue is two-fold: 1) the current demographic situation, which entails more early retirements and a lower fertility rate and; 2) the economic challenges that have accompanied our rather robust economy over the last 5 to 10 years, namely the acute shortage of qualified labour and greater international competition due to globalization. These are factors that have heightened the importance of the aging population in Canada.

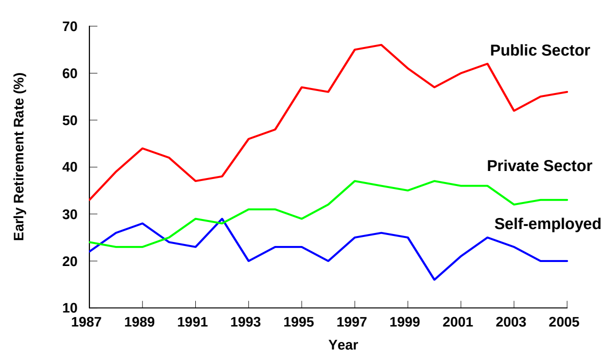
The purpose of this paper is to provide insight on the widening gap that exists between public and private sector retirement trends and pension plans. It is also meant to shed some light on the complexity of Canada's retirement income system. The paper is divided into the following sections: I) latest trends on early retirement; II) incentives to retire; III) brief statistics on pension coverage for Canadians; IV) employer-sponsored pension plans; V) current issues with defined-benefit pension plans; and VI) conclusion.

I. Latest Trends on Early Retirement

In terms of demographics, the early retirement[2] trend in Canada is becoming more common. For example, between 1987-1990, 29 per cent of people who retired did so before the age of 60. From 1997-2005, the proportion of early retirees had grown to 42 per cent[3]. What is particularly disconcerting with this is the fact that the trend is not mirrored between the public and the private sector. The situation is drastically different between both sectors (Figure 1).

Figure 1:

Public Sector Drives the Early Retirement Trend (under 60)

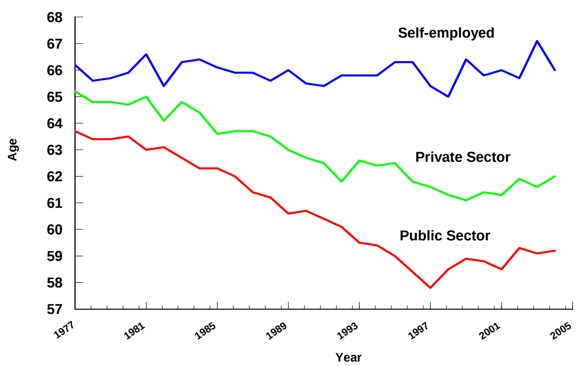


Source: Statistics Canada, *Labour Force Survey*, 2006.

Since the late 1980s, the public sector has driven the early retirement trend. The proportion of early retirees within the public sector was around 56 per cent in the year 2005, while for the private sector it was just over half that proportion at 33 per cent, and for self-employed individuals it was well below the public sector rate at only 20 per cent[4].

Furthermore, the average age of retirement for public sector employees over the last few decades has decreased more rapidly than that of the private sector and self-employed individuals (Figure 2).

Figure 2:
Average Age of Retirement



Source: Statistics Canada, *Labour Force Survey*, 2006.

In fact, Canada's self-employed individuals, retire the latest. From the mid seventies to today the average age of retirement for this group has remained stable at 66 years of age. For private sector employees the average age of retirement has decreased moderately from 65 years of age in the mid seventies to 62 years of age today. In the public sector, the average age of retirement has decreased from 64 years of age to 59 years of age in the last 30 years (Table 1).

Table 1:
Average Age of Retirement

	Public sector	Private sector	Self-employed
1976-79	64	65	66
1980-89	62	64	66
1990-99	59	62	66
2000-05	59	62	66

Source: Statistics Canada, *Labour Force Survey*, 2006.

These statistics are a signal that Canadians employed in the private sector may not have the same means as public sector employees to retire early. Thus, as the population is aging, the gap in retirement ages between the public sector and the private sector is increasing. This is a particularly alarming trend when considering the importance of the private sector in the Canadian economy.

Small establishments, with fewer than 50 employees, represent over 97 per cent of all Canadian businesses. Most Canadian businesses are relatively small. Moreover, they account for over half of total employment in Canada and roughly half of the GDP[5].

More importantly, self-employment has been a prevailing growth force in the labour market. From 1990 to 2004, the number of self-employed Canadians increased by 30 per cent[6].

This trend raises the need to better understand why this gap appears to have widened. From an economic perspective, this is an important issue to address because it could ultimately undermine Canada's productivity and competitive advantage, which have been responsible for our ever-increasing standard of living. Failing to address this issue would be a step backward rather than a step forward.

Given this, the logical questions to ask are what do we already know about the cause of the early retirement gap between the public and the private sector, and more importantly, can we mitigate it? To help answer these questions we need to first consider the factors that affect an individual's decision to retire.

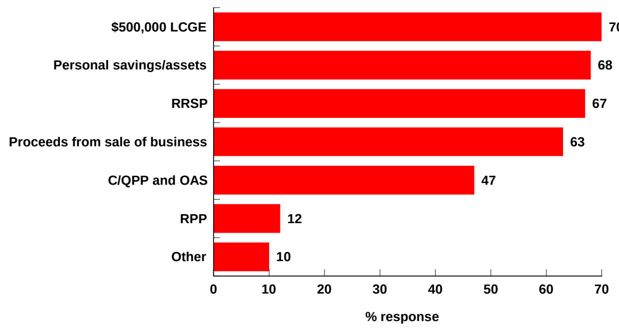
II. Incentives to Retire

For an individual, the decision to retire is very much a personal one, but it can be influenced by a number of factors. Some empirical evidence[7] has found that the presence of an employer sponsored pension plan, also known as a registered pension plan (RPP), is the most significant determinant in an individual's decision to retire. In particular, the generosity of an RPP weighs heavily on the decision to retire. For example, a study by the Conference Board of Canada[8] found that, on average, public sector servants retired, 2.5 years earlier than private sector employees because of the especially generous Canadian public service pension plans. Hence, the more generous the pension plan the more likely an individual will elect to retire.

In addition, literature suggests that the following factors also play a role in the decision to retire; treatment of registered retirement savings plan (RRSP) by the tax system, an individual's ability to accumulate savings, the health condition of an individual, and the restrictions on the public pension plan, such as age of eligibility for the Canada/Quebec Pension plan.

These factors, however, have much less impact on Canadian entrepreneurs' decision to retire. In fact, the RPP is one of the least important retirement savings vehicle for entrepreneurs. This is not surprising considering most Canadian firms are of small and medium size and offering an RPP within their firm is not financially feasible. The $500,000 Lifetime Capital Gains Exemption (LCGE), personal savings/assets, RRSP, and proceeds from the sale of business are the most important vehicles for retirement savings for independent business owners (Figure 3). Individual Pension Plans (IPP), which are similar to RRSPs but allow for larger tax deductions, are another form of retirement savings for business owners and their families. However, only a very small number of such plans exist in Canada.

Figure 3:
Most Important Retirement Savings Vehicle for Independent Business Owners (% response)



Source: CFIB, *Our Members' Opinions Survey No. 58*, January-June 2006, based on 22,027 responses.

It is clear that although the decision to retire is a personal one, the incentives to retire are very different for employees and employers.

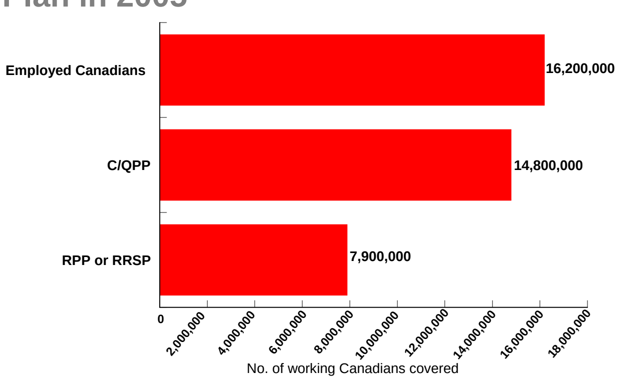
With respect to public policy, there is pressure both to encourage early retirement and to discourage early retirement. On one hand, an increase in the number of early retirements opens job and promotion opportunities for younger workers. Early retirement is also considered beneficial for firms looking to downsize. Furthermore, as we live longer some people wish to retire early to care for older family members, and early retirement is conducive to this form of work-family balance.

On the other hand, there is increasing pressure to reduce incentives for early retirement. In light of the growing shortage of qualified labour facing our economy, older individuals increasingly play a role in filling labour shortages. For example, part-time retirees fit nicely into the needs of employers for a flexible workforce. Moreover, employers understand the importance of keeping older individuals with accumulated firm-specific knowledge and networks in generating corporate memory. Finally, longer life expectancy is creating added pressure on public pension programs. So, encouraging individuals to work longer is viewed as a means of alleviating some of the demands on the system.

III. Who Benefits from Private Pension Plans?

The value of total assets accumulated in Canada's retirement income programs represents one of the largest pools of capital investment in the country. Total assets in retirement programs in Canada amounted to $1.3 trillion[9] in 2003. That same year, Canada's GDP was $1 trillion. With that said, the number of Canadians who are able to save for retirement through a private pension plan is limited. Today, approximately 50 per cent of total taxfilers aged 25-64 or 7.9 million Canadians[10] save through some form of private pension plan, namely an RPP or a Registered Retirement Savings Plan[11] (RRSP). Currently, the remaining half of Canadian taxfilers have no private savings vehicle for retirement and rely solely on the public pension system, such as Canada/Quebec Pension Plan (C/QPP) and Old Age Security (OAS), to ensure some form of income upon retiring[12] (figure 4).

Figure 4:
Public Pension Plan vs. Private Pension Plan in 2005

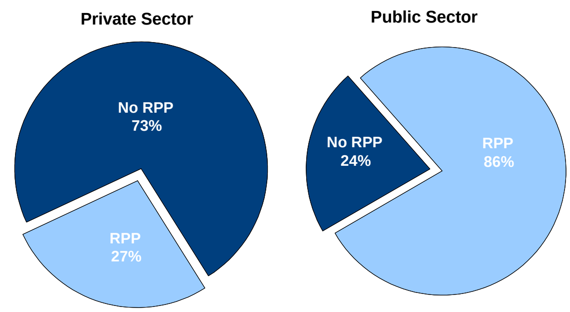


Source: Statistics Canada, *Canada's Retirement Income Programs,* 2006 edition.

People save for retirement to ensure they will be able to maintain the same standard of living when retired as when they were working. For individuals to achieve this goal, RPPs followed by RRSPs are the most generous types of pension plans, bar none. Relying solely on the public pension system, which half the population currently does, will not allow an individual to maintain the same standard of living as when they were working. This is why private pension plans are so important.

Most Canadians with no private pension plan work in the private sector. In 2003, the RPP coverage rate in the private sector was about 27 per cent, while in the public sector that same year the RPP coverage rate was over 86 per cent[13] (Figure 5).

Figure 5:
Private Sector RPP Coverage vs. Public Sector RPP Coverage
(% response)



Source: Statistics Canada, *Canada's Retirement Income Programs*, 2006 edition.

From 1977 to 1991, the coverage rate in the public sector increased, but has since dropped slightly. In the private sector, the RPP coverage rate has steadily declined moving from a 35 per cent coverage rate in 1977 to today's 27 per cent coverage rate[14].

Furthermore, studies comparing public sector and private sector wages, such as CFIB's *Wage Watch* study, show that there exists a wage gap for all levels of government. In addition, it shows that for all levels of government, paid non-wage benefits, which represent in aggregate employer pension contributions, insurance premiums, etc., are far greater in the public sector than in the private sector. For example, in 2000 the highest paid non-wage benefits, as a percentage of total wages and salaries, were found in the federal public sector. Federal employees received non-wage benefits valued at 19.1 per cent of their total wages and salaries, while private sector employees received non-wage benefits valued at 11.5 per cent of total wages and salaries[15]. Given this, it is worth reviewing the different characteristics of employer-sponsored pension plans, which many will argue is the key reason why public sector employees enjoy far greater non-wage benefits than their private sector counterparts.

IV. Employer-sponsored Pension Plans

The employer-sponsored pension plan is the original retirement income system. It is most commonly referred to as a registered pension plan (RPP) or a private pension plan. RPPs exist both within the public sector and private sector. A key feature of RPPs is that employers offer them to employees voluntarily. This means employers are in no way obligated to offer this type of compensation to employees. This is crucial because RPPs impose a significant financial cost to employers and not all employers can subsidize them, especially not small and medium-sized employers.

Basically, there are two different types of plans that an employer may offer its employees. One is the defined-benefit (DB) pension plan and the other is the defined-contribution (DC) pension plan. The two types of plan offer very different benefits (Figure 6).

Defined-Benefit (DB) Pension Plan

The defined-benefit pension plan is characterized as the safer and more generous type of plan for employees. Benefits are allocated based on a set formula; usually a unit benefit formula or a flat benefit formula. For employees this type of plan is advantageous because it is very low risk. Benefits are virtually guaranteed and typically fully indexed. The DB plan is clearly a consideration for employees when it comes to total compensation.

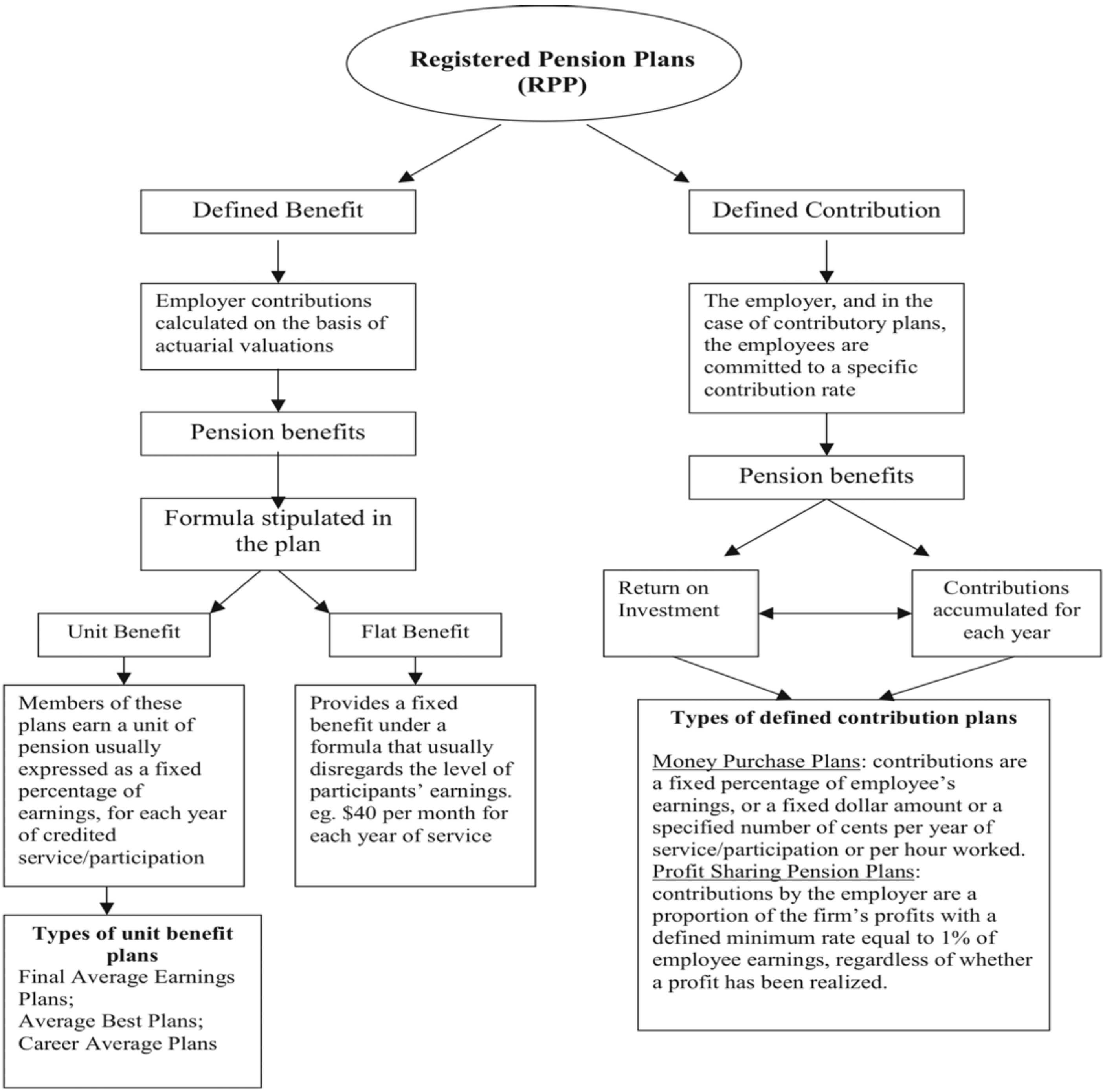
Conversely, there are some drawbacks to DB plans. The biggest drawback of DB plans is that the employer bears most of the financial risks associated with it. Employer contributions are calculated on the basis of actuarial valuations and are highly sensitive to market conditions, such as interest rate fluctuations. Consequently, the financial risk of a pension plan is part of the financial liability of a company[16]. Furthermore, for employers there is an asymmetry problem with DB plans. The asymmetry takes the form of a mismatch between risks and rewards, whereby, the employer is responsible for funding the DB plan, with or without employee contributions, and is also responsible for any shortfalls. Yet, employers cannot access or are constrained from accessing any surpluses in the plan. Finally, because of the complexity of most DB plans there are significant administrative costs for employers.

Defined-Contribution (DC) Pension Plan

The defined-contribution (DC) pension plan is different. The fundamental difference is that benefits are not determined by a pre-set formula. Rather the employer commits to a specific contribution rate. For example, a fixed percentage of employee's earnings or a fixed dollar amount per year of service. Benefits are calculated based on the value of the plan including accumulated contributions by the employer and the employee and the return on investment earned. For employees this type of plan is considered higher risk. Given there is no pre-set formula for benefits, the benefits are not guaranteed or indexed. What's more, DC Plan contribution limits for older higher paid employees have much less generous contribution limits compared to DB Plans.

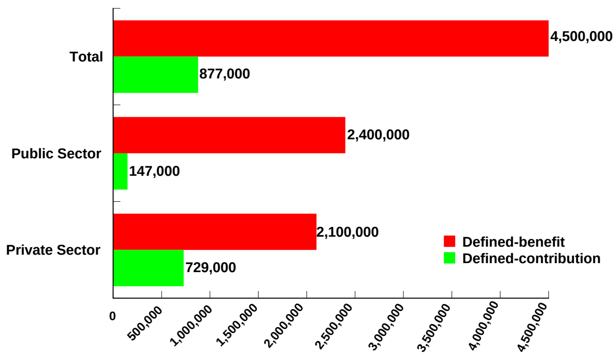
For employers, the main advantage of DC plans is that the financial risks of the plan are imposed on employees rather than on employers. Moreover, the costs of administration are smaller for employers than with the DB plan.

Figure 6:
Registered Pension Plans



Currently, there are 4.5 million Canadians covered under a DB plan and approximately 877,000 Canadians are covered under a DC plan. In the public sector over 2.4 million Canadians have a DB plan and only 147,300 Canadians have a DC plan. Similarly, in the private sector, 2.1 million Canadians are covered under a DB plan and 729,200 are covered under a DC plan[17] (Figure 7).

Figure 7:
Defined-Benefit Plans vs. Defined-Contribution Plans



Source: Statistics Canada, *Canada's retirement Income Programs*, 2006 edition.

V. Current Issues with Defined-benefit Pension Plans

Internationally, and in Canada, the trend in the private sector has been for firms to move away from DB plans and move to DC plans. For instance, in the US the number of DB plans in the private sector has fallen by about 75 per cent since 1985[18]. Similarly, in Canada from 1992 to 2003 the DB coverage rate declined from 44 per cent to 34 per cent of the workforce, 77 per cent of which occurred in the private sector[19]. A common explanation for this trend is that companies are starting to recognize the true financial risks and uncertainties associated with offering DB pension plans. This is especially true in light of the uncertainties facing economies around the world and the demographic realities of an aging population.

In Canada, the contentious issues with DB plans are two-fold. First, the availability of DB plans between the public sector and the private sector is drastically different. Almost all pension plans in the public sector are DB plans, while in the private sector DB plans seem to be disappearing. As was highlighted earlier, with DB plans the plan sponsor is entirely responsible for ensuring it is fully funded. The problem with this is that in the case of the public sector, the plan sponsor is the government. Ultimately, this means taxpayers are heavily subsidizing public sector pension plans. Meanwhile, less expensive alternatives, such as DC plans are becoming the norm in the private sector. It is frustrating and unfair for taxpayers that have a less generous pension plan or no pension plan to pay high taxes in order to subsidize the very generous public sector pension plans.

Additionally, the financial risks associated with DB pension plans are greater for employers in the private sector than in the public sector because in the private sector the government does not guarantee pension plans. Even though businesses may still be able to afford such plans, more and more businesses are opting to stay away from them because of the high financial risks associated with them. Subsequently, when it comes to employee compensation, the growing trend away from DB plans renders the private sector on an uneven playing field. This poses yet another barrier to the private sector in terms of competitiveness and the ability to attract and retain new labour. Moreover, some experts will argue that this structural issue is starting to create labour market distortions or a two-tier system between the public and the private sector.

The second issue of concern with DB plans in Canada is that there is a growing number of DB plans with unfunded liabilities, which in some instances are increasing. A report in 2004 by the Certified General Accountants Association of Canada (CGA) estimated that more than half of the DB plans in Canada had a funding deficit, and in total the shortfall was $160 billion at the end of 2003[20]. In Ontario, DB plans are between 77 and 90 per cent funded. For example, the

Ontario Teachers' Pension Plan (OTPP) has an estimated $6.1 billion shortfall for 2006. Similarly, the Ontario Municipal Employees Retirement System (OMERS) had a $3 billion shortfall in 2005, which was an increase of $2 billion from the previous year. The evaluation of pension plan shortfalls also raises some questions around the accountability and transparency of the process. For example, in 2005 the OTPP shortfall was estimated at $32 billion, up $12.5 billion from the previous year's shortfall. However, in 2006 estimates were revised and the plan shortfall is now estimated at $6.1 billion. The complexity of these practices adds another element of confusion when trying to understand pension plan shortfalls.

In a briefing to the federal Finance Minister, the Office of the Superintendent of Financial Institutions (OSFI) warned that the financial health of private pension plans significantly declined in 2005 and the outlook for 2006 looked even worse. A common explanation as to why pension shortfalls are growing is the impact of the low-interest rates that we have seen over the last few years. As a result of low interest rates, pension liabilities have increased, which essentially means it takes more money to fund pension plans. Another explanation for the growing shortfalls in DB plans is the common 60-40 equity-bond asset mix investment strategy. Although it is hard to find sound evidence as to why this investment strategy seems to be preferred among investment professionals, it is blamed for creating an asset-liability risk mismatch for DB plans. The asymmetry of DB plans is another explanation for financing shortfalls since it leads to minimum funding requirements for plan sponsors. Finally, the issue of increasing generosity in pension plans is another explanation for growing unfunded liabilities. It is not uncommon for DB pension plans to offer increasingly generous benefits in years where the plan is in surplus. And the prospect of an aging population and increases in life expectancy further worsens the situation.

Nevertheless, beyond the explanations relating to market sensitivity, it has been suggested that the regulatory framework for DB plans lacks a solid conceptual foundation. In addition, it is often brought up that pension arrangements for DB plans are ill defined, have ineffective governance and management processes, and the actuarial and accounting practices are too complex[21].

Furthermore, from a legal perspective, the precedent setting Monsanto[22] case ruling of July 2004, which allowed employees to share in the pension surplus of the company upon partial wind-up of the pension plan, provided yet another disincentive for firms not to fully fund their pension plans.

Another systemic problem that serves to worsen the disparity between public and private pensions is that private plans must be subject to an actuarial valuation every 3 years, and if the plan is found to be under funded the employer must undertake concrete steps to return the plan to solvency. There is no such requirement of public sector plans, as it is deemed that governments have endless resources to fund shortfalls – i.e.: we the taxpayers. This situation is already getting very serious and will only get worse unless governments take steps to bring public plans more into line with private plans now.

In looking at solutions for this situation, it is clear that putting the taxpayer on the hook by legislating the government to guarantee private sector pension plans will not work. The Pension Benefit Guaranty Corporation (PBGC) in the US is a good example of putting taxpayers at risk. The PBGC is a government institution that has been around since 1974. Its objective is to guarantee private sector pension plans, regardless of whether or not they are fully funded. Today, thirty-two years after it was created, the PBGC is insolvent. Its reported liabilities exceed its assets by $23 billion and the present value of its long-term cash deficit has been estimated at $92 billion. Essentially, the PBGC has exposed itself to huge financial risks to protect certain pension beneficiaries, but by doing so, it has also placed all taxpayers at risk[23]. It also may discourage some employers from being responsible about their pension solvency because they believe there is a backstop if they get into trouble. Clearly, this is not a viable solution. More studies are needed on this front. A look at corporate best practices from around the world, such as those in Europe or Australia could help in addressing potential solutions[24].

In order to effectively implement any long lasting changes regarding the pension gap, we first need to have a good understanding of the current system. Herein lies yet another barrier to pension-reform, information on pension plans and pension systems currently available to the public is extremely limited.

The most prominent lack of information pertains to data. The complex nature of pension plans and the differential treatment of pension plans between the public sector and the private sector when it comes to laws, regulations, and accounting practices make it difficult to present comparable statistics on this issue. However, the data exists, it is just not readily accessible for the public.

This unavailability of data has created many research limitations. For example, due to the lack of data available on employee and employer pension contributions, it is virtually impossible to accurately estimate the "true" value of the pension gap between the private sector and the public sector. The lack of data on benefits paid-out to pensioners, indexation factors, age of entitlement, etc., also limits the extent to which we can calculate the taxpayer dollars that are allocated to public sector pension plans. Governments must begin to make data publicly available so that the proper research can be done and relevant solutions proposed.

VI. Conclusion

Stating it simply, Canada's pension predicament is one of fairness between the public sector and the private sector. Undeniably, both sectors play a crucial role in the economic well being of Canada. However, the differential treatment, through laws, regulations or compensation philosophies, which exist between public and private sector pension plans, is unjustifiable and unfair to Canadians. There is no valid reason why Canadian taxpayers are on the hook for public sector pension plans when in fact half of the Canadians working in the private sector will not even benefit from any private pension plan upon retirement. The unfairness has gone on long enough.

Furthermore, the inequality issue many Canadians are faced with regarding pensions is a serious disservice to the private sector because it is imposing needless barriers for the private sector to compete on a level playing field with the public sector. This is particularly harmful for small and medium-size firms, which are the backbone of the Canadian economy. Unless the issue of pension unfairness is addressed, the situation will only get worse. It will undermine Canada's entrepreneurial spirit, productivity, economic growth and prosperity.

CFIB strongly recommends that additional information and statistics should be collected and reported publicly on both private and public pension plans.

In addition, CFIB recommends the following guiding principles as a foundation piece for any pension policy reform:

1) The taxpayer should not be the default go-to-mechanism to fund pension plan shortfalls, either in the private sector or in the public sector.
2) Transparency, accountability and consistency need to be instituted in accounting and actuarial practices for evaluating pension shortfalls.
3) Pension plan surpluses should not automatically be allocated towards

increasing pension benefits; stability and spending restraint are needed.

4) The overall objective of any pension policy reform should be to level the playing field between the treatment of retirement savings for public and private sector individuals.

The gap between public and private sector pension coverage is widening. Although, there has been no political appetite to address this issue, not surprisingly, policy reform is urgently needed to re-establish a level playing field between the public and the private sector. If we want to avoid further development of a two-tier culture on retirement, which many argue has already started, and if we want to ensure Canada stays productive and competitive, now is the time to address this issue. It is in everybody's best interest.

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