EXECUTIVE SUMMARY

Expansion of the Canada Pension Plan
and the Unintended Effect on Domestic Investment

by Charles Lammam, Taylor Jackson, and Joel Emes

Beginning in 2019, mandatory contributions by Canadian workers to the Canada Pension Plan (CPP) will increase, step by step, over seven years. While the expansion of the CPP may be well intentioned, it will result in several unintended consequences. One consequence is a reduction in the amount that Canadians save voluntarily in their private accounts such as RRSPs and TFSAs. Previous research has found that, when mandatory CPP contributions were raised in the past, there was a concurrent reduction in private voluntary savings.

The substitution of savings away from private voluntary modes to the CPP will have important consequences, one of which will be a reduction in the amount of money available for investment in Canada. This is likely to occur because, unlike the financial assets held by Canadian households, the portion of CPP contributions that are invested is heavily invested abroad. Indeed, the vast majority of invested CPP contributions, which are managed and invested by the Canada Pension Plan Investment Board (CPPIB), are invested in foreign markets. For instance, in 2016/17, 83.5% of the CPP fund's assets were invested abroad, while only 16.5% were invested within Canada; and the foreign share has steadily increased over time. Canadian households, on the other hand, demonstrate a greater "home bias" towards the location of their savings and financial assets, with 82.2% of their financial assets being invested within Canada, while only 17.8% are invested abroad.

As Canadian households are forced to increase their CPP contributions, they will reduce their levels of private saving, and the majority of those substituted private savings would have been invested within Canada. This means that there will be a reduction in the amount of money available for investment in Canada, compared to what would have been the case if the CPP was not expanded.

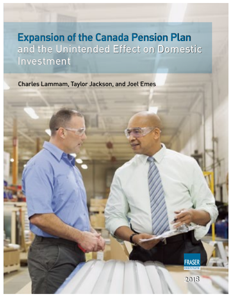
The reduction in the money available for investment in Canada as the CPP expands will depend on the extent to which Canadian households reduce their private voluntary savings in response to higher mandatory CPP contributions. The effect of past CPP expansion suggests the substitution rate will be 89.5%, meaning that every additional dollar of CPP contributions will result in a reduction in private savings of 89.5¢. Based on this rate of substitution, in 2019, investment in Canadian funds would be lower by approximately $1.13 billion (all figures are in nominal dollars). By 2030, five years after the CPP expansion is fully implemented, the annual reduction in the financial assets invested by Canadian households in the domestic market will be $14.8 billion. Under a scenario where Canadian households offset 75% of their increased CPP contributions with reductions in their private voluntary savings, in 2030 Canadian household assets invested in the domestic market would be approximately $11.8 billion lower.

In a scenario where households offset their higher CPP contributions with a 50% reduction in private savings, in 2030 the amount of money available for investment in Canada would fall by approximately $6.5 billion.

Over time, the annual reductions in assets available for investment in Canada will add up. By 2030, depending on the extent to which increased CPP contributions are offset with reduced private savings, the cumulative reduction in these assets could range from $49.9 billion to $114.4 billion.

A decline in investment within Canada will have negative effects on the Canadian economy, as investment is critical to making workers more productive, increasing wages and improving living standards. The decline in investment will also come at a time when business investment in Canada is already decreasing and lagging behind other industrialized countries.

To be clear, the authors do not recommend imposing domestic investment requirements on the CPPIB in response to the CPP expansion and the resulting reduction in the money available for investment in Canada. When the CPPIB is allowed to invest free of any domestic requirements, it is able to invest more broadly into assets which generate the highest risk-adjusted rate of return. This is generally positive (assuming risks are properly accounted for), since it enhances the performance of pension funds. Instead, the recommendation is that governments can help offset the looming reduction in domestic investment by pursuing policies that encourage investment in Canada. This includes policy reforms such as reducing capital gains taxes and lowering taxes on business investment to help spur investment. Indeed, such tax policies are sound and effective independent of the reductions in domestic investment that will result from the CPP expansion.



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