The Canadian Pension Model and how it could be applied in the UK

Next Thursday, the UK chancellor will give an important speech at Mansion House, which will lay out the framework of a new UK pension system. The FT has reported that the centre of her speech will be on reforms for the local government pension scheme, funnelling more funds into local projects[1]. Whilst Reeves has rejected the idea of creating a single £354bn superfund (which would be the world's 7th largest), she is expected to advocate for some consolidation. She is not expected to remove tax subsidies to push the pension funds into UK assets, but she would advocate for more UK focused investment. One thing that is clear is that Labour wants to copy the very successful Canadian pension model. What is the Canadian pension model? And what if the FT article is wrong? This note explores how a Canadian pension model could work in Britain today.

The Canadian vs. UK pension model

The Canadian pension model is broadly very similar to the UK's pension model, as both countries have the following[2]:

1. State pension is funded via mandatory contributions
2. There are voluntary tax-advantaged private pension arrangements that are not directly funded by the state
3. And public sector employees are covered by open defined benefits schemes

The main difference between the Canadian and UK pension model is that the Canadian model is fully funded, while only one of the six UK's largest public service pension schemes, the Local Government Pension Scheme (LGPS, which includes local authority employees and university lecturers in some universities), is fully funded, with the rest being on a pay-as-you-go scheme. The PAYG (pay-as-you-go) schemes do not have a pension pot and pension pay-outs are instead financed from National Insurance or other tax revenues collected today, and include civil servants, teachers, NHS workers and the armed forces[3]. How can these schemes move into a funded scheme and what would this mean? Before I answer this, let's first take a look at the current UK pension model and then the Canadian pension model.

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[1] https://www.ft.com/content/a7a4ee6e-835f-4e0c-9065-56bea4c41d28
[2] Policy_briefing_note_-_the_Canadian_model.pdf
[3] Managing my money: Week 7: 7.2.2 Funded and pay-as-you-go pensions | OpenLearn - Open University

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The current UK pension model

The UK pension system is defined by a state pension and a private workplace pension. The state pension (a defined benefit scheme) becomes payable at the age of 67 and is expected to be increased to 68 in the future. The amount received depends on how much the individual has contributed in national insurance contributions (NICs) over at least 35 years (in order to get the full State pension). The full State pension as of 2024/25 is set at £221.20 per week (£11,502 per annum). Each April, the State pension rises according to the triple lock: The highest rate of either the Consumer Price Index in September, average earnings or 2.5%[4]. The private workplace pension schemes are either defined benefit (DB) or defined contribution (DC). DB schemes provide employees with a fixed payout upon retirement depending on the employee's salary, how long they have worked for their employer and the scheme's accrual rate for each year of pensionable service, i.e. 1/60th or 1/80th of the employee's salary to be awarded as pension for each year the employee was a member of a DB scheme. Most private DB schemes are closed as a direct result of negative real interest rates after the Global Financial Crisis in 2008, as well as a rise in longevity, i.e. the average age a person dies is growing, which put most DB pension schemes into deficits. The DBs are still being operated and with high real interest rates, recently many of these DB pensions are being bought out by insurance companies, concentrating a large pot of money in mostly just a handful of insurance companies. DC schemes are the main source of private pension schemes these days, which are contributions by the employer and employee depending on the employee's salary paid into a pension pot. This pension pot is invested in financial markets and the payout (from age 55 or later) depends on how much was contributed and how much investment growth was achieved. In 2012, an auto-enrolment was established so that employers pay a minimum of 3% and employees a minimum of 5% of the employee's salary each year[5] from annual earnings of at least £6,240 to £50,270, which can be used to reduce taxable income. With the change in employer's NIC from £10k to £5k threshold and 13.8% to 15% rate in this autumn's Budget, some employers hinted that they offer employees more pension pay through DC to reduce NIC tax payments, reducing their overall tax bills.

[4] https://www.niesr.ac.uk/blog/breaking-down-different-types-pension-uk
[5] https://www.gov.uk/government/publications/automatic-enrolment-review-of-the-earnings-trigger-and-qualifying-earnings-band-for-202425/review-of-the-automatic-enrolment-earnings-trigger-and-qualifying-earnings-band-for-202425-supporting-analysis

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The 3 pillars of the Canadian pension model

The Canadian pension model is made up of three pillars. The first pillar is made up of Old Age Security (OAS), Guaranteed Income Supplement (GIS) and other government funded programmes, such as Spouse Allowance. OAS is a tax-supported income-assistance paid at age 65 to all Canadians at $6,800 per annum, which is reduced from earnings greater than $73,800 as of 2016 and gradually eliminated. GIS is an additional annual pension payment of up to $9,300 for a single and $12,300 for a couple (as of 2016) for pensioners who earned less than $17,300 a year or $22,800 as a couple (as of 2016). Pillar I is essentially the equivalent of the UK's State pension, but much more in favour for low-income households, and is eliminated for high income households entirely. Pillar II includes the Canada Pension Plan (CPP) and Quebec Pension Plan (QPP), which are mandatory earnings-related programmes for the employed and self-employed in Canada and Quebec. These contributory plans require a combined employer-employee contribution of 9.9% (10.5% for QPP) of earnings between $3,500 and the year's maximum pension earnings ($56,900 in 2016) shared on a 50-50 basis. Pillar II can be drawn upon at age 65 and the maximum annual payout is $13,000 (as of 2016). Finally, Pillar III consists of workplace pensions (defined benefit and defined contribution) and private savings plans, which all offer tax benefits[6]. The UK's current defined contribution plan is a mixture of Pillar II and Pillar III of the Canadian model, as it requires minimum contributions from employer and employee (like Pillar II), but the employee can decide who manages the investments.

(Diagram on the next page)

[6] https://documents1.worldbank.org/curated/en/780721510639698502/pdf/121375-The-Evolution-of-the-Canadian-Pension-Model-All-Pages-Final-Low-Res-9-10-2018.pdf

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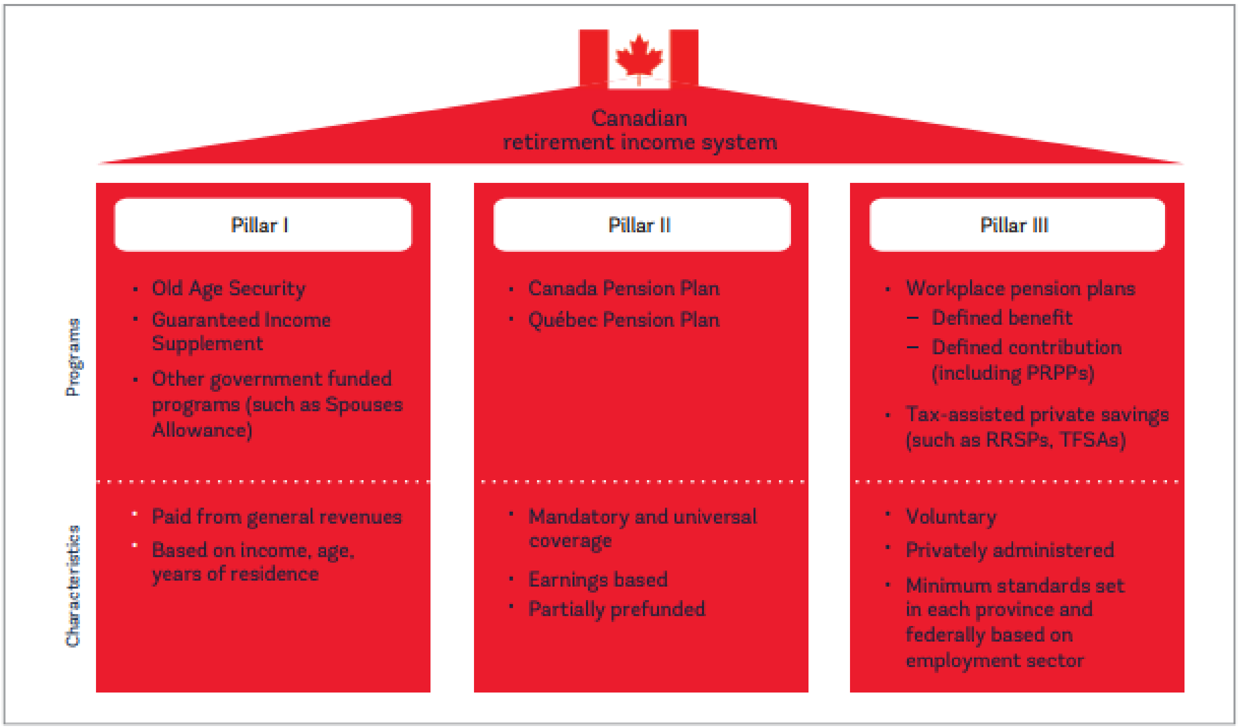
The Canadian Pension Model: 3 Pillars



Note: PRPP = Pooled Registered Pension Plan; RRSP = Registered Retirement Savings Plan; TFSA = tax-free savings account.

Source: https://documents1.worldbank.org/curated/en/780721510639698502/pdf/121375-The-Evolution-of-the-Canadian-Pension-Model-All-Pages-Final-Low-Res-9-10-2018.pdf

The likely adoption of the Canadian model in the UK

All in all, the UK will likely adopt the Canadian pension model by making high income households pay more into their pensions privately and eliminating their state pensions, while increasing the state pensions for low-income households. The outcome could mean lower pension expenditures for the government, and higher pension expenditures for employers and employees, especially high earners. Depending on the rates, it could also push some self-employed people back into employment, if they are required to allocate money into their pension pots, which they are currently not. Furthermore, Pillar II could give the government direct say where the pensions are being invested in, i.e. British infrastructure, UK equities, non-listed UK companies. Pillar I would be the State pension. Pillar II would be the currently mandatory defined contributions (employers pay a minimum of 3% and employees a minimum of 5% of the

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employee's salary each year[7] from annual earnings of at least £6,240 to £50,270) and would no longer go into privately managed pensions, but the newly created National Wealth Fund. And Pillar III would be anything extra that (high earning) employees chose to allocate into a pension and either manage the investments themselves or professional investment managers. As this would heavily impact the UK's sprawling investment managers, I could imagine that say 50% of Pillar II goes towards the UK's National Wealth Fund, and 50% to a privately managed investment fund.

More details on the evolution of the Canadian pension model can be found here.

[7] https://www.gov.uk/government/publications/automatic-enrolment-review-of-the-earnings-trigger-and-qualifying-earnings-band-for-202425/review-of-the-automatic-enrolment-earnings-trigger-and-qualifying-earnings-band-for-202425-supporting-analysis

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