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A Primer on Federal Social Security Contributions

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A Primer on Federal Social Security Contributions

(In Brief)

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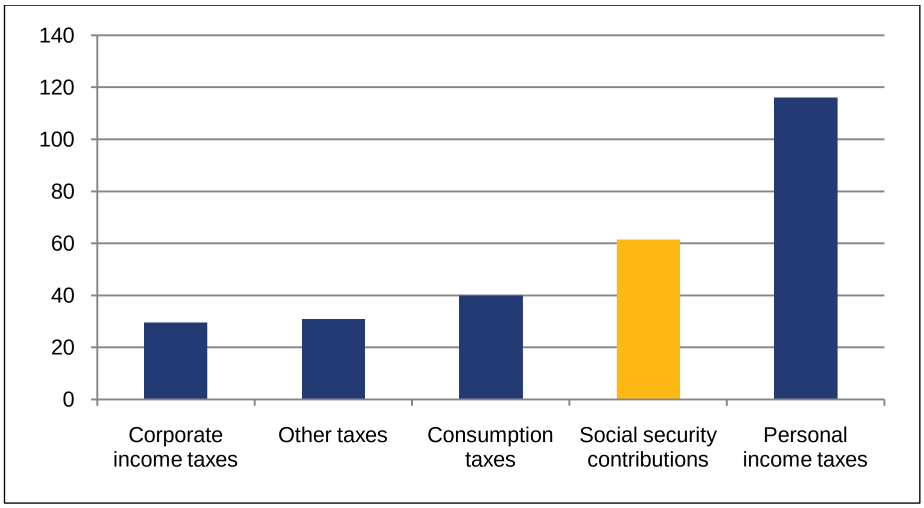
A PRIMER ON FEDERAL SOCIAL SECURITY CONTRIBUTIONS*

1 INTRODUCTION

Governments worldwide increasingly recognize social security contributions[1] as an important source of revenues with which to finance expenditures on social security programs, such as government-sponsored pension plans and employment insurance programs. In Canada, social security contributions at the federal level – contributions to the Canada Pension Plan (CPP) and the Quebec Pension Plan (QPP) as well as Employment Insurance (EI) premiums – totalled $61 billion in 2008–2009, as shown in Figure 1.[2]

Figure 1 – Canadian Federal Tax Revenues and Social Security Contributions, Fiscal Year 2008–2009 ($ billions)



Note: “Social security contributions” refers to contributions to the Canada and Quebec Pension Plans (CPP and QPP) as well as Employment Insurance (EI) premiums. Capital taxes on financial institutions are included in corporate income taxes.

Source: Figure prepared by the authors using data obtained from Statistics Canada, CANSIM table 385–0006, and from Receiver General for Canada, *Public Accounts of Canada 2010*, *Volume I, Summary Report and Financial Statements,* October 2010.

Social security contributions differ from other types of taxes in that the benefits associated with these contributions are available only to those who have made contributions and who meet certain qualifying conditions. Hence, social security contributions allow governments to ensure that those who benefit from such programs are those who bear the cost of these measures.

2 OVERVIEW

In principle, social security contributions are compulsory payments to governments that give the contributor an entitlement to future benefits, provided qualifying conditions are met.[3] These benefits are usually contingent on a life event, such as involuntary loss of employment, retirement, disability or death. Depending on the social security measure and the country, contributions may be made by employees, employers, self-employed persons and unemployed individuals. These contributions may involve either a payroll deduction or collection at the end of a taxation year on individual tax returns.

At the federal level in Canada,[4] social security contributions are made to the EI program, and to the CPP or the QPP.

2.1 EMPLOYMENT INSURANCE

The EI program provides a benefit to employees who unintentionally lose their jobs and who have worked the minimum number of hours to qualify for the program. This minimum number varies between 420 and 700, depending on the beneficiary's location, the unemployment rate for that region, and his or her individual circumstances.

Financial assistance is also provided to self-employed individuals registered in the EI program and to qualifying employees who are absent from work because they are sick, pregnant or caring for a newborn or adopted child, as well as to those who provide care to a seriously ill family member.

For 2011, employees and self-employed individuals contribute $1.78 for every $100 earned up to a maximum annual salary of $44,200; employers must contribute 1.4 times the employee's contribution.[5] The basic benefit is 55% of earnings up to a maximum weekly benefit of $468. The duration of basic benefits varies between 14 and 45 weeks, depending on the unemployment rate in the region where the beneficiary lives and the number of insurable hours he or she has accumulated.

2.2 CANADA PENSION PLAN AND QUEBEC PENSION PLAN

The CPP is a contributory, earnings-related program that partially replaces income losses resulting from the retirement, disability or death of a contributor. Quebec has the QPP, which closely resembles the CPP.

The CPP requires contributions by virtually all Canadians who earn a wage/salary and who are between the ages of 18 and 69. For 2011, employees must contribute 4.95% of their wage/salary on amounts between $3,500 and $48,300; employers must contribute an equal amount. Self-employed individuals must make both the employee and the employer contributions.

The CPP retirement pension is designed to replace about 25% of the earnings on which a person's contributions were based. For 2011, the maximum annual retirement pension is $11,520 when retirees start receiving payments on their 65th birthday. Retirees can start receiving their retirement pension as early as age 60, but pension amounts are reduced, in 2011, by 0.50% for each month prior to the retiree's 65th birthday, to a maximum of 30%. The monthly downward adjustment factor will change beginning in 2012 until reaching 0.60% in 2016.

Retirees can delay receiving their pension until their 70th birthday, in which case the amount of their pension is increased by, for 2011, 0.57% for each month after the retiree's 65th birthday, to a maximum of 34.2%. The monthly upward adjustment factor will reach 0.70% in 2013.[6]

Starting in 2012, individuals who are receiving a CPP retirement pension but who choose to work can continue to make CPP contributions; the following year, those individuals will start to receive the Post-Retirement Benefit in addition to their monthly CPP pension. Contributions to the Post-Retirement Benefit are mandatory for employees less than 65 years of age and for their employers. They are voluntary for employees between the ages of 65 and 70; however, if the employee chooses to make contributions, the employer will be required to make contributions as well.

The CPP disability benefit is available to qualifying individuals who have made CPP contributions, who have stopped working due to a severe and prolonged disability, and who are less than 65 years of age; the maximum monthly benefit for 2011 is $1,153.37. The dependent child(ren) of individuals receiving the CPP disability benefit may also be eligible to receive a children's benefit; in 2011, the maximum monthly benefit is $218.50.

Upon the death of a CPP contributor, qualifying individuals can apply for CPP survivor benefits, which consist of a death benefit, a survivor's pension and a children's benefit. The death benefit is a one-time payment to the deceased CPP contributor's estate; it has a maximum value of $2,500. The survivor's pension is available to the spouse or common-law partner of the deceased CPP contributor; in 2011, for survivors less than 65 years of age, the maximum monthly benefit is $529.09, while the maximum monthly benefit is $576 for survivors who are 65 years of age and older. The dependent child(ren) of a CPP contributor may also be eligible for a maximum monthly benefit of $218.50.

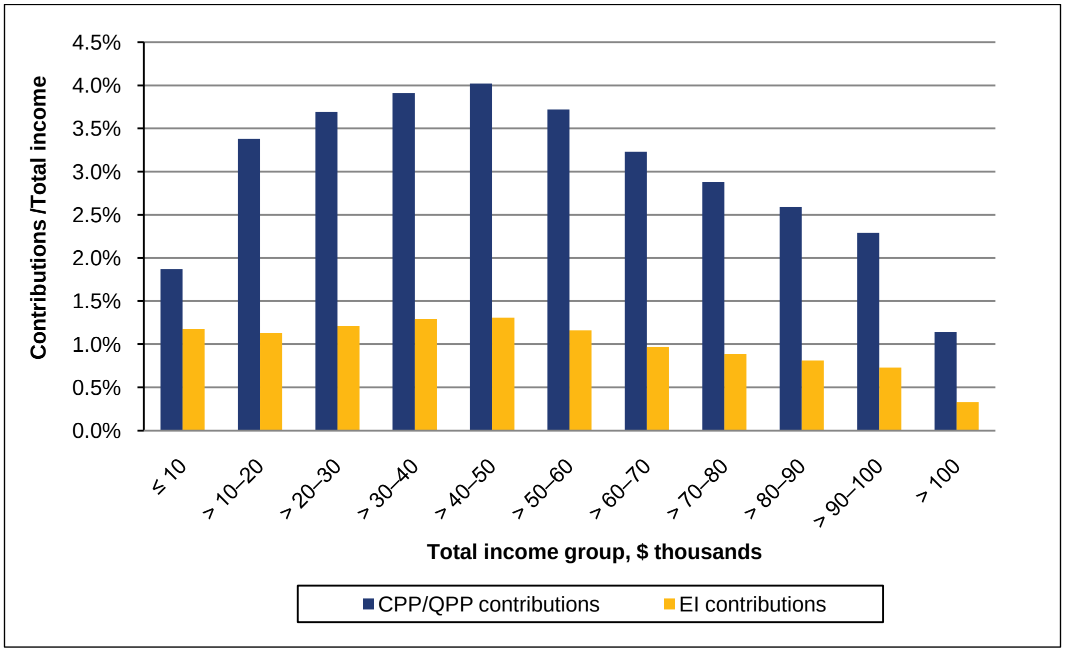
3 PROS AND CONS OF THE COLLECTION OF SOCIAL SECURITY CONTRIBUTIONS

3.1 EQUITY

Commonly accepted notions of fiscal equity suggest that taxpayers in similar circumstances should pay similar amounts of taxes, a situation described as horizontal equity, and that taxpayers with a greater ability to pay should pay more, a situation described as vertical equity.

One criticism of social security contributions is that they contravene the notion of vertical equity, since taxpayers with higher incomes pay proportionately less in contributions. As shown in Figure 2, the burden of federal social security contributions falls disproportionately on middle-income earners.

Figure 2 – Estimated CPP, QPP and EI Average Contributions as a Percentage of Total Income from Taxable Sources, by Income Group, 2011



Source: Calculations by Édison Roy-César, Library of Parliament, using Statistics Canada's Social Policy Simulation Database and Model (SPSD/M), version 18.0. The Library of Parliament is entirely responsible for the use and interpretation of this model.

This result is not surprising when the structure of the CPP and the QPP as well as the EI program is considered. As earnings rise beyond the maximum earning amounts on which contributions are made, taxpayers gradually pay a smaller share of their income in the form of CPP, QPP and EI contributions. Furthermore, higher-income earners tend to generate more revenues from sources on which CPP, QPP and EI contributions are not made, such as capital gains. Low-income earners also pay a smaller share of their income in the form of CPP, QPP and EI contributions relative to middle-income earners, which is compatible with the notion of vertical equity. This result is partly explained by the collection of CPP and QPP contributions only when earnings rise above $3,500. Also, low-income earners tend to receive more taxable government transfers on which CPP, QPP and EI contributions are not made.

3.2 Efficiency

Competitive markets tend to allocate resources, such as capital and labour, to their most-valued uses, resulting in relatively less expensive goods and services for customers. This efficient allocation of resources is achieved through market mechanisms, whereby prices rise when there is excess demand and fall when there is excess supply. To some extent, all taxes may affect the allocation of resources, since they may influence market prices and hence the quantity of goods and services demanded and supplied. Taxes that have a minimal effect on the allocation of resources are said to be efficient.

Social security contributions are considered to be an efficient form of taxation. First, they have minimal disincentive effects on labour force participation by individuals. Moreover, CPP, QPP and EI contribution rates are uniformly applied to employee earnings within the contribution thresholds. This uniform application leads to lower marginal tax rates[7] than federal income taxes, which apply higher tax rates on income that falls within higher income tax brackets. For a given level of income, high marginal taxes are believed to discourage work efforts. CPP, QPP and EI contributions effectively have marginal tax rates of zero for amounts above their respective contribution limits.

The link between social security contributions and the benefits they finance may also lessen the disincentive effects on labour force participation. Individuals may view social security contributions as forced saving or forced participation in an insurance plan, rather than as a tax.

Furthermore, CPP, QPP and EI contribution rates are the same across industries, hence minimizing any distorting effect of contributions to these measures on the allocation of resources.

Others, however, have suggested that since some social security contributions, such as those for the EI program, the CPP and the QPP, are applied only on labour income, these contributions may be particularly costly for employers in labour-intensive industries. These employers are required to contribute relatively more than employers in industries that are less labour-intensive.

If these costs are not passed on to customers and/or employees in the form of higher prices and/or lower compensation, social security contributions may increase the cost of goods and services produced by domestic companies. This cost increase, consequently, may impede domestic companies' international competitiveness if their foreign competitors do not face the same contributions, face contributions at a lower rate, and/or do not pass the cost of their contributions along to customers and/or employees.

Empirical evidence suggests that social security contributions are borne mostly by employees in the form of lower compensation, especially in the long run and when they are applied broadly across sectors.[8] From this perspective, the impact of these contributions on the competitiveness of labour-intensive companies, as well as exporting companies, may be limited.

3.3 Administration and Compliance

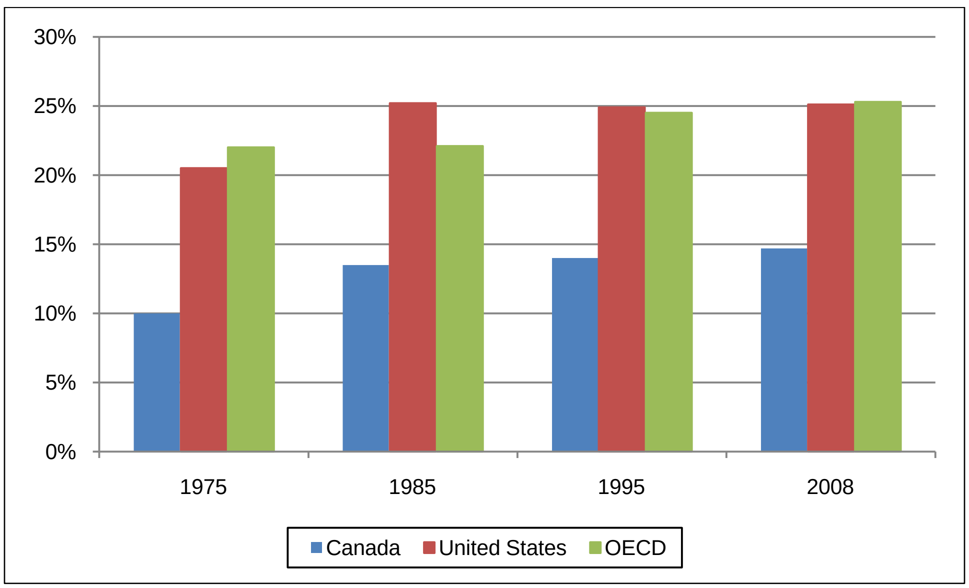
Social security contributions may be easier to administer and have lower compliance costs than other types of taxes. For example, the CPP, the QPP and the EI program have a broad, clearly defined range of employee earnings on which uniform contribution rates are applied. Furthermore, both employee and employer contributions are remitted by the employer, which simplifies compliance. This situation contrasts with the complexity of income taxes in Canada, which have several tax rates as well as numerous credits and deductions. Moreover, social security contributions imposed on employers are deducted as expenses by them for tax purposes, which also tends to enhance compliance levels.

4 INTERNATIONAL CONTEXT

Social security contributions as a proportion of total tax revenues have increased over the past 35 years in most Organisation for Economic Co-operation and Development (OECD) countries, including Canada and the United States. This increase can be explained in part by the rising cost of some social security programs, such as government-sponsored pension plans, as a result of factors such as population aging.

Canada's federal and provincial / territorial governments rely to a lesser extent on social security contributions to finance public expenditures than do most governments in OECD countries; Canadian governments generate a greater proportion of their revenues in the form of personal income taxes. As shown in Figure 3, social security contributions generated 14.7% of all tax revenues in Canada in 2008, compared with 25.1% for the United States and 25.3% for OECD countries on average.

Figure 3 – Social Security Contributions as a Percentage of Total Tax Revenues, All Levels of Government, Various Countries and Years, 1975–2008



Source: Organisation for Economic Co-operation and Development, *Revenue Statistics 1965–2009,* 2010.

NOTES

* This publication is an updated and revised version of *A Primer on Federal Social Security Contributions*, prepared on 27 August 2007 by Philippe Bergevin, formerly of the Library of Parliament.

1. “Social security contributions” includes Employment Insurance premiums as well as contributions to the Canada and Quebec Pension Plans.

2. While the QPP operates exclusively in Quebec, the contribution figures for Quebec’s plan are combined with those for the CPP, which operates in the rest of Canada, thereby giving rise to the use of the term “federal.”

3. Organisation for Economic Co-operation and Development, *Revenue Statistics 1965–2009*, p. 291.

4. See note 2.

5. Under a Canada–Quebec accord, the EI premium rates are reduced for the province of Quebec as a result of the establishment of the Quebec Parental Insurance Plan, which provides parental benefits.

6. Beginning in 2011, the upward adjustment factor for those who apply for their CPP retirement pension after age 70 changes from 0.50% per month to 0.57% in 2011, 0.64% in 2012 and 0.70% in 2013. The downward adjustment factor for those who apply for their CPP retirement pension before age 65 will change from 0.50% per month to 0.52% in 2012, 0.54% in 2013, 0.56% in 2014, 0.58% in 2015 and 0.60% in 2016.

7. “Marginal income tax rate” refers to the proportion of additional income that is paid in taxes.

8. Robin W. Boadway and Harry M. Kitchen, *Canadian Tax Policy*, 3rd ed., Canadian Tax Paper no. 103, Canadian Tax Foundation, Toronto, 1999, p. 330.