IN BRIEF

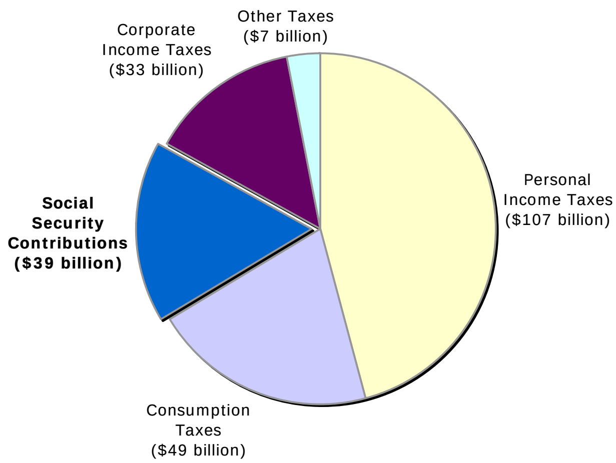
Parliamentary Information and Research Service
Library of Parliament

Philippe Bergevin
27 August 2007

A Primer on Federal Social Security Contributions

Social security contributions are increasingly recognized by governments 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 and Quebec Pension Plans and employment insurance premiums – totalled $39 billion in 2005-2006, as shown in Figure 1.

Figure 1
Canadian Federal Tax Revenues and Social Security Contributions, Fiscal Year 2005-2006



Note: Social security contributions include contributions to the Canada and Quebec Pension Plans and employment insurance premiums. Capital taxes are included in corporate income taxes.

Source: Data obtained from Statistics Canada, CANSIM tables 385-0002 and 385-0006.

Social security contributions differ from other types of taxes in that the benefits associated with social security 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 may benefit from such programs are those who bear the cost of these measures.

This paper will describe federal social security contributions and will explore some of their pros and cons. The last section will analyze Canadian social security contributions in an international context.

OVERVIEW

In principle, social security contributions are compulsory payments to governments that give the contributor an entitlement to future social benefits, provided qualifying conditions are met.[1] These benefits are usually contingent on a life event, such as involuntary loss of employment, retirement, disability or death. Social security contributions are paid by the employee, the employer, or both; in some instances, they may be paid by self-employed or unemployed individuals. These contributions involve either a payroll deduction or collection at the end of a taxation year on individual tax returns. At the federal level, the two types of social security contributions are made in respect of the employment insurance program and the Canada/Quebec Pension Plan.

A. Employment Insurance

The employment insurance (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. The minimum number of hours to qualify varies between 420 and 700, depending on where the person lives and the unemployment rate for that economic region.

The program may also provide financial assistance to individuals who are absent from work because they are sick, pregnant or caring for a newborn or adopted child, as well as to those who must care for a family member who is seriously ill.

For 2007, an employee must contribute $1.80 for every $100 earned up to a maximum annual salary of $40,000; the employer must contribute 1.4 times the employee's contribution.(2) The basic benefit is equal to 55% of earnings up to a maximum weekly benefit of $423. 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 amount of insurable hours he or she has accumulated.

B. Canada/Quebec Pension Plan

The Canada Pension Plan (CPP) is a contributory, earnings-related program that protects contributors and their families against the loss of income resulting from retirement, disability and death; Quebec has the Quebec Pension Plan, which closely mirrors the CPP. The CPP requires contributions by virtually all Canadians who earn a salary and are between the ages of 18 and 69. For 2007, employees must contribute 4.95% of their salary on amounts between $3,500 and $43,700; 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 2007, the maximum annual retirement pension available is $10,365 when pensioners start receiving payments on their 65th birthday. Pensioners can start receiving their retirement pension as early as age 60, but pension amounts are reduced by 0.5% for each month prior to their 65th birthday. Pensioners can delay receiving their pension until their 70th birthday, in which case the amount of their pension is increased by 0.5% for each month after their 65th birthday.

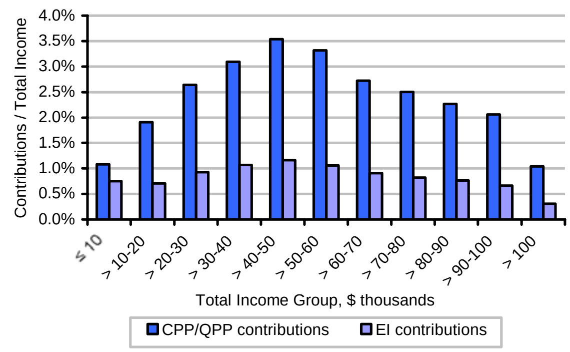
PROS AND CONS

A. Equity

Commonly accepted notions of fiscal equity suggest that taxpayers in similar circumstances should pay similar amounts of taxes (horizontal equity) and that taxpayers with a greater ability to pay should pay more (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 than do most taxpayers with lower incomes. As shown in Figure 2, the burden of federal social security contributions falls disproportionately on middle-income earners.

Figure 2
Estimated Canada/Quebec Pension Plan (CPP/QPP) and Employment Insurance (EI) Average Contributions as a Percentage of Total Income from Taxable Sources, by Income Group, 2007



Source: Statistics Canada's Social Policy Simulation Database and Model (SPSD/M).

This result is not surprising when the structure of the C/QPP and EI programs is considered. As earnings rise beyond the maximum earning amounts on which contributions are applied, taxpayers gradually pay a smaller share of their income in the form of C/QPP and EI contributions. Furthermore, higher-income earners tend to generate more revenues from sources on which C/QPP or EI contributions are not applied, such as capital gains. Low-income earners also pay a smaller share of their income in the form of C/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 fact that C/QPP contributions are paid only when earnings rise above $3,500. Also, low-income earners tend to receive more taxable government transfers in proportion to total revenues, on which C/QPP and EI contributions are not required.

B. Efficiency

Competitive markets tend to allocate resources, such as capital or labour, to their most valued uses and to result in cheaper 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 affect the allocation of resources, since they influence market prices and hence the quantity 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 (i.e., labour supply). Moreover, C/QPP and EI contributions are applied at a flat rate on amounts within the contribution thresholds, which leads to relatively lower marginal tax rates – i.e., amounts of taxes paid on additional revenues – 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. C/QPP and EI contributions effectively have marginal tax rates of zero for amounts above their respective contribution limits. The fact that social security contributions are linked to social benefits 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, C/QPP and EI contribution rates are the same across industries, hence minimizing any distorting effect of the contribution on the allocation of resources.

Others, however, have suggested that since many types of social security contributions, such as those for EI, are applied only on labour income, these contributions may discriminate against labour-intensive industries. Moreover, social security contributions may increase the cost of goods and services produced by domestic companies and, consequently, may impede their international competitiveness. Empirical evidence suggests, however, that social security contributions are borne mostly by employees, especially when they are applied broadly across sectors.(3) In the long run, even when social security contributions are paid by the employer, they may be borne by employees – at least partly – in the form of lower wages. From this perspective, since employees bear most of the burden of social security contributions, the impact of such contributions on the competitiveness of labour-intensive companies as well as exporting companies may be limited.

C. Administration and Compliance

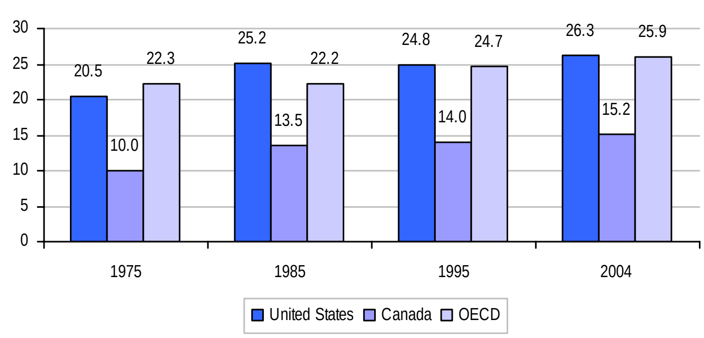
Social security contributions are often easier to administer and to comply with than other types of taxes. For example, the C/QPP and the EI program have a broad, clearly defined range of earnings on which uniform contribution rates are applied. Furthermore, both the employee and employer contributions 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 by them for tax purposes, which also tends to enhance compliance levels.

INTERNATIONAL CONTEXT

The contribution of social security contributions to total taxation revenues has increased over the past three decades in most Organisation for Economic Co-operation and Development (OECD) countries, including Canada and the United States. The increasing contribution of social security contributions can be explained in part by the rising cost of many social security programs, such as government-sponsored pension plans, as a result of factors such as the aging of the population.

Federal and provincial Canadian governments, however, rely to a lesser extent on social security contributions to finance public expenditures than most governments in OECD countries. As shown in Figure 3, social security contributions generated 15.2% of all taxation revenues in Canada in 2004 compared with 26.3% for the United States and 25.9% for the average OECD country. Although social security contributions in Canada may be relatively lower, Canadian governments generate a greater proportion of their revenues in the form of personal income taxes. In 2004, personal income taxes in Canada generated 35% of all taxation revenues compared with 25% for the average OECD country.

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



Source: Organisation for Economic Co-operation and Development, *Revenue Statistics, 1965-2005*.

(1) Organisation for Economic Co-operation and Development, *Revenue Statistics, 1965-2005*, 2006 edition, p. 291.

(2) 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.

(3) Boadway, Robin W. and Kitchen, Harry M., *Canadian Tax Policy*, 3rd Edition, Canadian Tax Paper No. 103, Toronto: Canadian Tax Foundation, 1999, p. 330.