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Expanding the Canada Pension Plan is back on the table. Several provinces are in favour of increasing the Canada Pension Plan, including Ontario, Manitoba and Quebec. Alberta and Saskatchewan are at least open to discussion on the possibility. Ottawa had been more reluctant to go this route, preferring instead a privately managed, voluntary pooled registered pension plan. But discussions reportedly have been going well during this round of pension reform. The federal and provincial finance ministers have been exploring several proposals for expanding the CPP in a paper prepared by their officials.

The Caledon Institute for several years has been proposing a ‘1.5’ solution for expanding the Canada Pension Plan in which the Year’s Maximum Pensionable Earnings would increase by 50 percent and the earnings replacement rate would also rise by 50 percent. We illustrate that option later. But first, a brief overview of Canada’s retirement income system and its achievements and failings.

Pension tension

Canada’s retirement income system has two main aims: to ensure that no senior lives in poverty (the anti-poverty objective) and to maintain in retirement the standard of living to which Canadians have been accustomed during their working years (the earnings replacement objective). To pursue these goals, we have built a three-tier pension system over the years which, in theory, makes a lot of sense and has been lauded internationally. Unfortunately, the system’s performance falls short of its promise.

The foundation of the retirement income system is the federal Old Age Security and Guaranteed Income Supplement programs; in addition, a number of provinces and territories offer income supplements for their elderly poor. These public programs have played a crucial part in the substantial decline in poverty among elderly Canadians over the years, although they have not yet managed to reduce the low-income rate to zero. Though directed mainly to the anti-poverty objective, Old Age Security also plays an important role in helping meet the earnings replacement objective for low- and modest-income seniors.

The second tier of the retirement income system consists of the Canada Pension Plan and Quebec Pension Plan, geared to the earnings replacement objective. These parallel public programs have several strong points: They cover the entire labour force, both employees and the self-employed. They are fully portable – all workers and the self-employed contribute to the plans throughout their working life no matter what jobs they have and where in Canada they live. Benefits are indexed to protect them from inflation. The programs were put on a solid financial footing during the last round of pension reform a decade ago. They are inexpensive to administer.

The third, private tier of the retirement income system is directed to the earnings replacement objective. It consists of employer-sponsored plans (Registered Pension Plans or RPPs) and

individual retirement savings, notably Registered Retirement Savings Plans (RRSPs). There are two kinds of Registered Pension Plans.

‘Defined benefit plans’ pay a specific benefit, generally based on earnings and years of service. Members of defined benefit plans can find out exactly how their pension will be calculated and how much it will be.

‘Defined contribution plans,’ by contrast, pay benefits according to accumulated contributions and investment returns. The workers in these plans know only the amount they are contributing. What they actually will get upon retirement depends on the performance of the plans over the years.

When the Canada and Quebec Pension Plans were created in the mid-1960s, they were deliberately designed to pay relatively modest benefits. The maximum amount is only one-quarter of average earnings, which in 2012 means a maximum CPP retirement payment of just \$11,840.

The reasoning was that the private tier of employer-sponsored pension plans and individual savings plans would play the lion’s share of the earnings replacement objective for middle- and upper-income Canadians. The Canada and Quebec Pension Plans would play a secondary role – except in the case of low- and modest-income recipients, for whom the two public tiers provide all or most of their earnings replacement.

Unfortunately, things did not work out according to plan. The Achilles heel of Canada’s retirement income system is that private pension and savings plans never grew sufficiently to properly serve the earnings replacement objective for many Canadians. To the contrary, coverage of employer-sponsored pensions has fallen significantly over the years – from 46 percent of the employed workforce in 1977 to just 38 percent by 2010.

While most employees in public sector jobs belong to employer-sponsored pension plans, only about one in three workers in the private sector have them. Coverage of RRSPs is also weak – at last count (2010) only 24 percent of taxfilers contributed to an RRSP.

Employers are abandoning expensive and complex defined benefit plans, some switching to defined contribution plans or getting out of the business of pension plans altogether. Public sector pension plans are generally superior to those in the private sector, with arrangements for portability and indexation of benefits that private employers typically do not provide. And of course, most Canadians work for employers that provide no pension plan, period.

This is a slowly unfolding crisis. Our real choice is whether we address the problems now in a planned way that minimizes future economic disruption and income inadequacy. Or do we postpone doing what needs to be done, so we are forced to react with inadequate options in the future?

Options for reform

The Canada Pension Plan's superior design suffers none of the failings of private pension plans. But it cannot, in its current form, make up for the weaknesses of the third tier because its level of benefits is so low. The answer is to boost the Canada Pension Plan's earnings replacement power.

The Caledon proposal would enhance the Canada Pension Plan by changing two key features of its design. We would raise the Year's Maximum Pensionable Earnings level from its current \$50,100 to \$75,150 – an increase of one-half. The earnings replacement rate would go from 25 to 37.5 percent – also an increase of 50 percent. As a result, the maximum CPP benefit would more than double, from \$11,840 to \$28,181.

Finance ministers are said to be discussing three main options for expanding the Canada Pension Plan. Option 1 would leave the Year's Maximum Pensionable Earnings level at its current \$50,100 but raise the earnings replacement rate from 25 percent to 35 percent. Option 2 would raise the Year's Maximum Pensionable Earnings by 50 percent, from \$50,100 to \$75,100 but leave the earnings replacement rate at its current 25 percent. The third option would combine the first and second options, increasing the earnings replacement rate to 35 percent and the Year's Maximum Pensionable Earnings to \$75,150.

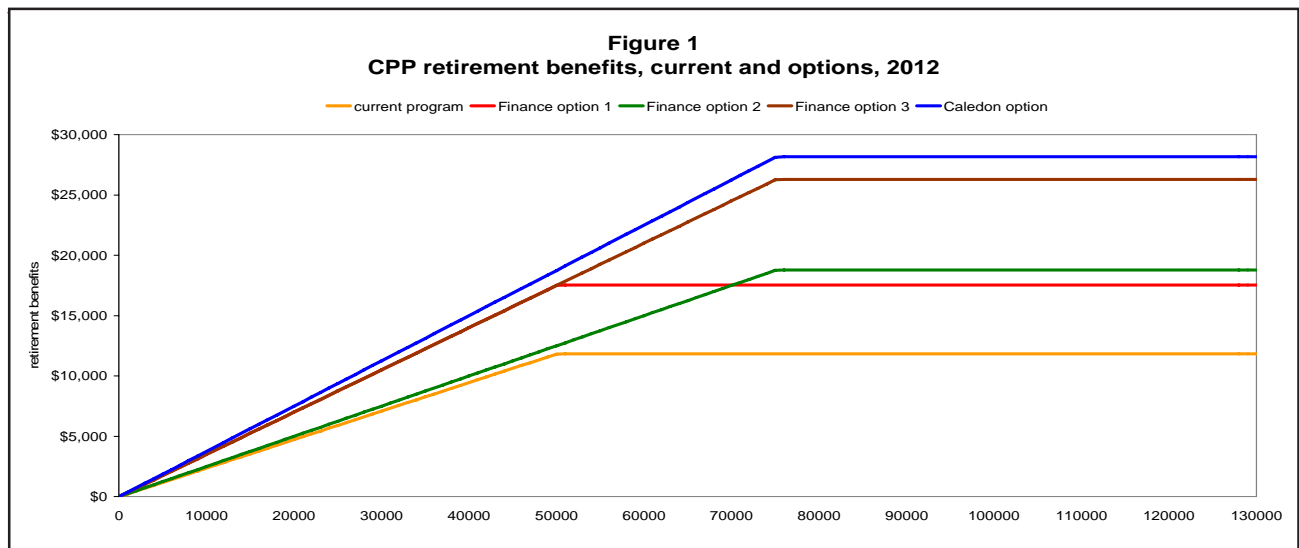


Figure 1 pictures the current program, the three Finance options and the Caledon option.

The orange line illustrates the Canada Pension Plan retirement benefit in its present form. Payments rise gradually until they reach the maximum \$11,840 at pensionable earnings of \$50,100, above which they plateau at \$11,840.

Finance option 1, shown in red, reaches a maximum benefit of \$17,535 at pensionable earnings of \$50,100. Finance option 2, shown in green, rises to a maximum amount of \$18,788 at pensionable earnings of \$75,150. Finance option 3, in brown, reaches a maximum benefit of \$26,303 at pensionable earnings of \$75,150. The Caledon proposal, illustrated in blue, would see benefits rise to a maximum \$28,181 at pensionable earnings of \$75,150.

There is a striking similarity between Finance option 3 and the Caledon proposal: Both increase the Year’s Maximum Pensionable Earnings by 50 percent, from \$50,100 to \$75,100, and both boost the earnings replacement rate (from 25 percent to 35 percent under Finance option 3 and to 37.5 percent under the Caledon option).

Figure 2 shows by how much Canada Pension Plan recipients would see an increase under Finance option 3 and the Caledon option. Benefit improvements would rise more rapidly above the current Year’s Maximum Pensionable Earnings (\$50,100) and would level off at \$14,463 under Finance option 3 and \$16,341 under the Caledon option at the new Year’s Maximum Pensionable Earnings (\$75,150). The Caledon option provides better benefits than the Finance 3 option at all income levels except the very lowest.

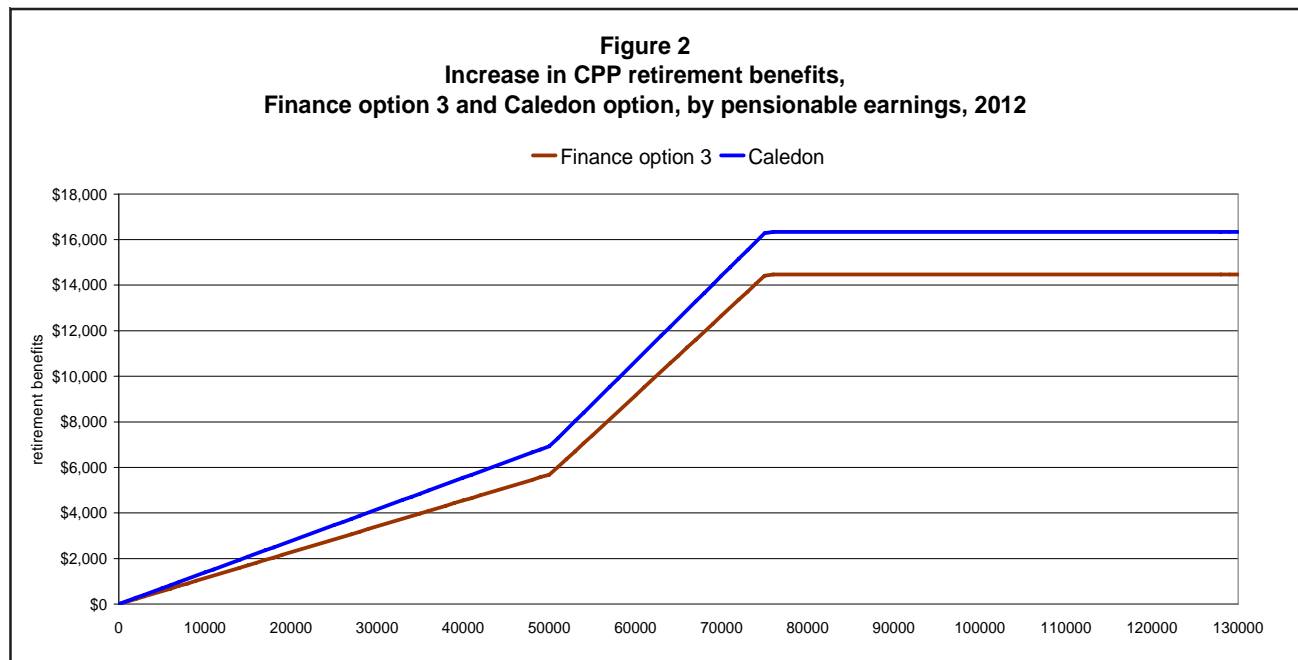
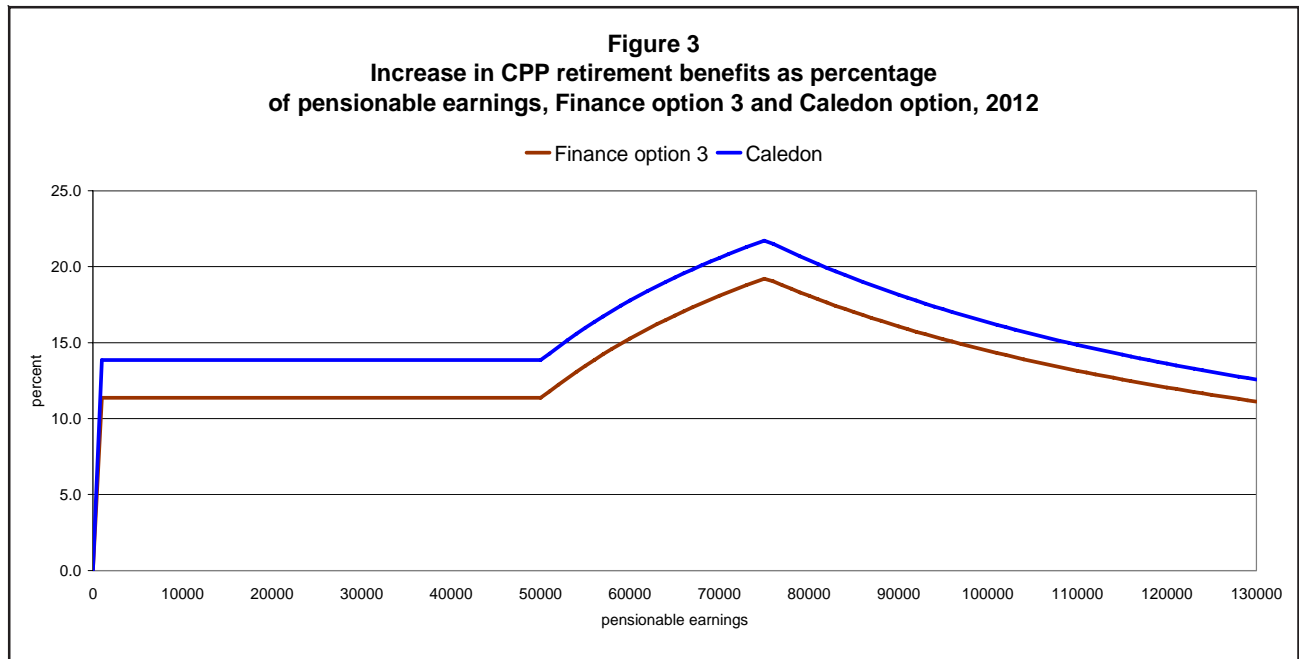


Figure 3 illustrates benefit increases as a percentage of pensionable earnings. Canada Pension Plan recipients in the \$50,000 to \$130,000 range – from the modest- to upper-middle incomes – would see the largest proportionate increase under the Finance 3 and Caledon options.



The biggest winners from Finance option 3 and the Caledon proposal would be the large majority of private sector workers in the modest- to upper-income range who are not in employer-sponsored pension plans. The Canada Pension Plan is a universal social program that cannot (and should not) distinguish between workers with and without employer-sponsored pension plans, so our proposal would also boost benefits for CPP recipients fortunate to belong to private pension plans.

The cost of proposals to expand the Canada Pension Plan, such as those presented here, is a key concern. Only the federal Department of Finance has the capacity and required data to assess accurately the cost of these various options. We would expect the Department to publish cost estimates as part of the public dialogue on pension options – including Caledon’s 1.5 proposal and others’ options.

The potential cost is dependent upon a number of factors such as the phase-in of benefits and rates, demography, labour participation and unemployment rates, economic growth and other variables.

One of the critical considerations in the new contribution rate and an especially tricky issue is the phase-in of new benefits and new contribution rates. Would increased benefits go to all Canada Pension Plan recipients immediately, including current retirees, or is there a phase-in period related to the increase in contributions? This issue will be important in setting contribution rates since the immediate implementation of new benefits implies a substantial increased liability. Contribution rates will likely be higher over the foreseeable future the sooner benefits are improved.

Alternatively, higher benefits could be phased in over time, along with increased contributions, which would presumably reduce the long-run contribution rate. Again, only the Department of Finance is equipped to work out accurate estimates of the alternatives, and we would hope and expect that these would soon be made public to ensure a sensible dialogue on pension options.

Conclusion

The ministers of finance have before them three key options for improving the Canada Pension Plan. Now is the time for Canada to come to grips with its failing retirement system, rather than waiting until we face an unaffordable crisis in a decade or so.

In our view, increasing both the Canada Pension Plan's Year's Maximum Pensionable Earnings and earnings replacement rate of the Canada Pension Plan is the only reform that can address the deteriorating retirement position of modest- and middle-income earners, especially those who work in the private sector. The Caledon Institute has been advocating just such a reform that boosts both the Year's Maximum Pensionable Earnings and earnings replacement rate by 50 percent. Our proposal is clearly in the policy ballpark: The finance ministers' third option is very close to Caledon's 1.5 solution.