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Strengthening the Canada Pension Plan: Take it to the public

by

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Fixing the ailing pension system has periodically engaged Canadians and their governments over decades, and expanding the Canada Pension Plan always comes up as a winning solution. But so far, all the talk has not managed to turn into action. No longer, we hope.

Include the public

Over the past few years, the federal and provincial/territorial governments have been exploring ways to enhance the Canada Pension Plan. Most recently, PEI's finance minister floated an option that would double the Canada Pension Plan's maximum contributions and payments, focusing enhancements on middle-income workers. On November 1, 2013, provincial/territorial finance ministers met and agreed on four conditions for reforming the Canada Pension Plan. Increased benefits:

- must be fully funded
- have a limited economic impact on businesses, which have to pay higher contributions
- improve benefits for the middle class
- protect low-income earners.

The finance ministers hope to advance matters when they meet with the federal finance minister in December. But prospects for immediate action look dim.

Finance Minister Flaherty, who three years ago backed CPP expansion but pulled out because he couldn't obtain provincial agreement, has said that he sees the merits of CPP expansion but not until the economy improves more and employers can better afford the higher contributions (i.e., premiums) required. To deal with this issue, Ontario's finance minister has proposed a phased approach to CPP expansion. But Ontario also warns that it will go it alone and create its own version of the CPP if Ottawa fails to act.

Whatever happens, one thing is certain: CPP reform has so far remained a government-only affair.

Deliberations on reforming the Canada Pension Plan are taking place behind closed government doors, restricted to officials and ministers. There is no formal consultative process to provide a voice for the wide range of non-governmental organizations and individuals interested in pension reform, such as labour, business, advocacy groups, think tanks, academics, researchers, media and Canadians in general. Individual groups (especially labour and business) will make their voices known to governments, as a matter of course, but not as part of a broader open consultation.

Canadians have waited many years for improvements to the Canada Pension Plan. Spending a few more months on a public reform process only makes sense: We should take the time to do it right.

Ottawa and the provinces/territories should release to the public a consultation paper explaining the rationale for reform. There should be several options for enhancing the Canada Pension Plan, illustrated by graphs showing amount of benefits relative to level of pensionable earnings. Analysis of distributional changes according to income groups is essential.

The cost of proposals to expand the Canada Pension Plan is, of course, a key concern. The potential cost is determined by a number of factors such as the phase-in of benefits and contribution rates, demography, labour force participation, unemployment rates, economic growth and other variables. The federal Department of Finance has the capacity and data to assess accurately the cost of various proposed improvements. We would expect the Department to publish cost estimates as part of a public dialogue on CPP options.

One of the critical considerations and an especially tricky issue is the phase-in of new benefits and new contribution rates. Would higher benefits go to all Canada Pension Plan recipients immediately, including current retirees, or would there be 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 that 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, the Department of Finance is well equipped to work out accurate estimates of the various policy options. We hope and would expect that these cost estimates would be made public to ensure a sensible and informed dialogue on pension options.

A sound but skinny program

All working Canadians are covered by either the Canada Pension Plan or the Quebec Pension Plan. The Government of Quebec operates the Quebec Pension Plan, which is parallel to the Canada Pension Plan. The Quebec Pension Plan offers all the same advantages of the Canada Pension Plan. The reform option put forward in this paper, along with other proposals, would apply to the Canada Pension Plan, though hopefully the Quebec Pension Plan would adopt the same changes to maintain parallelism between the two.

The Canada Pension Plan (and Quebec Pension Plan) is one of our most important social programs and is an exemplary model in the world as a fair, solid and secure retirement income plan. It affords universal coverage to all workers – including the self-employed. Administrative costs are low. Participation is mandatory, so the program is portable across the country. All working Canadians contribute to the Canada Pension Plan or Quebec Pension Plan throughout their working life no matter what jobs they have and where they have worked. Benefits are protected from inflation.

The CPP Fund, which holds and invests the pool of employer and employee contributions, has performed well in recent years. Actuarial assessments show the CPP in a secure fiscal position now and at least seven decades into the future.

The CPP is not fully funded, which means that it does not have sufficient assets on hand to totally pay off benefits earned to date. Rather, it is funded on a 'steady-state basis' such that the contribution rate will neither have to be increased nor decreased in the foreseeable future.

It is not immediately clear why full funding is recommended or whether it is even possible for an expansion of the CPP. Pension expert Michael Wolfson argued in a recent paper that:

> We must challenge conventional assumptions about pension reform. Most critical is the premise, underlying nearly every proposal to date, that future enhancements to the CPP/QPP must be fully funded. This requirement means new benefits can be drawn only as they are built up over time, thus extending the period for full implementation over nearly a half century [Wolfson 2013: 1].

This is an important issue that must be debated in our proposed public consultation.

A proposal

The Canada Pension Plan's superior design suffers none of the failings of private pension and savings plans. (The appendix gives a brief description of Canada's three-tier retirement income system).

But the CPP cannot in its current form compensate for the weaknesses of the private tier of the pension system because its level of benefits is so low: The maximum CPP retirement pension is just $11,848 in 2013. The answer is to strengthen the Canada Pension Plan's earnings-replacement power. We would achieve this by boosting two key components of its design – the earnings replacement rate and the level of the Year's Maximum Pensionable Earnings.

Over the years, the Caledon Institute has proposed what we call the "1.5 solution." We did so most recently in a report released in December 2012.

Under our 1.5 solution, the earnings replacement rate would rise by 1.5 times from its current 25 percent to 37.5 percent of Yearly Maximum Pensionable Earnings.

We also would raise the Year's Maximum Pensionable Earnings by one-half, from $50,100 to $75,150 in 2013. This change would be of particular assistance to middle-income earners, especially those who work in the private sector and therefore are unlikely to enjoy coverage of employer-provided pension plans. Right now, the value of their CPP benefits is effectively capped at the average wage, which means that the wages of about half of Canadian workers are not being adequately replaced.

As a result of these two changes, the maximum CPP retirement benefit in 2013 would more than double from $11,840 to $28,181. Figure 1 compares Caledon's proposal to the current CPP.

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

above which they remain at $11,840. The Caledon proposal, illustrated in green, would see an increase in benefits until they reach a maximum $28,181 at pensionable earnings of $75,150.

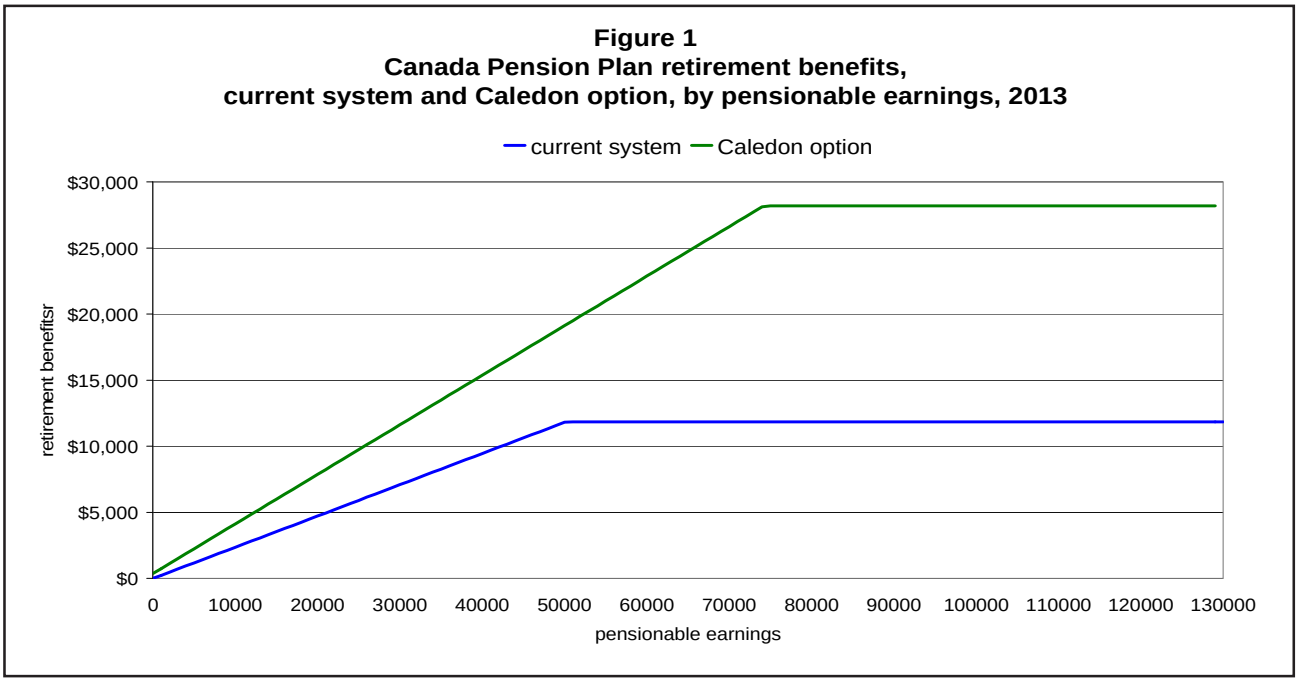


Figure 2 indicates that all CPP retirement pensioners would see an increase under the Caledon option. Benefit improvements would rise more rapidly above the current Year's Maximum Pensionable Earnings ($50,100) and would level off at $16,341 at the new YMPE of $75,150.

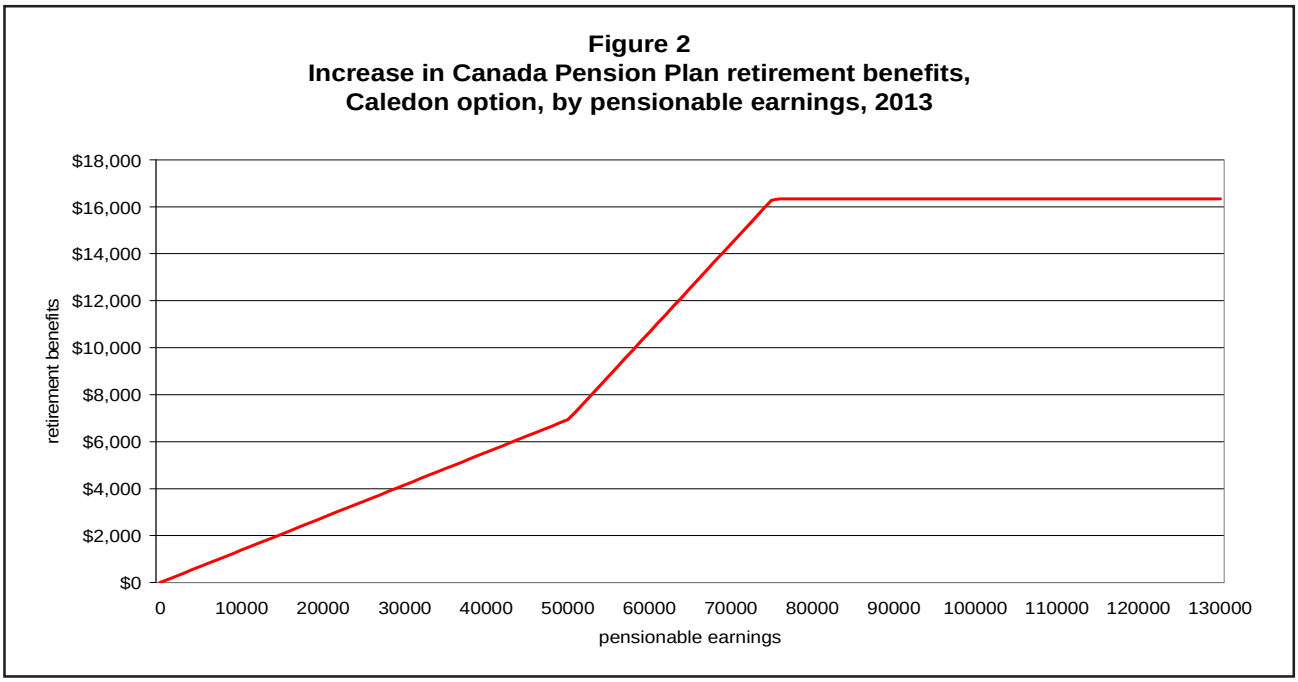
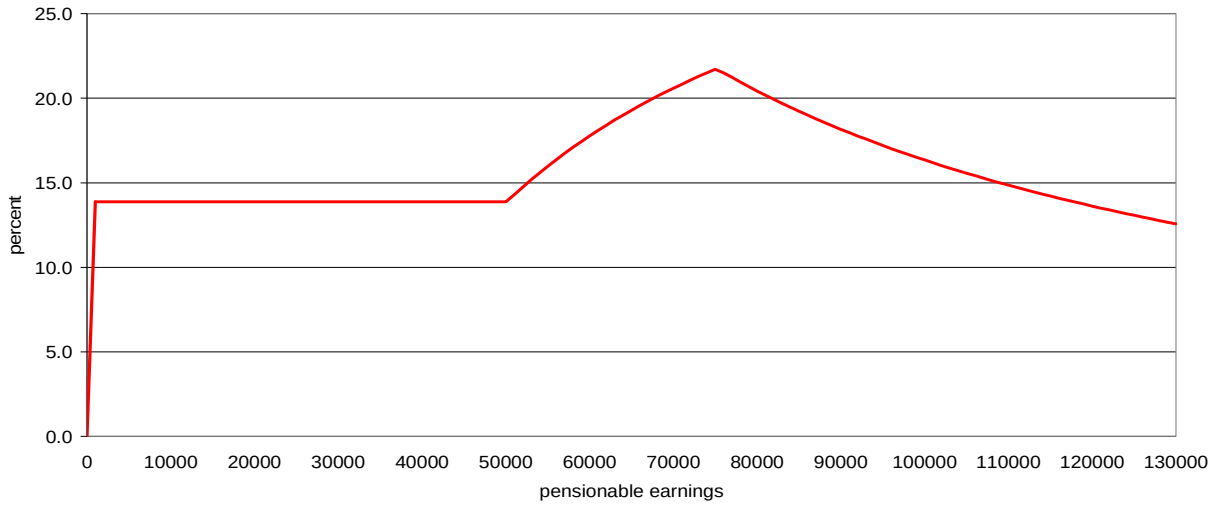


Figure 3 illustrates benefit increases as a percentage of pensionable earnings. Pensioners in the $50,000 to $110,000 range – from the modest- to upper-middle income range – would see the largest proportionate increase. The biggest winners from the Caledon proposal would be the large majority of private-sector workers in the modest- to upper-income range who are not in employer-sponsored pension plans.

Figure 3
Increase in Canada Pension Plan retirement benefits, as percentage of pensionable earnings, Caledon option, 2013



Our proposed option of raising both the replacement rate and the Year's Maximum Pensionable Earnings by 1.5 times their current levels will boost the Canada Pension Plan's earnings replacement power. We believe that our suggested design is sound and that pending cost estimates will demonstrate the relative affordability of our recommended reform.

The figures show that middle- and higher-income earners would be the primary beneficiaries of our proposed CPP enhancement. It should be noted that Caledon has also recommended bolstering the Guaranteed Income Supplement paid to low- and modest-income seniors. *A Simple Way to Help Canada's Poorest Seniors*, published in April 2011, explains the need for this increase and how to pay for it from existing expenditures.

Open pension policy development

Expanding the Canada Pension Plan is now widely accepted as the best way to go in pension reform. But we must also expand the range of reform to enable a national conversation that includes non-governmental actors. Canadians require a public discussion paper that explains the need for reform and presents a variety of options and their cost. The provinces and territories must continue to play a major role in this work. But only the federal finance department has the firepower and experience to undertake this crucial task.

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Appendix

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 federal Old Age Security and Guaranteed Income Supplement programs comprise the foundation of the retirement income system. 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 2013 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 assume 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 retirement 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 – only 24 percent of taxfilers contribute 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 make available no pension plan, period.