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# Canada Pension Plan: The New Deal

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July 1 is fast upon us. It is the day we don red and white, and head to the balcony, backyard or beach to celebrate all things Canadian. Typically, we give expression to our Canadian-ness through our eclectic music and performance arts – as diverse and varied as the many faces of the country itself.

But there is another important dimension of Canada that we rarely celebrate openly, woven as it is into our collective DNA. Our social programs comprise the fabric of this nation. They are part safety net in the face of tough economic times and part springboard that opens the door to opportunity. Some social programs provide immediate benefits while others are designed to safeguard our well-being in the future.

When Canadians are asked about what makes us most proud, many cite medicare, our public health insurance, as one of this country's most shining achievements. It is the national railway of social programs, binding us together in common commitment to the health and well-being of every citizen. While there are challenges and problems to be sure, a strong foundation, nonetheless, is in place.

Often overlooked and less well understood is the Canada Pension Plan, another core building block within Canada's social architecture. Québec runs its own parallel plan. The Canada Pension Plan, commonly known as the CPP, is a vital component of this country's multi-tier retirement income system. Its crucial role is discussed below.

We rarely celebrate the Canada Pension Plan as a national achievement – though it clearly qualifies. It was no mean feat to craft a complex political agreement that has translated into one of the most sophisticated and financially successful pension programs in the world. It is no easy task to maintain the complex financing foundation to sustain this unique social insurance that binds together current and future generations in their mutual well-being.

The CPP was introduced in 1966. 2016 marks the 50th year of the introduction of this landmark achievement.

But we should celebrate not only the significant birthday of this vital program. This Canada Day, we need to recognize the new political agreement reached last week to renew and revitalize the Canada Pension Plan for future generations.

It is by no means a perfect agreement, and there are some key unanswered questions, which we highlight below. Moreover, some critics argue that the agreement was made too quickly – not necessarily the decision to improve the CPP, but rather the commitment to specific details that likely should be decided only after an opportunity for further study and debate.

There had been no major upgrades to the Canada Pension Plan since the fundamental reconfiguration of its financing in 1996. These reforms moved the plan to a more secure financial footing.

But the next 20 years saw little change. Payroll contributions were made and benefits were paid – but there were no notable policy shifts in that period. In fact, the past decade was not kind to the prospect of CPP reform.

Discussions did take place. The federal and provincial finance ministers explored several proposals, in a paper prepared by their officials, for expanding the CPP. The Caledon Institute of Social Policy weighed into the debate by proposing a '1.5 solution' for expanding the Canada Pension Plan.

CPP contributions are paid on earned income between a minimum (frozen at \$3,500 a year since 1966) and a maximum level of earnings, equal to average annual earnings in Canada. This is called the Year's Maximum Pensionable Earnings (YMPE).

CPP retirement benefits currently are calculated as 25 percent of a worker's pensionable earnings as a percentage of the YMPE during his or her contributory period, less 17 percent of the worker's lowest earning years and other possible exempt years – e.g., for child rearing. The contributory period starts when he or she turns 18, or 1966, whichever is later. The contributory period ends when the worker starts collecting the pension. So if a worker was above average national earnings for his or her entire working life of 40 years or more, the result would be a CPP retirement benefit equal to one-quarter of average annual earnings.

Over the last decade, a variety of proposals have been put forward to strengthen the Canada Pension Plan. Under the 1.5 Caledon option, for example, both the earnings replacement rate and the YMPE would increase by 50 percent.

At the end of the day, the Harper government was not keen to expand the CPP. It did not throw its political capital behind this public insurance system, favouring instead a privately managed, voluntary registered pension plan. But neither the latter measure nor any significant CPP reforms saw the light of day.

Due to the lack of progress in negotiations over the CPP with the federal government, Ontario decided to go it alone and implement its own public plan, the Ontario Retirement Pension Plan (ORPP). This program was slated to begin enrolling employers in 2017, with the first phase of contributions beginning January 1, 2018. By 2020, every eligible employee in Ontario would have been required to be enrolled in the ORPP or a comparable workplace pension plan.

Ontario's fast-moving timetable ended up acting as a major driver behind the surprise agreement on CPP reform that appeared to be so quickly reached. Had Ontario proceeded with its own trajectory, the likelihood of ever getting all the players back to the federal-provincial table for a joint agreement on the CPP would have been slim to nil.

So the June 20 announcement of an agreement in principle to a CPP deal is a big deal – from several perspectives.

First, it marked the renewal of federal leadership as steward of this vital social program.

Second, it brought on side sufficient provincial support, which was not at all certain when the talks began late last year (major CPP reform requires the agreement of the federal government along with at least seven provinces comprising two-thirds of the Canadian population.) Manitoba did not sign the agreement, but is pushing for additional improvements to the CPP, including phasing in the enhancement over two more years and technical modifications to help low-income widowed seniors. Québec, which operates its own similar Québec Pension Plan (QPP), has said it will adopt some of the CPP reforms to the QPP.

Third, the announcement of an enhanced CPP will redress one of the major shortcomings of the retirement income system. Its foundation was becoming increasingly shaky for growing numbers of Canadian workers. Here's why.

## CANADA'S RETIREMENT INCOME SYSTEM

Canada's retirement income system has two main aims. First, it seeks to ensure that no senior lives in poverty – i.e., the anti-poverty objective. The second purpose, known as the earnings replacement objective, is to maintain in retirement the standard of living to which Canadians have been accustomed during their working years.

In order to pursue these twin goals, Canada built over the years a three-tier pension system that generally works well and has been praised internationally. Unfortunately, one of its fundamental underlying assumptions – that there would be relatively robust private contributions through a third tier – has not been the case.

The foundation of the retirement income system is the federal Old Age Security and Guaranteed Income Supplement programs. Several provinces also 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, but they have not yet managed on their own to reduce the low-income rate to zero. While directed mainly to the anti-poverty objective, Old Age Security also plays an important role in meeting 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 Québec Pension Plan, geared to the earnings replacement objective. These parallel public programs have several strong points.

The two plans together cover the entire labour force, including employees and the self-employed. Benefits are indexed to protect them from inflation and are fully portable – they follow working Canadians no matter what the worker's job or place of residence in the country. The plans are relatively inexpensive to administer.

The third, private tier of the retirement income system is also directed toward the earnings replacement objective. This tier 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 pension 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 and the markets over the years.

## THE COVERAGE PROBLEM

When the Canada and Québec Pension Plans were created in the mid-1960s, they were deliberately designed to pay modest benefits. The maximum amount is only one-quarter of average earnings, which in 2016 means a maximum annual CPP retirement payment of \$13,110.

The private tier of employer-sponsored pension plans and individual savings plans was expected to play the lion's share of the earnings replacement objective for middle- and upper-income Canadians. The Canada and Québec Pension Plans were designed to play only 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 the original intent. Private pension and savings plans never grew sufficiently to properly serve the earnings replacement objective for many Canadians.

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 (2013) only 22.8 percent of tax filers contributed to an RRSP.

The coverage problem is due partly to the growth of nonstandard work, which includes part-time, seasonal and temporary work. These jobs typically do not provide private pensions or savings. There has been corresponding erosion of middle-wage employment, including middle management positions and well-paid blue-collar jobs in traditional industries, such as manufacturing.

## PROPOSED IMPROVEMENTS TO THE CPP

As noted, the CPP retirement pension is a monthly benefit designed to replace 25 percent (the replacement rate) of the average worker's lifetime pre-retirement employment earnings, up to a maximum amount – the Year's Maximum Pensionable Earnings (YMPE). In 2016, the CPP retirement benefit pays a monthly maximum of \$1,092.50 – or \$13,110 per year.

Over the past decade, Finance ministers had discussed three main options for expanding the Canada Pension Plan [Battle, Torjman and Mendelson 2012]. As noted, Caledon also put forward an expansion proposal that would change two key features of the plan. Our proposal would increase the YMPE by one-half. The earnings replacement rate would go from 25 to 37.5 percent – an increase of 50 percent as well.

These changes 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.

The 1.5 Caledon option is considerably more generous than the June 20 deal just announced by the federal and provincial governments. Under the Caledon proposal, the maximum CPP benefit would more than double from its current maximum annual of \$13,110 to \$30,880 in 2016.

While governments did not explore the Caledon option, nevertheless we welcome the expansion of the Canada Pension Plan agreed upon by Ottawa and eight of the provinces.

The new federal-provincial agreement will see the CPP replacement level gradually increase from the current one-quarter of eligible earnings to one-third of these earnings from 2018 to 2023 – more than the current level but less than the 50 percent Caledon had proposed. The maximum amount of earnings employed for the calculation of CPP benefits, the YMPE, will subsequently increase by 7 percent in each of 2024 and 2025 – i.e., 14 percent higher in 2025 than it otherwise would have been.

To help assess the scale of the increase in CPP implied by the new proposal, if there were no growth in real average wages between now and 2025, the new plan would be equivalent to a current YMPE of \$62,586 (compared to today's \$54,900) and a maximum retirement benefit of \$20,862 in constant 2016 dollars – \$7,752 more than at present. If the YMPE remained at average wages (i.e., if there were no 14 percent increase in the YMPE) and there were no growth in real wages, the maximum pension under the new proposal would be \$17,480 – an annual increase of \$4,370.

The contribution requirements are even more difficult to describe than the new benefit regime. There are two parts to the expansion, and their contribution requirements will be different. Part 1 of the expansion is the increase in benefits from the one-half to two-thirds replacement rate for those earning up to the YMPE as currently set (i.e., at one-half of average earned income). Part 2 of the expansion is the increase in this YMPE of 14 percent. For the sake of clarity, let's call yearly maximum pensionable earnings for Part 1 YMPE1 and for Part 2 YMPE2.

Contributions for Part 1 will increase to 11.9 percent from the current rate of 9.9 percent of YMPE1 for combined employer/employee contributions, with the increase phased in from 2019 to 2023. So for Part 1, contributions will eventually be 11.9 percent of pensionable earnings between the minimum (still frozen at \$3,500) and the maximum as currently defined. Contributions from employers and employees for Part 2 will be 8 percent of the amount by which earnings exceed YMPE1 up to YMPE2.

To complicate matters further, the increased contributions required for the enhanced CPP will be tax deductible whereas the contributions for the current CPP are treated as a tax credit. The difference is that a tax credit always reduces tax owing only by the percentage of the lowest tax rate bracket (15 percent plus the provincial lowest rate).

A deduction, by contrast, reduces tax owing by the tax rate for the tax payer's income (up to 33 percent plus the provincial highest rate). This tax treatment is necessary to make the CPP expansion equivalent to the tax treatment of registered plans. But while necessary, it adds complexity to the expansion.

And a further layer of complexity is added by the full funding of the CPP expansion.

It is little understood that the CPP is not at present fully funded. Rather, the CPP fund is kept at a level sufficient to maintain a 'steady state' of contributions at 9.9 percent – 4.95 percent for employees and 9.9 percent for the self-employed. The fund has to be large enough so that when demographics or other factors result in the flow of contributions at 9.9 percent being insufficient to pay current obligations, then supplementary financing will be provided by the fund. In the current forecasts, the CPP funds will have to be partly sold in the first half of this century to pay for pensions.

Not so for the expansion of the CPP. The new enhancements are to be fully funded. This means that a second separate fund will have to be maintained that will have enough in it at any given time to pay all of the additional benefit obligations stemming from the expansion. Aside from whether or not full funding is necessary, this dual track funding policy will require building one or perhaps two more funds segregated from the current CPP fund.

## GRADUAL IMPLEMENTATION

If "modest" is the watchword of the proposed CPP reform, then "gradual" is the other. The changes that comprise the CPP agreement will be phased in over a seven-year period, from 2019 to 2025, supposedly to minimize the impact of rising contributions upon both employers and employees. If there is any such impact, perhaps "to postpone" might be a more accurate description.

Regardless of the slow and ever-so-gradually-paced implementation, some in the business community have argued that the increases to the Canada Pension Plan contribution rates will slow down the economy. While most pensions have roughly equivalent benefits and contributions, it is correct that in the period of building up a funded plan, contributions will exceed benefits. So it may be contended that the contribution increases will have a similar fiscal impact as a tax increase.

However, every working household will have added “forced saving” and the additional security of a much more reliable pension benefit. This may at least partly offset any fiscal drag by boosting spending – i.e., reducing household saving for private pensions. In all, the net effects are likely to be small, may be offset as well by other fiscal and monetary measures and will depend upon the economic circumstances at that time. While the potential economic effects cannot be ignored, they are most likely to be small.

## LOW-WAGE EARNERS

Of course, Caledon’s interest lies in securing the current and future well-being of workers. The pressure of increased payroll contributions upon the take-home pay of low-wage employees is a major concern.

The federal government cleverly addressed this problem through its promise to boost the Working Income Tax Benefit (WITB), an earnings supplement intended for low-wage workers. It will spend an additional \$250 million a year for this purpose.

However, no design details of these improvements to WITB have yet been announced, pending further discussions with the provinces. The current design allows provinces to make changes to the Working Income Tax Benefit in their respective jurisdictions in order to dovetail the federal program with their existing set of income programs, such as social assistance, minimum wages and other tax credits.

For years, Caledon has called for an increase to the Working Income Tax Benefit, which was introduced in the 2007 federal Budget. In theory, it is an important federal lever to reduce poverty. In practice, the amount is so negligible that it barely moves the needle on low income [Battle and Torjman 2012].

The Working Income Tax Benefit sits in 2016 at a modest maximum \$1,015 for a single worker per year and \$1,844 for a family. This measure needs a healthy, multi-year injection of funds before it becomes an effective weapon in the war on poverty and inequality.

Moreover, its cut-off point is so low (\$18,292 for a single worker and \$28,209 for a family in the 2015 tax year) that minimum-wage workers in some jurisdictions, such as Ontario, earn too much to qualify – clearly a weakness that needs to be addressed.

If the Working Income Tax Benefit is to be the means to offset the negative impact of contributions on low-income workers, then Ottawa must make certain that low-income workers who are entitled to the benefit actually get it.

Presently, workers must fill out a separate income tax form for the Working Income Tax Benefit to qualify. There is no public information on the current take-up rate or overall evaluation of the Working Income Tax Benefit.

But like most social programs that are kept quiet and for which an application is required, the take-up rate is likely only a fraction of those eligible. In our view, the Working Income Tax Benefit should be made an automatic benefit within the tax system, without the requirement for a special application or, if this is not possible, at the very least any expansion must be accompanied by a significant campaign to encourage applications.

Another aspect of the CPP affecting low-wage earners is the continued freeze of the minimum contribution. The amount has been frozen at \$3,500 since 1996. Translated into constant 2016 dollars, it now amounts to only about \$2,400 in 2016. But if it had been indexed to the cost of living, this year it would come to \$5,100. Why should the minimum contribution be frozen when all other aspects of the CPP are indexed to real wages or the Consumer Price Index?

It is difficult to analyze the effects of the falling real value of the minimum contribution. On the one hand, more low-income workers will get at least some coverage from the CPP with a lower minimum. But on the other hand, many of these workers may be entitled to the Guaranteed Income



Supplement and so just lose half those benefits. On the third hand, CPP recipients with the lowest incomes would benefit disproportionately from an increase in the minimum, making the otherwise 'flat' payroll contribution rate somewhat progressive. Therefore, the freeze is making the CPP contribution less progressive over time through "stealth."

It would be good, after 20 years of a frozen minimum, to have government undertake an analysis of the effects of at least allowing the relative value of the minimum contribution to stabilize in real terms by indexing it to the cost of living. We believe that indexing the minimum contribution may represent an additional way to offset some of the effects of higher contributions on low-income workers and would be worth further discussion.

## CONCLUSION

The CPP agreement is a welcome announcement and a significant advance in Canadian social policy. It bolsters one of Canada's most important social programs. It will also boost the Working Income Tax Benefit, though the extent and design of the increase are unknown at this time.

In fact, there are many unknowns in the new plan and many unanswered questions. Retirement benefits are not the only payments made by the CPP. What will the effects be on disability benefits? Survivor benefits? Will the whole plan be proportionately adjusted?

If the expanded CPP is to be fully funded, what will happen if there are 'experience liabilities' – i.e., the fund is short because investment returns turn out not to be adequate. On the opposite side of the coin, what happens if there are surpluses?

Finally, there is no explanation as to the rationale for a 14 percent increase to the Year's Maximum Pensionable Earnings (YMPE). From where did this percentage come? The how and why of this amount are – at least publicly – unknown.

Canadians will have to wait while the design is hammered out a little more fully with the provinces. We recognize that it will take a lot of work to fill in the many blanks of this agreement in principle. At the appropriate time, Ottawa and the provinces should build in an opportunity for public consultation and discussion.

But at least the first tough and long-awaited steps have been taken.

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