POLICY BRIEF

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April 2010

Options For Pension Reform

Expanding the Canada Pension Plan

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In the current debate about reforming Canada's retirement income system, there is growing support for expanding the Canada Pension Plan as the best way to ensure all Canadians have adequate incomes in retirement. The plan covers virtually all Canadians; it provides them with an indexed defined benefit retirement pension that doesn't depend on stock market ups and downs; it is a stable and well-run plan, and trusted by workers and their families. But benefits are too low to provide an adequate income in retirement.

This mandatory public pension plan is designed to replace a percentage of a worker's earnings up to a maximum limit at retirement. Together with Old Age Security programs, which constitute the basic tier of Canada's three-tier retirement income system, public pension plans replace about 40% of pre-retirement earnings for someone earning the average wage—roughly $47,200 in 2010. It is generally assumed that retirees need about 70% of their pre-retirement earnings to preserve their standard of living in retirement.

The assumption has always been that, while public pensions in the first two tiers may provide adequate income for those at the lower end of the income scale, most people—those with higher earnings, for example—would be able to generate an adequate retirement income for themselves through supplementing public pension programs with their own savings or through membership of a workplace pension plan. These private arrangements, consisting mainly of workplace pension plans and RRSPs, receive tax subsidies from federal and provincial governments.

In 2010, the net cost to the federal government of tax subsidies to the third tier of the system is projected at $29 billion. (Net cost is the cost in lost tax revenues of allowing income deductions for contributions to these plans, plus the cost of not taxing investment income accumulating in the plans, minus the tax revenues generated by taxing withdrawals from the plans.) [Department of Finance 2008: Table 1]. Provincial governments also lose tax revenues through subsidies to third-tier programs. In contrast, the cost to the federal government of OAS benefits in the 2009-2010 fiscal year is estimated at $27.6 billion, plus another $8 billion for GIS benefits.

Not only are third-tier benefits very costly in terms of lost tax revenues, but these programs are also directed at a minority of mostly higher-income Canadians. It is important to note that, while OAS and GIS are funded by the federal government alone and third-tier benefits receive costly tax subsidies, an improvement in CPP benefits would not involve any government funding. (However, the government gives a tax credit for contributions to the CPP and QPP which was estimated to have cost about $2.9 billion in 2009.)

The CPP is funded by contributions from employees, employers, and the self-employed in the paid workforce. Contributions from the current workforce are used to pay the benefits of those who are retired. Contribution revenue not needed to pay current benefits is directed to the CPP investment fund and invested in the market. Starting in about 10 years' time, when retirement of the baby boomers is at its peak, the revenue from contributions will be supplemented by earnings on the CPP investment fund and used to pay the benefits. Contrary to some public misconceptions, however, CPP pensions are not paid from earnings on the investment fund. The CPP Investment Board operates at arm's length from the government and, unlike EI funds, CPP investment funds do not form part of the government accounts.

For workers with above-average earnings, an even greater percentage of their retirement income needs are assumed to be generated by these third-tier programs. But, in comparison with other countries, Canada's public pension programs offer much lower benefits. They provide relatively low replacement rates, and the level of earnings covered has been described by the World Bank as "exceptionally low." For example, while public programs in Canada cover incomes up to the level of the average economy-wide wage, comparable programs in other OECD countries cover income levels up to almost double the average wage in those countries [Provincial and territorial finance ministers 2010:7]. United States Social Security programs, for example, cover earnings up to US$106,800 (about C$115,400 or roughly 2.5 times the average wage in Canada at current exchange rates). In Canada, the upper limit for RRSP contributions in 2009 is $116,667.

Retirement benefits from the CPP alone are designed to replace 25% of a worker's average adjusted annual earnings up to a maximum slightly exceeding the average wage. This relatively modest replacement rate has been in place since the CPP was established in 1966 when insurance companies and chambers of commerce were conducting a "vitriolic attack" on the CPP [Little 2008: 28]. The implication, of course, was that providing retirement income for Canadians was their prerogative. It is perhaps of interest that the current proposals to expand the CPP are also strongly opposed by the life insurance industry, among others, who oppose a "government-run" pension plan. Former Governor of the Bank of Canada David Dodge has described the proposed expansion of the CPP as "a nanny state approach" that doesn't allow for individuals' preferences in how they want to live out their golden years [Dodge 2009]. He apparently believes Canadians must decide for themselves if they want to cut into their standard of living now to pay for a more comfortable retirement later. As well, the president of the Canadian Life and Health Insurance Association says: "We believe that meaningful change can be achieved most effectively by using the infrastructure and expertise that already exists within the financial services industry" [CLHIA 2008].

However, according to the recent report of the Steering Committee of Provincial/Territorial Ministers on pension coverage and retirement income adequacy:

> The Canadian investment industry appears vibrant and profitable, with a large number of insurers and mutual fund providers. Nevertheless, the industry has had little success in filling the gap in retirement savings among the middle to high income group. Where the industry has been successful, such success has been accompanied by some of the highest management expense ratios (MERs) in the world—particularly mutual funds [Provincial and territorial finance ministers 2010: 27].

It is notable that, 44 years after the CPP was established, only 38% of workers have a workplace pension plan—down from 45% in 1992. In other words, more than 11 million Canadian workers have no pension plan at work—although 76% of workers who have a workplace pension plan belong to a defined benefit plan. Private savings through RRSPs are also woefully inadequate. Last year,for example, only 31% of taxpayers eligible to contribute to an RRSP actually did so. Unused RRSP contribution room may be carried forward for use in future years, but there is now roughly $500 billion in unused contribution room being carried forward. The average amount held in RRSPs by people coming up to retirement (age 55-64) is estimated at about $55,000—enough to generate an income of roughly $250 a month at current rates of return [Pyper 2008]. There is now widespread concern that unless changes are made, a significant number of workers will reach retirement age without sufficient income to support themselves.

The current economic situation and recent financial meltdown have exacerbated problems in the third tier of the retirement income system. Many workplace pension plans are underfunded — that is, they do not have enough money in their funds to pay all the promised benefits. Although pension laws allow pension plan sponsors to make up the shortfall over a period of years, companies may go under in the meantime, leaving potential pensioners without benefits or even resulting in reductions of pensions to workers who have already retired and are receiving benefits.

Workers who are owed pensions when their employers face bankruptcy may find themselves ranked behind other creditors, such as bond-holders and banks, and may never receive the pensions they are owed. Workers who had been saving for retirement through RRSPs have seen the value of their savings dropped precipitously as a result of the financial situation, so that they can no longer afford to retire when they had planned to.

Various proposals have been put forward to address some of the problems with the third tier of the system, but it seems increasingly obvious that, unless something is done, more and more workers will be forced to go on working longer or will enter retirement without adequate income to support themselves and their families. For all these reasons, those concerned with pension reform are turning their attention to the possibility of expanding the Canada Pension Plan as a possible solution to the problem.

As an alternative, it has been suggested that a Canada Supplementary Pension Plan (CSPP) could be put in place. This would be a voluntary, defined contribution tier that would be added to the CPP. It would be operated at arm's length from the government and enrolment would be automatic with a choice to opt out. But retirement pensions would depend on the performance of the contributor's investments, and no particular pension would be guaranteed or indexed. In other words, contributors would be required to bear the full risk of retirement income provision. Because it is considered that the first two tiers of the retirement income system provide adequate retirement income to those at lower income levels, the proposed CSPP would be directed at employees and self-employed individuals earning between $30,000 and $100,000, with the possibility of additional voluntary contributions from those with higher earnings.

Expansion of the CPP, on the other hand, envisages a richer defined benefit plan in which the eventual pension is guaranteed in relation to earnings and years of contributions. It would remain a public pension plan in which risks are pooled so as to provide adequate benefits to all contributors. It should also be noted that the House of Commons passed a motion in June 2009 that the federal government should work with the provinces and territories to introduce measures such as expanding and increasing the CPP and other federal retirement programs.

This paper provides an analysis of options for expanding the CPP, which we consider the most effective way to address Canada's pension difficulties.

Advantages of the CPP

The CPP is seen as secure, reliable, cost-effective, and well managed. As noted earlier, it is a defined benefit plan, guaranteeing retirement benefits related to earnings and years of contributions. It covers virtually all Canadian workers, whether employed or self-employed, full-time or part-time; it is fully portable when workers move from one job to another; it is indexed for inflation; and it accommodates the different work patterns of women — for example, allowing parents to exclude periods when they had a child under age seven from the calculation of average earnings on which their pension will be based. As well, since it is a social insurance program, the CPP also provides pensions for workers who become disabled. Clearly, the CPP is working well and providing pensions to virtually all Canadians, whether they have spent their adult lives in paid employment, or whether they are associated with those who have — as spouses and partners who may share a contributor's pension in the event of retirement, disability, divorce or death, or as other dependants who may be entitled to benefits on the death or disability of a contributor.

But benefits from the CPP were never intended to provide the major source of retirement income for Canadians. The maximum monthly retirement benefit for those reaching age 65 in 2010 is $934.17, or about $11,200 a year. But actual benefits are on average considerably less than this. For example, the average monthly retirement pension being paid to women who retired in May 2009 was only $391.29 compared with an average of $564.23 a month for men retiring the same month. The CPP is an earnings replacement program and women's low retirement pensions reflect their lower earnings and less time spent in paid employment than men.

Expanding the CPP, whether by increasing the replacement rate or increasing the level of covered earnings , or both, would address the issue of coverage, security of benefits and low cost of administration — all key objectives of pension reform. In an analysis of the fair value of a public defined-benefit pension plan, economists from the CPP Investment Board and the University of Toronto concluded that "partly-funded defined benefit plans like the CPP rely on both a fund and future contributions to meet future liabilities. They exploit economies of scale and pool longevity and investment risks across all participants. These features enable the CPP to deliver a low-risk benefit at a cost below that prevailing for risk-equivalent market alternatives" [James et al. 2009: 16].

Expansion of the CPP is supported by David Denison, president and chief executive officer of the CPP Investment Board. He told a conference of international social security actuaries and statisticians in September 2009 that "a supplement to the CPP would also be a very cost- effective way to provide a relatively predictable stream of retirement income." In his presentation, Denison cited a 2007 study by the Canadian Institute of Actuaries that found "only about one-third of Canadian households are currently saving at levels that will generate sufficient income to cover their non-discretionary expenses in retirement."

Among other advantages of the CPP cited by Denison, he notes that, "`by providing the certainty of a fully-indexed defined benefit, the CPP provides a predictable level of income and eliminates the risk that beneficiaries will outlive this element of their retirement income" [Denison 2009: 5].

"A mandatory national plan creates scale and certainty of cash inflows that permit the effective pooling of longevity risk, investment risk, and timing risk. With no dependence on a plan sponsor, and so no solvency risk, we are able to manage the Fund from a sustainability perspective — in our case, over the span of 75 years — rather than from the triennial solvency funding perspective of an employer-sponsored defined benefit plan. This is an enormous advantage," he concluded. [Denison 2009: 10].

Bernard Dussault, former Chief Actuary of the CPP (1992-1998), also supports CPP expansion and has developed a detailed plan to phase in an increased replacement rate over a 47-year period, so that eventually the CPP would provide retirement pensions equivalent to 70% of average adjusted pre-retirement earnings.

Reports from the current Chief Actuary indicate the CPP will be sustainable in the long-term and able to withstand economic and demographic ups and downs for at least the next 75 years — the projection period used in CPP actuarial reports — a finding which was endorsed by a group of independent actuaries who reviewed the most recent report. In fact, the most recent actuarial report, released in the fall of 2007, indicates the plan is expected to be able to meet its obligations "despite the projected substantial increase in benefits paid as a result of an aging population." [Office of the Chief Actuary 2007: 12].

Options for expanding the CPP

The Canada Pension Plan is administered jointly by federal and provincial governments and governed by the Canada Pension Plan Act. Changes to the plan must receive the approval of two-thirds of the provinces having two-thirds of the population. (Quebec has a vote on CPP changes even though it has its own pension plan — the Quebec Pension Plan). Draft legislation may be tabled in Parliament, but the requisite number of provinces must then pass orders in council agreeing to the changes. Until this is done, changes do not come into effect. Provinces with large populations, such as Ontario, effectively have a veto on CPP changes. For example, CPP legislation was amended in 1977 to provide for a child rearing drop-out which allowed a contributor to exclude years when she/he had a child under the age of seven from the calculation of average earnings on which the pension is based. But Ontario withheld its approval, so the provision was not implemented until 1983 when Ontario withdrew its veto.

As well, when changes were made in the financing of the plan in 1997, federal and provincial ministers agreed that any future benefit improvements must be fully funded. Expansion of CPP benefits would therefore entail an increase in contribution rates to ensure that there is full funding of the improvements, i.e., each generation pays for its own benefits.

The Canadian Labour Congress proposal

Various options for expanding the CPP have been put forward. The Canadian Labour Congress, for example, proposes a doubling of the replacement rate from 25% of covered earnings to 50% of average adjusted pensionable earnings. The worker contribution (matched by the same percentage of wages contributed by the employer) is estimated to rise from 4.95 % in 2010 to 7.70% by 2016. Combined employer/employee contributions would then be 15.9% of earnings up to the YMPE. (It should be noted that a doubling of benefits does not require a doubling of contribution rates, since part of the current premium is used to bring down the previous unfunded liability, whereas an expansion of benefits would be fully pre-funded.)

While increased contribution rates would be phased in over a seven-year period, the additional dollar amount of CPP expansion-related pensions would accrue gradually over about 40 years to meet the requirements of the CPP Act that any improvement in benefits be done on a full advance funding basis. By the end of the initial seven-year period, Canadians would be able to start earning twice the benefit level currently available under the CPP for all future contributions.

Once the expansion is fully phased in, the maximum monthly CPP retirement pension would be $1,817.50, or double the current maximum benefit. To ease the pressure of higher contribution rates on lower-income workers, the CLC recommends that the tax credit for CPP contributions should be increased for lower-paid workers. Since it would take much longer than seven years to qualify for a doubling of CPP benefits, the CLC notes this reform would primarily benefit younger workers [Canadian Labour Congress 2009: 11-12].

The Bernard Dussault (FSNA) proposal

The Dussault proposal, developed for the Federal Superannuates National Association (FSNA) and supported by the Canadian Association of Retired Persons (CARP), would have a much larger replacement rates [Dussault 2009]. Dussault characterizes his plan as a "vertical expansion of the CPP (VECPP)." Essentially, while the existing CPP would continue as is, a second level would be added on top of it and financed by additional contributions to meet the requirement that changes in the plan must be fully funded.

Under this proposal, the CPP retirement benefit replacement rate would be increased by 45%—from 25% of covered earnings to 70%, gradually, over a period of 47 years. Effectively, this would mean the demise of workplace pension plans and private retirement savings through RRSPs because the CPP in conjunction with OAS would provide an adequate replacement rate for all.

Covered earnings—the Year's Maximum Pensionable Earnings (YMPE)—would be increased immediately from $46,300 (the 2009 rate) to $122,222 , which was the 2009 limit applying for income tax purposes to contributions to Registered Pension Plans (RPPs). The CPP contribution rate, shared equally by employers and employees, would be increased—based on the most recent actuarial report,

- from 9.9% to 19.8% of salary up to the YMPE; and
- from 0% to 15.4% of salary between the YMPE and $122,222.

The two- stage contribution rate ensures that the increased benefit would be fully funded, as the legislation requires.

Dussault's proposed plan envisages that, when the CPP expansion is implemented, contributions to existing registered pension plans would be discontinued and all future pension contributions would be made to the expanded CPP. There would be no transfer of funds from any RPP to the expanded CPP. While he admits there would be a significant increase in business expenses for employers not already sponsoring pension plans for their employees, Dussault says Canadian workers would be able to contribute better to the Canadian economy, both before and after retirement, due to their more reliable retirement and disability pensions. As well, he says, the expanded CPP would be reflected in a reduced poverty level among Canadian seniors and lower expenditure by the government on Guaranteed Income Supplement benefits. (The cost of GIS benefits for the 2009/2010 fiscal year was forecast at $8 billion.)

The Steering Committee of Ministers on Pension Coverage and Retirement Income Adequacy

Federal, provincial and territorial finance ministers met in Whitehorse in mid-December 2009 to receive the report of a research working group they had established to study retirement income adequacy. The report suggested that the retirement income system was doing well and there was really nothing to worry about. But another report released after the Whitehorse meeting and produced by a Steering Committee of Ministers on Pension Coverage and Retirement Income Adequacy, chaired by Colin Hansen, British Columbia's Finance Minister, contradicted some of the findings of the Working Group report. The Steering Committee report outlines a detailed analysis of various options for CPP expansion. The following description draws on that analysis.

The report states that, "while the FSNA version of expanding the CPP may be considered too extreme—for example, it would provide significant additional pensions to individuals at the lower end of the salary spectrum for whom existing Pillar 1 an 2 programs already provide significant income replacement in retirement—variations on it could have strong potential for an efficient and relatively simple fix" [Provincial and territorial finance ministers 2010: 7].

Three possible options are analyzed:

Variation 1 applies to all earnings levels. It would quadruple the maximum pension payable (available to individuals who work a full 40 years and have earnings at or greater than the YMPE of $92,600 in each of those years). Employee and employer contributions would each increase by 3.0% on earnings up to $46,300, and by 6% on earnings between the $46,300 and $92,600.

Variation 2 does not apply to earnings of less than the average wage. It would double the maximum pension payable (available to individuals who work a full 40 years and have earnings at or greater than the YMPE of $92,600 in each of those years). Employee and employer contributions would not increase on salaries up to $46,300, but each would pay 3% on earnings between $46,300 and $92,600 to pay for the cost of providing benefits on the higher salaries.

Variation 3 does not apply to earnings of less than the average wage. It would see the maximum pension payable increase by one and a half times (available to individuals who work a full 40 years and have earnings at or greater than the YMPE of $69,450 in each of those years). Again, employee and employer contribution rates would not increase on salaries up to $46,300, but each would contribute 3% on earnings between $46,300 and $69,450 to pay for the cost of providing benefits on the higher salaries [Provincial and territorial finance ministers 2010: 17].

The contribution rates are split because of the requirement that any new benefits under the CPP be fully funded.

The Standing Committee's report emphasizes the importance of making sure that the preferred solution fits the actual problem identified. The proposed solutions focus on the future—i.e., those who will retire in 20 years. As well, the Committee says, "Based on the evidence that Canadians at the lower income levels (those earning less than $30,000) are already receiving a relatively high level of income replacement through Pillar 1 and Pillar 2 programs, retirement savings solutions should target Canadians earning over $30,000." It is also argued that mandatory "over-saving" for retirement at the lower income levels should be avoided, so that lower-income individuals and families are not forced to curtail current consumption in order to increase post-retirement living standards [Baldwin 2009: 25].

In all the suggested variations, the proposed CPP expansion aims at improving income replacement ratios for Canadians earning up to 1.5 to 2 times the current average wage.

Is change possible?

Many of the details for a CPP expansion remain to be worked out, but it is clear that serious discussion of the options is still on the table. The Steering Committee points out that the two options of a voluntary defined contribution plan or a mandatory expansion of the CPP are not "mutually exclusive." In fact, they suggest "some combination of options may provide the best solution to improve Canada's retirement income system." But they also emphasize that "the insurance industry's notion that it could create a large-scale, low-cost model that would be equivalent to the ABC plan developed by the Alberta/BC joint pension commission may not be realistic." (The ABC plan is a version of the pan-Canadian voluntary defined contribution plan.)

Ultimately, expansion of the CPP will depend on political or ideological decisions—on whether provincial and territorial finance ministers can withstand the pressure from the financial industry to go with a voluntary, private sector solution, or whether they will succumb to those who believe an expanded CPP is a "nanny state" solution and that people should be required to go it alone and sink or swim. The Steering Committee apparently believes some combination of both options could be seen as "a way to bolster both second and third pillars, furthering the objective of strengthening the system in a balanced way" [Provincial and territorial finance ministers 2010: 36].

They argue that a consultation strategy, which could include a federally hosted Pension Summit, should also be developed. To date, the federal government has not responded. But such a summit is essential to allow all stakeholders, including governments, pension experts, seniors, and labour representatives, to consider the options and voice their opinions.

Federal, provincial, and territorial finance ministers are scheduled to meet again in May 2010. At that point we should have a clear idea of which options they will favour. But implementation is likely several years further down the road. As well, any changes that are agreed on now are not likely to benefit those coming up to retirement in the next couple of decades. That means serious consideration must be given to other changes that are urgently required to protect those workers facing the prospect of inadequate income or even poverty in retirement. For example, workers who have lost their pensions as a result of corporate bankruptcy need protection, and so do those who must rely on inadequate benefits from the first tier of the system, for whom an improvement in OAS/GIS benefits is required.

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