The mission to overhaul CPP (and save Gen Y in the process)

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Let's admit it: Pension reform sounds like a deadly dull topic, the sort of thing only geezers could possibly give a hoot about.

So let's relabel the issue. A better name would be "the mission to save Gen Y."

That is an entirely accurate description of what federal and provincial finance ministers will be discussing in Vancouver on Monday. Their talks about overhauling the Canada Pension Plan are really a debate about building a better way for Canadians under the age of 45 to amass wealth. At issue is whether Canada's current retirement system is falling short in a world in which traditional corporate pensions are under threat.

The Vancouver meeting may well strike a deal to supersize CPP in some way. But "Big CPP" – whatever form it might take – won't be a money grab by today's seniors.

The last reform of the CPP system, in 1997, stipulated that one generation can no longer leave a big tab on the table for future generations to pick up. Any expansion to benefits must now be fully prefunded by additional contributions. As a result, a change to CPP today will take years to ripple through the system before it builds up to the point where it could result in significantly higher benefits to retiring workers.

"Any conversation about expanding CPP today is really about future retirees, not current retirees," said Tammy Schirle, associate professor of economics at Wilfrid Laurier University in Waterloo, Ont. "The target is people under 45."

"This is about the middle-income, private-sector workers of the future," concurred Keith Ambachtsheer, director emeritus of the Rotman International Centre for Pension Management in Toronto. "It's about people who are now in their 20s and 30s."

The question is how best to help those younger workers. Ontario is already intent on launching its own supplementary pension plan in 2018. Other reform proposals abound.

What these proposals share is a desire to tackle some common problems.

The best-known challenge is the endangered status of traditional corporate pensions. Many of our parents had defined-benefit plans – the type of sweet deal, once common at big companies, that guaranteed retired workers a regular monthly cheque for a clearly defined amount.

Over the past few years, a multitude of companies have slammed the door shut on defined-benefit plans as managers shy away from the cost of ensuring future payouts. With interest rates at historic lows, and highly uncertain returns on stocks, the price of guaranteeing a retiree's income five or six decades from now has become prohibitively expensive.

Defined-benefit plans are fading fast, especially in heavy industry and other traditionally male industries. Between 1971 and 2011, the proportion of men with defined-benefit retirement plans fell nearly in half, according to Statistics Canada.

The slide, from 48 per cent of men in 1971 to 25 per cent a generation later, highlights companies' increasing desire to push financial responsibility onto workers' shoulders. (Defined-benefit coverage is also falling among women, but the magnitude of the decline has been much smaller because women are more likely to be employed in schools, hospitals and governments – public-service

sectors where defined-benefit pensions are still common.)

Across the private sector, employees are now expected to take charge of building their own financial safety net. Many are required to plot their own investing strategies through "defined-contribution" pension plans that set out how much an employer will contribute, but leave it up to the employee to pick investments with no guarantee of the final result.

In addition, individuals are supposed to save diligently in RRSPs and TFSAs. On top of that, they must navigate the complex maze of government programs and tax shelters aimed at the elderly.

It's an infernally complicated system, but, over all, it functions pretty well and earns above-average grades in international comparisons. Exactly how well it works, though, tends to depend on how much you make.

The current bundle of government programs does a reasonable job of looking after Canadians who earn low incomes during their working lives, according to a 2014 study by Prof. Schirle and Kevin Milligan of the University of British Columbia.

In retirement, various programs combine to replace a large portion of those workers' previous paycheques. There are still pockets of poverty – notably among single women – but the level of financial distress among seniors has faded to a fraction of its level in the 1970s.

At the other end of the income scale, affluent families have few worries. Even if their income declines in retirement, they still live well in absolute terms.

The pain falls mainly on families who earn modest to middling incomes during their working lives – households with, say, $50,000 to $80,000 of annual income. If they're not fortunate enough to be covered by a workplace pension, they face a sharp drop in their standard of living when they retire.

The ABCs of retirement savings plans

Anyone planning for retirement needs to review their alphabet – or, at least, the baffling variety of three- and four-letter programs aimed at seniors. Each program has its own complicated set of rules. To make things even more fun, the various programs interact in odd ways.

OAS stands for Old Age Security, a benefit paid to Canadian residents who have lived in Canada for at least 10 years after they turned 18. It starts when you turn 65, although you can boost how much you get by delaying when you start collecting the stipend.

CPP (or **QPP**) stands for Canada Pension Plan (or Quebec Pension Plan). Either program pays out benefits based on how many years you have worked in Canada and your typical compensation (at least, up to a point). You can begin collecting at 60 but get more if you wait.

GIS stands for Guaranteed Income Supplement, a non-taxable top-up to OAS that is paid to low-income seniors over 65 living in Canada. You can earn up to $3,500 in wages without affecting your GIS eligibility, but self-employment, RRSP withdrawals or dividend income can result in clawbacks.

RRSP stands for Registered Retirement Savings Plan, a plan that lets you shelter a portion of your income from the tax man – at least for a while. You can deduct RRSP contributions from your taxable income, but must pay income tax when you withdraw money.

TFSA stands for Tax Free Savings Account. It's like an RRSP turned inside out: You don't get a tax break for contributing, but your savings grow tax free and you can withdraw money without paying tax. Those withdrawals don't affect your eligibility for GIS.

"The vast majority of those Canadians retiring without an employer pension plan have totally inadequate retirement savings," according to statistician Richard Shillington of Tristat Resources, who earlier this year wrote a paper on the topic for the Broadbent Institute.

Mr. Shillington calculated that a family headed by someone 55 to 64 who has no employer pension plan typically has retirement assets of just over $3,000 – a thin cushion indeed on which to rest anyone's golden years.

This lack of retirement preparation reflects a couple of stubborn problems.

There is, for starters, the inherent difficulty in saving. "Most of us want to save, but it's tough," Prof. Schirle said. "If you're a middle-income family and something comes up with the kids – they need braces, they have camp, they require daycare – you may decide that your money should go there instead of into an RRSP."

Of course, some frugal souls do zealously stash away their cash. But that's when they run into the system's other big challenge – the lack of efficient ways for the average, financially unsophisticated person to invest cheaply and wisely.

Canada's mutual funds are among the world's most expensive, often dinging investors for 2 per cent or more of their assets each year. Those charges carve a big chunk out of a portfolio over the course of several decades.

In comparison, most large pension plans are run far more efficiently. For instance, the Canada Pension Plan Investment Board (CPPIB), the investing arm of the CPP, says it has annual operating expenses of about 0.34 per cent of its assets.

"The impact of charges on retirement cannot be stressed enough," wrote Edward Whitehouse, an international pension expert who reviewed Canada's pension apparatus for the Department of Finance in 2010. While giving high marks in general to the Canadian retirement system, he pointed to high investing fees as one of its flaws.

He pointed out that a simple reduction in fees could lead to major gains in retirement benefits. "Moving from a levy of 2 per cent of assets per year to 0.5 per cent would increase net benefits by more than 40 per cent," he calculated.

Most plans to reform CPP aim to address both the savings problem (by requiring expanded contributions) and the efficiency problem (by sweeping those savings into investments that would be managed by the CPPIB). The devil, though, is in the details.

Some CPP proposals, such as one put forward by the Canadian Labour Congress, suggest increasing the current contribution rate and doubling current benefits, but leaving everything else unchanged. The average new 65-year-old retiree now collects about $8,000 a year in CPP benefits; Big CPP would eventually boost that to more than $16,000 a year, everything else being equal. (Most retirees also receive Old Age Security, which can be worth more than $6,800 a year.)

One objection to the Canadian Labour Congress idea is that it doesn't work particularly well without accompanying changes to the Guaranteed Income Supplement, a program designed to aid low-income seniors.

Under current rules, every dollar extra in CPP payout would result in 50 cents or so less in GIS benefits. So if this version of Big CPP were implemented, many low-income couples would find themselves contributing more to CPP during their working years, but losing a large chunk of their GIS payout as a result, with no great increase to their overall retirement income.

Some competing reform proposals address this difficulty by focusing on the middle-income workers who appear most at risk under the current system. Economist Michael Wolfson has suggested keeping things as they are now for those with low incomes, but boosting both contribution rates and payouts for those making more than a certain threshold.

The "Wolfson wedge" proposal gets its name because it creates a wedge payment for middle-income workers. Your first $27,500 or so in annual earnings would be eligible for a 25-per-cent pension, as under the current system. However, contribution rates would rise after that point, allowing additional earnings to qualify for a 40-per-cent pension.

Tweaks to GIS could provide immediate help

CPP reform is a slow-motion affair, with extra contributions taking years to build to the point where they can finance significantly higher payouts. However, fixes to other parts of Canada's retirement system could provide immediate help for Canada's struggling seniors.

The changes would involve fine-tuning rules around the Guaranteed Income Supplement, an extra benefit offered to low-income seniors on top of the Old Age Security Pension. GIS is vital to seniors who have little in the way of assets or other pensions – a larger group than you might think. An estimated 37 per cent of Canadian seniors now receive GIS, according to statistician Richard Shillington of Tristat Resources. Nearly half of single women over 65 depend on the GIS.

But the system doesn't help poor seniors as much as it could because the interplay between GIS and other income gets complicated. A senior's GIS is often reduced if he or she has money coming in from other sources. An extra dollar of income can result in a clawback of GIS ranging from 50 cents to more than a dollar.

The rules are confounding. A senior, for instance, can earn up to $3,500 in wages without any impact on his or her GIS. However, any income from self-employment results in lower GIS. Withdrawals from a Tax Free Savings Account don't affect GIS, but withdrawals from Registered Retirement Savings Plans do. Income from CPP also reduces GIS.

There are other trap doors, too. Ottawa has announced it will bump up the maximum amount of GIS for single seniors by 10 per cent, but Mr. Shillington says that actually expands the income range in which there's a total clawback of the extra benefits because of the way that federal and provincial programs interact.

"My simple proposal is that a senior should be able to generate up to $3,500 a year of income regardless of source without it affecting their GIS," said Mr. Shillington, author of several papers on pensions and financial literacy. "That would improve the lot of lower-income seniors, because most of them have something, like CPP, and at least CPP benefits would not get clawed back."

It would also, he says, give seniors more financial freedom and encourage them to do more to help themselves. "The problem with our current income-support plans for seniors is that we help you up, then hold you back."

To make this even more effective, Mr. Wolfson also suggests raising the limit on the earnings that CPP will cover. Instead of the current $54,900 earnings cap, he would double the ceiling to more than $100,000. Result: No more worries about middle-income folks entering retirement with next-to-no resources. Under this scenario, a person who has consistently earned a six-figure salary could receive slightly more than $35,000 a year in CPP benefits once the system was fully mature.

The wedge proposal is a favourite of policy wonks, but it might be more complicated than strictly necessary. Prof. Schirle and Prof. Milligan compared various reform proposals in their 2014 paper and concluded that simply doubling the earnings cap on CPP would yield many of the same benefits.

Some experts would also prefer to see more freedom of choice. Mr. Ambachtsheer, for instance, has proposed a supplementary CPP that would help middle-income earners, but also allow workers to opt out. Canadians would be able to contribute more of their working income to CPP in exchange for a higher pension upon retirement, but no one would be forced to do so.

With so many alternatives on the table, the finance ministers' meeting in Vancouver will have no end of options. It's still unclear, however, if they'll choose any of them.

CPP reform proposals foundered in recent years, most notably when former finance minister Jim Flaherty rejected the supplementary CPP notion as unworkable back in 2010.

Employer groups, such as the Canadian Federation of Independent Business, continue to argue that CPP expansion would endanger profits and jobs because of the higher contributions that would be required from both workers and employers.

However, the new government of Justin Trudeau is far more receptive to CPP reform than its Conservative predecessor.

Federal Finance Minister Bill Morneau has vowed to reach a deal on expanding CPP by December. To do so, he must win the support of seven provinces representing two-thirds of Canada's population.

His strongest talking point is Ontario's move to launch its own supplementary pension plan, the Ontario Retirement Pension Plan, in 2018.

With more than a third of Canada's population, Ontario effectively has veto power over national pension reform. Its model – which essentially aims to provide another level of pension benefits on top of the existing CPP, either through ORPP or comparable workplace pensions – could provide the template for action.

"Ontario really has drawn a line with the ORPP," Mr. Ambachtsheer said. "They would love for it to go national, but if they don't get agreement on something that's fairly close to what's already in motion, they'll go it alone."

Could the roll-out of an ORPP-like system slow the economy? It seems unlikely. Between 1997 and 2003, significant hikes in CPP premiums coincided with a falling unemployment rate.

Policy makers must keep in mind that retirement issues will persist far longer than any blip in the economy, Prof. Schirle said. The goal of the current talks is to create a system that can withstand the challenges of the coming decades.

"Baby boomers are one of the wealthiest generations moving into retirement in Canadian history," she said. "They have lots of wealth and good coverage with defined-benefit plans. The real target for concern now is people under 45. We have to think about what will happen to them 25 or 30 years from now."

The low-down on CPP reforms

Know who you're rooting for, pension fans. Some of the top proposals for CPP reform include:

Do nothing: Many believe the current system is doing just fine. The stand-pats can point to international comparisons of pension systems, such as the one by benefits consultant Mercer, that award above-average grades to Canada's existing system just as it is.

Double-down: The Canadian Labour Congress urges a doubling of CPP benefits. Big CPP would be financed by increased contributions from both workers and employers. However, the earnings cap – that is, the maximum amount of your annual earnings covered by CPP (now $54,900) – would remain where it is under the current system, so reform would have only a limited impact on many middle-income workers.

Wolfson wedge: Devised by economist Michael Wolfson, this proposal targets middle-income workers. It would require you to contribute to CPP at a higher rate once your annual income climbs above a certain level. The payoff for those extra contributions? Much lusher CPP payouts in retirement. Those payouts would replace a higher percentage of your past income than the current system does – and that's not all. The wedge proposal would also double the earnings cap, expanding CPP coverage to incomes over $100,000. The result would be a system in which CPP both covers more earnings and also replaces them in retirement at a higher rate.

Double-up: Kevin Milligan of the University of British Columbia and Tammy Schirle of Wilfrid Laurier University suggest that simply doubling CPP's earnings cap – taking it from the current $54,900 to nearly $110,000, but keeping the contribution and replacement rates as they are now – would address many of the deficiencies of the current system. This plan would boost middle-income coverage while

avoiding clawbacks of Guaranteed Income Supplement in lower-income ranges.

Supplementary CPP: Keith Ambachtsheer, director emeritus of the Rotman International Centre for Pension Management, suggests a system in which workers would be able to contribute more to a supplementary system during their working lives to receive bigger benefits in retirement. Enrolment would be automatic, but individuals could choose to opt out.

Longevity insurance: This proposal, tabled by a panel of Quebec-based experts, assumes most of us can save enough to make it to 75. It suggests setting up a supplemental pension that would kick in after that age to cushion individuals who might otherwise risk outliving their savings in their 80s or 90s. This extra pension would be financed by contributions from workers and employers.