Intelligence MEMOS

From: Alexandre Laurin and Bill Robson

To: Young Canadians

Date: December 18, 2017

Re: **We Need Deeds, Not Words, to Make the New Canada Pension Plan Financially Secure**

Cannabis taxation garnered most of the headlines about Canada's finance ministers' semiannual meeting last week. But for young Canadians who face higher premiums over their working lives to fund the expanded Canada Pension Plan, a more important item on the ministers' agenda was the long-term financial sustainability of the plan.

When they announced the expanded CPP back in June, the federal and provincial governments called the new tier on the plan "fully funded." That is distinct from the older CPP, which pays the bulk of each year's benefits from premiums collected the same year – a "pay-as-you-go" model. In theory, the second tier will pay its promises, not from money flowing in at the time, but from the past contributions from employers and employees, and the investment returns they have earned meanwhile.

The risk, as with all defined-benefit pension plans, is that the payouts of the expanded CPP have been established before the investment returns have been earned. Along with other risks associated with future promises of specific amounts, such as people living and drawing pensions longer than expected, and future politicians changing the terms – both of which have repeatedly affected the CPP – investment returns might be lower than assumed. If they are, benefits will be lower than promised or, more likely in government-run plans, contributions will rise, forcing the young to cover inadequate saving by the old.

The projections for the expanded CPP assume investment returns much higher than those available on other government obligations. As well, averages over long periods gloss over the problems that market fluctuations can cause for pension plans. As we demonstrated earlier this year, over a 40-year period, there's a 2-in-5 chance investment returns won't cover 90 percent of benefits, and a 1-in-3 chance they won't cover even 80 percent.

Improving benefit security by investing in less risky assets would require the expanded CPP to charge contributions 60 percent higher than planned.

The finance ministers agreed to move forward with regulations that will specify how the sustainability of the expanded CPP will be calculated, and how the plan will adjust if funding looks inadequate. The specifics of those regulations matter for young Canadians.

For sustainability, the ministers could take their inspiration from the New Brunswick approach for modeling the future in their shared-risk plans. They use multiple projections with distributions of values for key variables to establish thresholds of confidence about ability to cover promises.

For adjustments if things go wrong, the CPP should set a base benefit, backed by conservative investments and/or higher contribution rates, with a very high level of confidence. Above that, benefits would vary, becoming less rich if funding falls below a specified threshold, and becoming richer if funding evolves better than expected.

The good news is that governments now appear ready to deal with the fact that the expanded CPP is risky, and will not be "fully funded" unless a proper funding policy is in place, and appropriate default mechanisms exist to deal with contingencies. But whether the measures and mechanisms they put in place will truly protect young Canadians from the intergenerational transfers typical in social security systems remains to be seen. The finance ministers have said the right thing. They need to follow through.

Alexandre Laurin is Research Director, and Bill Robson is President and CEO of the C.D. Howe Institute.

To send a comment or leave feedback, email us at blog@cdhowe.org.