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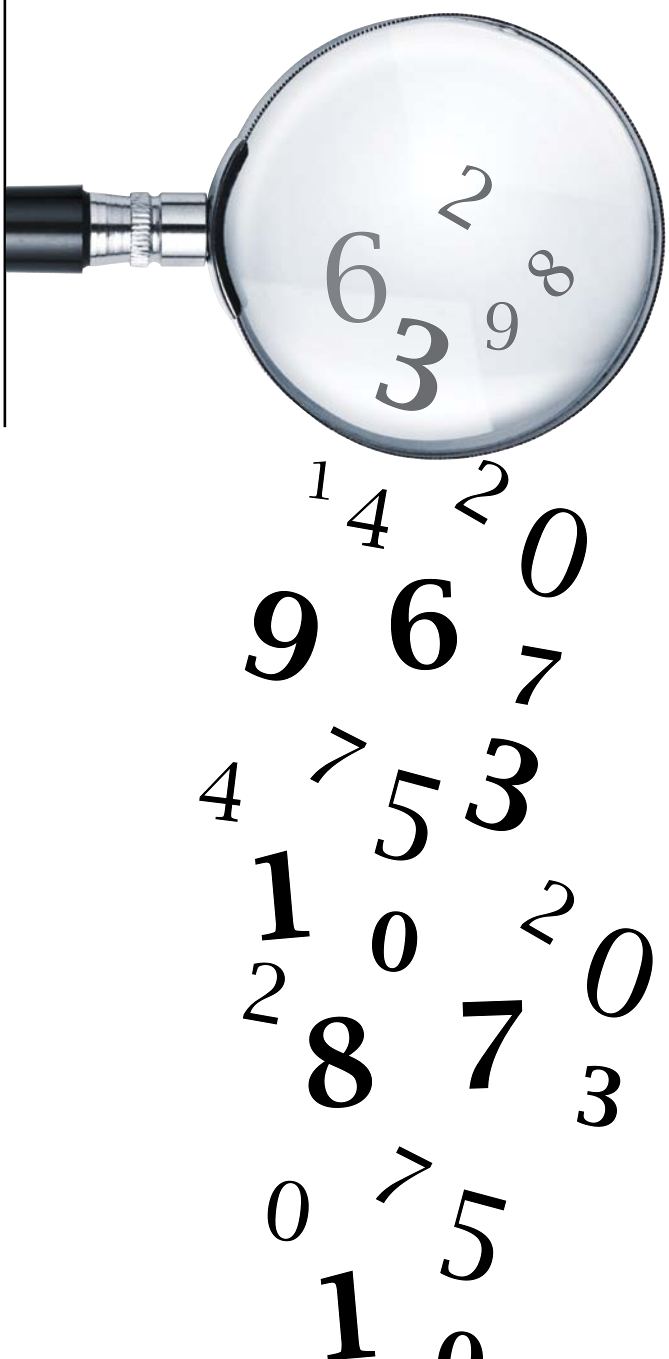
REPORT 2: Public Sector Pensions: a Runaway Train?



Public Sector Pensions: a Runaway Train?

Ted Mallett, Vice-President and Chief Economist

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Canada's pension system is a disaster waiting to happen. Public sector pension plans at all levels of government are massively underfunded which will demand higher taxes and strain Canada's economy. There is also a widening pension gap between Canadians in the public sector and those in the private sector. This will create resentment as more and more public servants retire earlier—and more comfortably—than anyone else in society. Continuing on this track is unsustainable and unfair. Major reforms are clearly needed.

This publication represents part of a series of research reports by the Canadian Federation of Independent Business (CFIB) on pension, retirement income and compensation issues. The series builds on CFIB's extensive work on these topics, including our Wage Watch reports and Pension Tension campaign. The purpose of the series is to provide greater insight on what has always been a complex and poorly-understood issue. It will also provide policy recommendations on how to bring fairness and sustainability into the system.

Public Sector Pensions: a Runaway Train?

There are clear signs that the current model of most government employee defined benefit (DB) pension plans is on an unsustainable path. Not only are the benefits rich, but enrolments in these public sector plans are growing at twice the rate of growth of private sector employment levels—a proxy for the economy's general capacity to pay for them. Something has got to give. Although governments seem to acknowledge the problem, action to address it is slow and incomplete. Delays in dealing with these problems will only raise the costs and risks to all parties, plan beneficiaries and taxpayers.

Pension systems tend to be built with too great an emphasis on short-term considerations—as potential difficulties tend to be pushed down the road in the hope that the long-run will smooth them out. In cases where pensions are negotiated by collective agreement, the need to maintain labour peace or to get striking workers back on the job appears to carry far more weight than the long-run sustainability of a fund. In the private sector, where businesses are not guaranteed an existence, long-term considerations are at least partially preserved. The tendency there has been to move to more sustainable forms of defined contribution (DC) pension plans. In the public sector, however, the discipline of market forces is not as strong, encouraging governments to defer problems to future taxpayers.

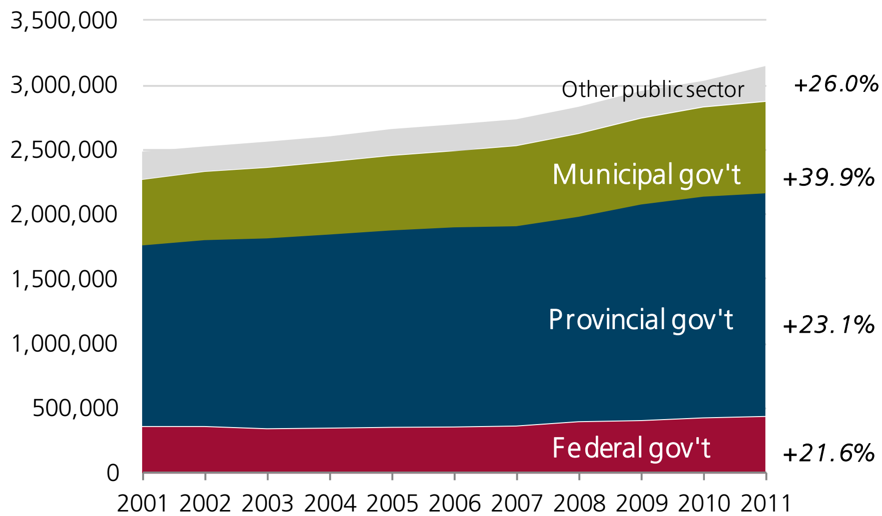
We have seen this before in the pension arena. The Canada and Quebec Pension Plan (C/QPP) system was a good case study on how reasonable policy ideals were pushed off track. The C/QPP had solid original intent, but short-sighted political decisions followed years of delay in facing up to the challenges forced a costly repair in the mid-1990s, increasing payroll premiums for everyone by more than two-thirds.

Similarly, today the signs of unsustainability in the cost and breadth of public sector pension systems are growing—trends that, if not reversed or at least stabilized, could lead to undesirable outcomes for taxpayers and retired public servants. The public sector is now much larger than when these pension plans were developed. As of the beginning of 2011, there were 3.14 million members of public sector pension plans (those who are not yet retired)—an increase of 26.6 per cent since 2001 (see Figure 1). This is about double the rate of growth of total private sector employment, 12.8 per cent, during that period.[1]

[1] Statistics Canada, Labour Force Survey, CANSIM table 282-0089

Figure 1.

Membership* in public sector registered pension plans



Source: Statistics Canada, *CANSIM Matrix 280-0012*

*Pre-retirement. Number of people on which contributions are being made

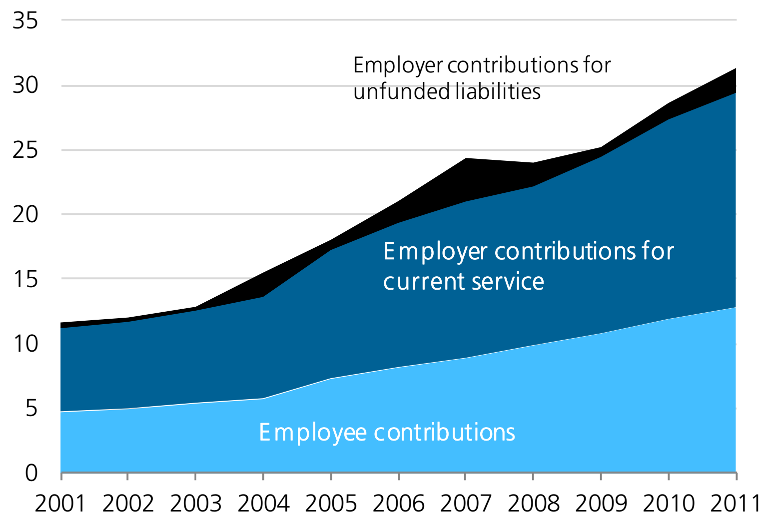
Membership in municipal government plans grew the fastest at 39.9 per cent, while membership in provincial and federal government plans was higher by 23.1 and 21.6 per cent respectively, with DB plans accounting for the overwhelming share (94 per cent) of membership. In comparison, private sector pension plan membership remained flat at about 2.9 million members for the entire decade—only half of whom are in DB plans.[2]

Of course public sector employees are contributing part of their earnings to these plans, but to a larger degree it is private sector activity that is indirectly tasked with footing the bill via their taxes. In all, more than $31.3 billion was put aside for public sector pensions in 2011, $12.8 billion from employees' contributions and $18.6 billion from the taxpayer (see Figure 2). Not only do governments as employers have to cover the contributions for employees' current service, employers are also responsible for topping up any funds that fall below sustainable levels. These top-ups can vary considerably from year to year, but in the decade following 2001, they were equivalent to about seven per cent of total contributions, or about $1.3 billion per year.

[2] Source: Statistics Canada, CANSIM table 280-0012

Figure 2.

Total contributions to public sector pension plans ($B)



Source: Statistics Canada, *CANSIM Matrix 280-0026*

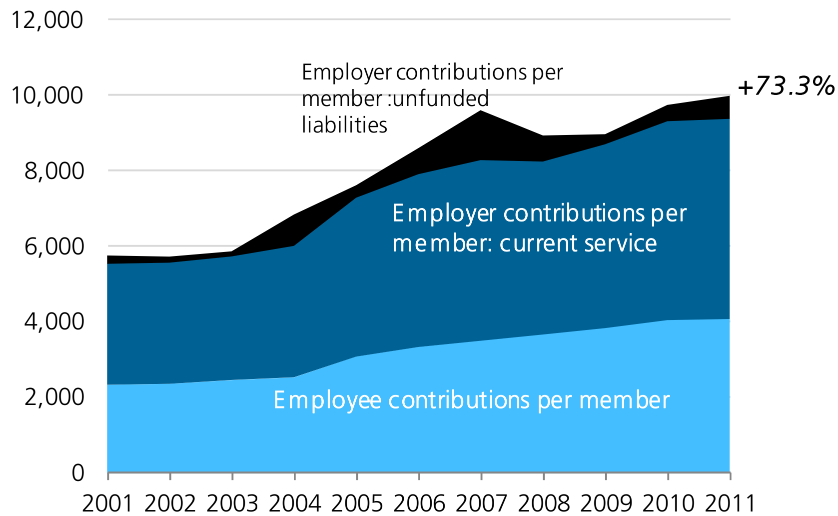
Even if one takes into account inflation and plan membership, the upward trajectory in total public sector pension plan contributions remains steep. In 2011, $9,976 per year was being put aside for an average public servant in Canada, a 73 per cent increase over the average $5,754 (in 2011 dollars) contribution in 2001 (see Figure 3).

The rapid increase in costs is troubling enough. The fact that most public sector plans are defined benefit arrangements means that cost control is made even more difficult, because the true costs of payouts only materialize many years after the pension promises are made. Our latest estimates conservatively suggest that public sector plans are underfunded by more than $300 billion (about $1 trillion in liabilities against assets of $673 billion)[3] in today's dollars, despite the volumes of money being poured into the system.

[3] CFIB, Canada's Hidden Unfunded Public Sector Pension Liabilities, May 2012, http://cfib.ca/a4034e

Figure 3

Employer and employee contributions to public sector registered pension plans, per plan member (Constant 2011$)



Source*: Statistics Canada, CANSIM Matrix 280-0012, 280-0026, 326-0021*

Lessons from south of the border are worth noting since the problem is well advanced in many US government pension plans. The escalating costs of many state and municipal plans are seriously eroding their ability to deliver fundamental public services. In some notable cases, municipal retirees are opting to accept reduced pensions in efforts to keep their former government employers from declaring bankruptcy, which would have far worse implications.[4] In Canada, the problem is now showing up with greater force. For example, the City of Montreal Pension Plan costs now accounts for 13 per cent of its operating budget[5]—even more than the amount devoted to public transit. The Ontario Teachers' Pension plan is receiving billions of dollars per year in contributions from the Ontario government above and beyond the usual employer and employee contributions, and still its fund is underwater by a staggering $9.6 billion.[6] It is only a matter of time before more pension plans succumb to crisis.

Clearly, the problem is not from a lack of money. These systems are falling behind despite rapid growth in contributions. The only real correction can be in the form of scaling back how benefits are calculated, or salary levels, which form the basis to these calculations. For some plans, it may be possible that trimming pension entitlements of new employees is enough to get their systems back in balance. But if other government plan managers don't act quickly enough, they may be forced to cut current employee pension eligibility. For example, California Governor Jerry Brown's 12-point pension reform proposals[7] take decisive steps in that

[4] The Economist, *Public Sector Pensions: Burning Fast*, June 23, 2012. http://www.economist.com/node/21557364?fsrc=scn/tw/te/ar/burningfast
[5] City of Montreal, 2012 Operating Budget at a glance, pg 3. http://ville.montreal.qc.ca/pls/portal/docs/PAGE/SERVICE_FIN_EN/MEDIA/DOCUMENTS/BUDGET-2012-ATAGLANCE_CORRIGE_JAN_2012.PDF
[6] http://docs.otpp.com/annual_report/PDF2012/AnnualReport2011.pdf
[7] http://gov.ca.gov/docs/Twelve_Point_Pension_Reform_10.27.11.pdf

direction—raising the retirement age, ending pension spiking[8] and forbidding retroactive benefit increases, among others. Federal agencies, the Bank of Canada and Export Development Corporation have already made moves to overhaul their employee plans. Likewise, The New Brunswick government has introduced a new 'shared-risk' pension model[9] aimed at its public service to prevent its plans from collapsing. Details of New Brunswick's proposal are still forthcoming, but it is a promising sign that steps are finally being taken.

- Taxpayers in other parts of the country and public sector employees themselves, however, are going to have to see more of these types of comprehensive reforms from governments before the pension train can be put back on track. There are many ways to design pension plans, which fortunately give many opportunities to rein in costs. Alone or in combination, choices include: Ensuring that base pay in the public sector does not exceed that of similar work in the private sector. High pensions can only be justified if they compensate for low wages or high job instability—neither of which generally exist in the public sector.
- Eliminating opportunities for workers to 'spike' their pensions upward through high use of overtime in their final few years of service.
- Moving toward defined contribution plans for new employees.
- Using 'career earnings' rather than 'final years' earnings to calculate benefits for pension amounts still based on defined benefits.
- Slowing down the rate of accumulation of pension benefits so that career public servants only qualify for full pensions at age 65 (or 67 when Old Age Security benefits are realigned).

Adopting the above recommendations in whole or in part would have significant effect on the future affordability of public sector pensions and would bring them in line with what larger private sector employers offer their employees. The sooner governments take action, the easier the transition and the greater the fairness for all involved.

[8] A widespread employee practice of significantly ratcheting up overtime hours in the final few years of working to boost pension dollar entitlements.
[9] http://www2.gnb.ca/content/gnb/en/corporate/promo/pension.html