Intelligence MEMOS

From: William B.P. Robson and Alexandre Laurin

To: Canadian Taxpayers

Date: June 5, 2018

Re: THE SURPRISING HIDDEN COSTS OF FEDERAL EMPLOYEE PENSIONS

Taxpayers are on the hook for the unfunded liability of pension plans for federal employees, and official figures for federal pension obligations understate future costs and leave many plans seriously underfunded.

The federal government presents a misleadingly rosy picture of the situation of its plans. Ottawa's unfunded pension liability is nearly $100 billion worse than stated. This is unsettling news for the federal employees who belong to these plans, as well as for taxpayers.

Ottawa provides its employees with defined-benefit pensions that promise relatively generous benefits to a large current and former workforce. Being largely unfunded, these plans require future taxpayer support. As we outlined in our recent C.D. Howe Institute *Commentary*, they also create taxpayer risk because the economic value of the benefits they will provide can fluctuate by tens of billions of dollars annually. Ottawa's current accounting practices understate this burden and the risks these plans create for taxpayers and, potentially, for the employees themselves.

Official figures on the current cost of these plans and their accumulated obligations are based on notional interest rates that are too high for this kind of commitment. Since pension promises are guaranteed by taxpayers and indexed to inflation, the appropriate rate for discounting the value of future payments should be the yield on federal-government real-return bonds, which for years has been much lower than the assumed rate in official figures.

Correcting this distortion would produce a fair-value estimate of $245.9 billion for Ottawa's unfunded pension liability at the end of the 2016/17 fiscal year – around $27,000 per family of four and $96 billion higher than the reported figure. Because the unfunded pension liability is part of Ottawa's debt, applying this fair-value adjustment raises the net public debt from the $631.9 billion reported at the end of 2016/17 to an adjusted $727.9 billion.

To relieve taxpayers of their current sole responsibility for risks in the federal plans, we recommend Ottawa switch to a different type of pension plan with benefits based not only on salary and years of service but also on the plans' funded status. Such plans, already common in much of the provincial public sector, have a variety of labels – shared-risk and target-benefit are two common ones. Their common feature is that when things do not go as expected, the plan sponsor and the employees share the costs and benefits of the new reality. Ottawa could also protect taxpayers from liability risk by capping employer contributions at a fixed share of pensionable pay.

Most importantly, economically meaningful reporting of the plans' benefit values and their cost to taxpayers would foster improvements in Canada's retirement saving and income system generally. And it would foster reforms that would provide federal employees with better-funded pensions and taxpayers with protection against risks too few know they face.

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