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E-BRIEF

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PENSION POLICY

Federal Employee Pension Reforms: First Steps – on a Much Longer Journey

by
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- Ottawa's proposed changes to the pension plans of MPs and federal employees are a move in the right direction. Currently before Parliament, the new provisions include increasing employee contributions to the plans and raising eligibility ages for new employees' benefits. But much remains to be done.
- Better funding and a more reasonable division of obligations and risks between taxpayers and public servants will require more fundamental revisions to what increasingly stands out as Canada's most important dysfunctional pension system.

Legislation currently under consideration in Parliament would make important changes to the pension plans of federal employees.[1] Starting next year, new hires to the public service would become eligible for unreduced pensions at age 65, rather than the current age 60.[2] The eligibility age for members of parliament (MPs) would also go to 65, up from the current 55, starting in January 2016.[3] The contributions made by most employees and MPs themselves to their pension

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[1] Changes to federal employee pension plans are in Bill C-45, introduced in the House of Commons on October 18. Changes to the MPs' pension plan were put in a separate Bill (C-46) on October 19; approved by the House of Commons, this bill is currently before the Senate.

[2] New hires who put in 30 or more years of service will become eligible for an unreduced early retirement at 60, up from 55 at present. Changes to pension eligibility age for new hires do not apply to members of the RCMP and Canadian Forces.

[3] Although the eligibility age to an unreduced pension will go up by 10 years, MPs will still be eligible for a pension at age 55, reduced by a 1 percent penalty for each year of age below 65, and only one-fifth the reduction applying to public-service employees.

plans would rise to 50 percent of the current service cost of the plans.[4]

The prospective increases in employee contributions would start saving taxpayers money in the short term,[5] and raising eligibility ages for new employees' benefits would reduce the growth of these plans' liabilities in years to come. While MPs and the public servants who designed the changes deserve recognition, not least for their personal sacrifice, the flaws in Ottawa's employee pension plans are so serious that these steps should – and almost certainly will – not be the end of the journey. The guaranteed incomes those plans promise participants are far more valuable, and their costs and obligations on taxpayers are far larger, than reported. Better funding and a more reasonable division of obligations and risks between taxpayers and public servants will require more fundamental revisions to what increasingly stands out as Canada's most important dysfunctional pension system.

Background on Key Federal Employee Pension Plans

The federal government has many pension plans for its employees. The three with the largest impact on Ottawa's finances, all affected by the proposed changes, are the Public Service (PS), the Canadian Forces (CF), and the Royal Canadian Mounted Police (RCMP) plans. The changes also affect the MPs' plan, which naturally has a high public profile.

These plans, like others[6] the legislation will leave unchanged, have key common elements. They are classic defined-benefit plans that promise annuities calculated with reference to salary and years of service.[7] They are all badly underfunded – the PS, CF, and RCMP plans only began investing in segregated assets in 2000 – or totally unfunded. They are sponsored and administered by a single employer, the federal government, which treats the plans like a subsidiary of its own operations.

The key focus of discontent about these plans, and the proximate cause of the reforms, is the rich retirements they offer compared to what other Canadians can hope for, and the modest contribution the employees themselves make.

One way to summarize the plans' generosity is their current service cost: the retirement wealth that accrues annually to the average participant. Even the understated amounts reported by the government (shown in the first column of Table 1) show accruals above the limit of 18 percent of pay that applies to participants in defined-contribution pension plans and RRSP savers – a clear case of unequal treatment compared to non-federal employees.[8] The inequality is enormous in the case of MPs, whose reported current service cost is more than 50 percent of pensionable pay.

[4] The exceptions are employees of the Royal Canadian Mounted Police and Canadian Forces, who will contribute less than 50 percent of their costs (about 44 percent for RCMP and 43 percent for the CF).

[5] Taxpayers will save money only if wages and salaries are not adjusted upward to compensate for increased employee contributions.

[6] Some professional categories, such as federal judges, have separate plans; other employees have special retirement compensation arrangements beyond their pension plans.

[7] Some pension plans that call themselves defined-benefit plans, or are often referred to that way, are actually target-benefit (sometimes referred to as "shared-risk") plans, with provision for downward adjustment of benefits when assets are below certain thresholds. Major plans covering the broader public sector in Ontario, Alberta and British Columbia are of this type. The federal plans contain no such provision.

[8] The proposed modifications to age of eligibility of benefits will slightly alleviate this inequality in the longer run as new employees come in.

Table 1: Current Service Cost for PS, RCMP, CF, and MP Pension Plans, 2012

Pension Plan	Reported Current Service Cost	Contributions: Employees	Contributions: Taxpayers	Current Service Cost at Fair-Value
	(percent of pensionable pay)			
Public Service (PS)	19.8	6.7	13.1	47.7
Royal Canadian Mounted Police (RCMP)	22.5	6.9	15.5	56.9
Canadian Forces (CF)	23.1	6.5	16.6	60.2
Members of Parliament (MP)	51.5	7.1	44.5	72.1

Notes: Contributions and current service costs are for 2012 before the proposed changes. Fair-value refers to the cost of funding the pension obligations based on the market yield for matching inflation-indexed, taxpayer-backed bonds (real return bonds).

Revisions on 12/14/2012: Because the RRB yield is currently well below the range the Chief Actuary presents in his sensitivity analysis, different methods for extrapolating current service costs to such low yields produce quite different results. Of the various straightforward methods for extrapolating, the log linear gives higher estimates while the polynomial and exponential methods give similar and lower numbers. The original version of this E-Brief presented loglinear estmates. This revised version presents the polynomial estimates.

Sources: Authors' calculations based on OCA 2011a, 2011b, 2012a and 2012b, and the RRB yield as of March 31st 2012 (0.51%).

As for contributions, the deductions from employee paycheques for the PS, RCMP and CF plans were between 6.5 and 6.9 percent of their average annual wages and salaries in 2011, covering no more than one-third of the reported current service cost of these plans (see the middle two columns of Table 1).[9] MPs contributed, on average, 7 percent of their pensionable pay – an even smaller portion of the reported cost of their pensions.

The Plans' True Cost

The actual cost of these plans, moreover, is higher than reported. The estimate of current service costs that determines contributions depends on the Chief Actuary's projections of the returns on a risky portfolio of assets. But these plans are largely unfunded, and the returns on what assets exist may differ from the Chief Actuary's projections. Taxpayers are the guarantors of benefits in the event of shortfalls.

As we have documented elsewhere (Laurin and Robson 2010, 2011; Robson 2012), the appropriate way to value these guaranteed benefits is to ask what it would cost someone not in one of these plans to build a nest-egg promising a similar retirement. Because the annuities in these plans are indexed to inflation and backed by

[9] The rates above represent average contributions for all employees. Individual contribution rates for employees in the plans mentioned above in 2012 were 6.2 percent on pensionable earnings up to $50,100 and 8.6 percent on pensionable earnings above $50,100.

taxpayers, the closest parallel available to that non-participant is a portfolio of the federal government's real-return bonds (RRB).[10]

Those bonds are currently very expensive. High-quality debt has become precious in recent years, the counterpart of its low yield, which reflects expectations of slower economic growth and – in the case of some countries, including Canada – savers' search for safer havens in a world of much heightened credit risk. Therefore, the size of nest-egg needed for any future taxpayer-guaranteed payout has gone up.

The Public Accounts as of March 2012, the most recent available, showed Ottawa's obligation for employee pensions – the liability on its balance sheet representing the amount it would need to meet the various payments as they come due – at $231 billion. But that amount was calculated assuming rates of return of 6.0 percent after inflation on invested contributions, and 4.8 percent on the unfunded portion. Using the actual real-return bond yield prevailing at the time, the total obligation was more than 40 percent higher: $331 billion.[11]

The MPs' plan does not appear separately in the Public Accounts, but a similar calculation based on the most recent valuation from the Chief Actuary as at 31 March 2010 raises the present value of its pension obligation from $817 million to more than $1 billion (Robson 2012). Since the MPs' plan is completely unfunded – the contributions MPs notionally make to their plan simply disappear into the consolidated revenue fund, and the same will happen to the higher ones these reforms propose in the future – that entire amount is an unfunded liability.

The same logic – what it would cost to add enough RRBs to these plans every year to match the new benefits they promise – yields annual accruals of retirement wealth for an average participant in the PS, RCMP and CF plans that is not the roughly 20 percent of pensionable pay shown in their actuarial reports, but 48 percent or more of pay (shown in the fourth column of Table 1). And the annual wealth accrual for an average MP is not the 51 percent of pensionable pay shown in the actuarial report on the MPs' plan, but 72 percent.

So whatever the split between employer and employee contributions after the changes, the underfunding of these plans, and therefore taxpayers' exposure, will still increase.

Deeper Reforms Needed

Notwithstanding the merits of increasing the employees' share of the current service cost of these plans, taxpayers will still bear more than half of the risk of changes in the cost of new obligations and – more important – the entire risk of changes in the cost of servicing past obligations. Mitigating that risk would require converting the federal plans to target-benefit plans – in which benefits adjust depending on funding – such as exist in the broader public sector in many provinces and are envisioned in recent legislation in New Brunswick (Steele 2012), or capping taxpayers' contributions – to, say, 9 percent (half the 18 percent maximum tax-deferred limit available in RRSPs and DC plans) – with the rest of the amount needed to fund the plans at their actual current service cost coming from employees (Laurin and Robson 2012).

[10] Since RRBs are indexed to inflation and backed by taxpayers, they strongly resemble the promise made to participants in federal plans. The suitability of yields on RRBs as a discount rate for government pensions is not universally accepted, but they are better than any alternative (Laurin and Robson 2009). The thin float of these bonds is not an argument against using their yield, since that scarcity makes inflation protection more valuable; it is an argument for issuing more RRBs, which would be desirable in any event (Bergevin and Robson 2012).

[11] Authors' calculations using RCA 2012 and the RRB yield as at 31 March 2012.

Equalizing the tax-deferred saving opportunities available to different classes of workers is another task still outstanding. Why should federal employees get tax-deferred saving that is triple or more what Canadians contributing to defined-contribution pension plans or RRSPs get? One option that deserves more attention is a uniform lifetime accumulation limit (Pierlot and Siddiqi 2011). Failing that, Ottawa could go further than suggested in the previous paragraph, and convert all federal plans to defined-contribution plans (Laurin and Robson 2012).

In the case of the MPs' plan, one further change deserves underlining: the contributions of MPs and of taxpayers as their employers should, whatever the structure of the plan, become actual cash contributions that buy assets. Even after the 2012 reforms, the only backing for the pensions Canada's political leaders promise themselves will be their power to tax in the future. But funding pensions with assets that represent claims on someone other than the sponsor is a key discipline; the need to achieve, rather than simply assume, higher investment returns curbs tendencies to promise overly rich benefits. Fully backing their own plan with real assets would earn MPs valuable moral authority to lead the ongoing process of pension reform in Canada.

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The C.D. Howe Institute launched the Pension Papers in May 2007 to address key challenges facing Canada's system of retirement saving, assess current developments, identify regulatory strengths and shortfalls, and make recommendations to ensure the integrity of pension earnings for the growing number of Canadians approaching retirement. The Institute gratefully acknowledges the participation of the Policy Council for the program.

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