Intelligence MEMOS

From: Alexandre Laurin and William B.P. Robson

To: Finance Minister Chrystia Freeland

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Re: **Under the Rug: Pitfalls Abound in Reporting Federal Employee Pension Obligations**

The federal government's fall economic update included some unfamiliar lines in its fiscal projections. Its Summary Statement of Transactions presented totals for the federal government's expenses and the budget balance "excluding net actuarial losses."

It then presented "net actuarial losses" – between $10 and $16 billion every year from fiscal 2019/20 to fiscal 2023/24 – which add to the deficit and the net public debt. Even amid the billions of spending and borrowing in the statement, those are large amounts. What is going on?

Knowing where to focus when looking at the financial statements of any organization, including governments, is always a challenge.

For some purposes, items in the annual statement of operations that highlight developments relative to management's annual budget are most useful – helping a reader understand whether revenue came in above or below projections, say, and how efficiently the organization managed its expenses. For other purposes, the organization's statement of financial position is better – changes in net worth show whether its capacity to operate is improving or deteriorating.

The tension between these two approaches to interpreting financial reports –focusing on operations and items relevant to assessing management's current actions, versus focusing on changes in the organization's viability – is useful context for understanding why the federal government added these lines. And for understanding why they amount to an effort to sweep a big problem with the federal government's pension costs under the rug.

The federal government's pension obligations to its employees are big. The public accounts for the 2018/19 fiscal year showed them at about $350 billion. That number, however, understates their true value.

Since 2018, about $200 billion of it is a present value calculated using current federal government bond yields, which is appropriate. Lower yields on obligations valued at current bond yields are producing most of the net actuarial losses in the Fall Economic Statement.

Another $150 billion of pension obligations are a present value calculated using an artificially high discount rate. Using federal government yields would increase that latter amount, and thus the federal government's total pension obligation, by a further $165 billion. The federal government will be gradually reversing that understatement in the future, which will give rise to actuarial losses that the Fall Economic Statement's presentation is relegating to a line below other expenses, and below a key measure of the deficit.

It would be reasonable to de-emphasize these amounts if they resulted from unpredictable fluctuations in the bond yields used to calculate the value of future pension payments. But future revaluations of funded pension costs that are now valued at an artificially high discount rate are not unpredictable. They are the result of the federal government's systematically under-recording costs in its three biggest pension plans, using a high discount rate that understates today's value of the benefits its employees will receive tomorrow. The full costs of federal employee pensions should appear in federal expenses, and in the bottom line, as federal employees earn those pensions. Excluding those costs presents a misleadingly positive picture. The government is making its annual operating expenses look smaller than they are, and the balance line without them more positive than it should.

The Fall Economic Statement sets a bad precedent. The government likely plans to use this presentation in future financial statements in the public accounts and in future budgets. If it does, it will sweep major costs under the rug, and make the gradual appearance of those costs – in "net actuarial losses" – look like an obscure accounting issue or the result of circumstances beyond the government's control.

Ottawa should move to record the value of all of its pension obligations and expenses using a discount rate reflecting current bond yields. If not, Canadians should insist on disclosure of all these costs as part of the federal government's program expenses – we need to see them, and

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