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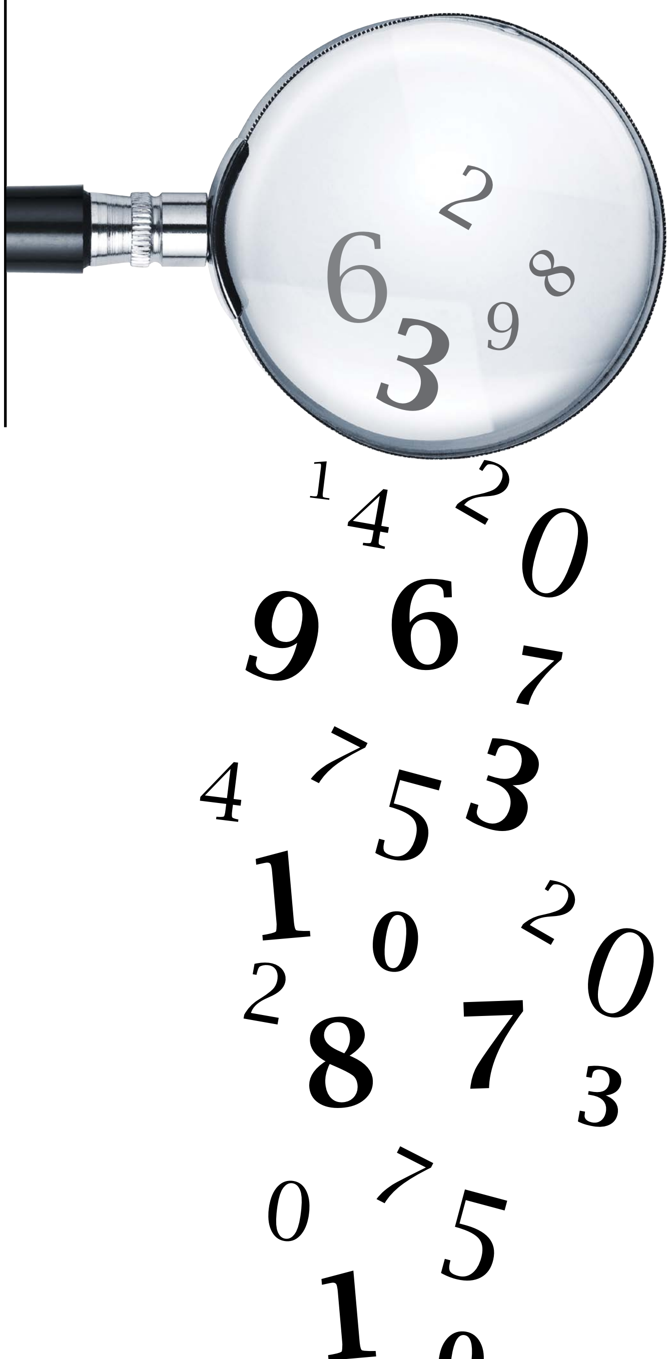
REPORT 1: Canada's Hidden Unfunded Public Sector Pension Liabilities



Canada’s Hidden Unfunded Public Sector Pension Liabilities

Ted Mallett, Vice-President and Chief Economist

CFIB Pension Research Series

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 the first installment 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.

Canada's Hidden Unfunded Public Sector Pension Liabilities

Public service employee pension plans have long been run from the assumption that government employers cannot fail. These plans are often thought of as bulletproof and always capable of delivering a safe and reliable source of retirement earnings for their members. Short of a coup, no government is going to find itself displaced in the public service marketplace by a smaller, more nimble competitor. Beyond that, governments also have the power to draw upon the taxpayer to cover the costs of public sector employee compensation and pensions.

The privileged status of public sector pensions has bred a dangerous complacency on the risks they pose to future pensioners and taxpayers and have, overall, made the concept of defined benefit (DB) pension plans look better than justified. Moreover, the state of disclosure of public sector plans as a whole is abysmally low. Using what information is available, and making assumptions on what isn't, the unfunded shortfall of public plans may well exceed $300 billion, which is equivalent to $100,000 per government employee, or $9,000 for every man, woman and child in this country.

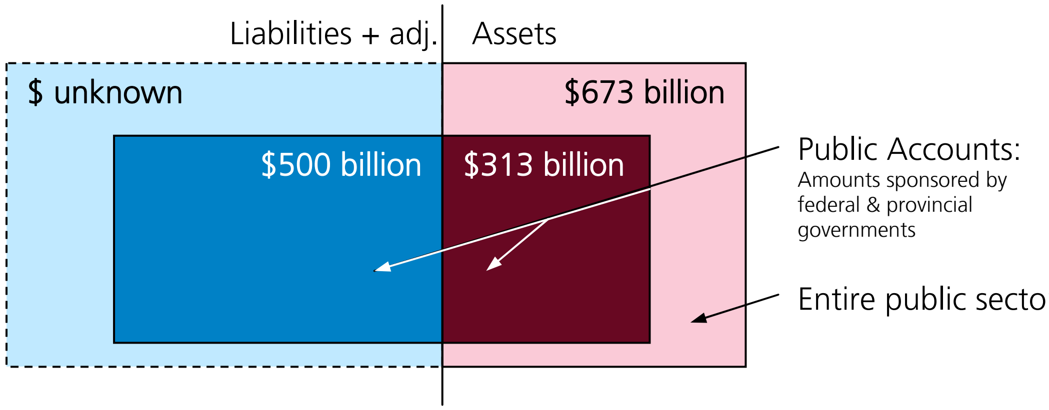
The Canadian public needs to know if they will be on the hook for topping up government employee plans—and by potentially how much. But where does one turn to scrutinize the assumptions and potential risks of public sector plans? Unfortunately, there is no easy path to an answer. The public sector is widely spread, including not just government administration, but also public entities like school boards, universities, hospitals, transit commissions and crown corporations.

One could try to assemble the annual financial reports of all the major public sector plans across Canada, but there are well over 300[1] such plans and their reports are not often easily available or presented in consistent fashion. Statistics Canada collects detailed pension statistics from public (and private) plan providers, but will only release data on public sector plan assets, not liabilities, thereby hobbling any reasonable attempts to track pension plan performance and affordability.

Finally, annual Public Accounts data give out the most consistent information, but they cover only the amounts sponsored by the federal, provincial and territorial governments. This means large numbers of education, hospital and municipal employee pension plans are not reported centrally. For plans partly sponsored by respective provincial governments, like many teachers' and hospital pension plans, only the sponsored portions are included in the Public Accounts. The $313 billion in pension plan assets reported in the aggregated government Public Accounts in fiscal year 2010-11 amount to less than half the $673 billion reported by Statistics Canada's trusteed pension plan statistics (see Figure 1).

[1] Statistics Canada. *Table 280-0007 - Trusteed pension funds, funds and members by sector, type of plan and contributory status, occasional (number),* CANSIM (database). (accessed: 2012-05-03)

Figure 1: Financial position of public sector employee pension plans, Public Accounts and Census of Trusteed Pension Funds



Sources: Federal, Provincial, Territorial Public Accounts 2010-11; Statistics Canada, *Table 280-0002 - Trusteed pension funds, book value of assets, by private and public sector category, Q1 2011 (dollars),* CANSIM (database). (accessed: 2012-05-03)

Public Accounts data tell us that the estimated present value of future pension obligations amounted to $530 billion at the end of 2010-11, leaving a funding shortfall of $186 billion once unamortized pension adjustments[2] are taken into account (see Table 1).

The lack of full statistics on the broader public sector plans obscures the true value of total unfunded liabilities (UFLs). Three of the largest plans outside or partially outside Public Accounts reporting—the Ontario Teachers' Pension Plan (OTPP)[3], Ontario Municipal Employees Retirement System (OMERS)[4] and those of the 105 Quebec municipalities[5] operating DB plans alone—had net UFLs exceeding $18 billion at the end of 2010. The full national picture on UFLs, therefore, is likely far darker.

These massive shortfalls persist despite many governments putting large top-up payments into their employee plans from general revenues. Beyond their regular contributions, to address unfunded liabilities, public sector employers topped up their employee pension plans by an average of $1.27 billion per year between 2001 and 2010.[6] Therefore, although a province may appear to have their pension plan in relative balance, it is more than likely it has been leaning heavily on taxpayers to make it happen.

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[2] Differences between estimates and actual experience in a pension plan that are to be deferred and amortized to pension expenses of future periods
[3] 2010 OTPP Annual report. http://docs.otpp.com/AnnualReport2010.pdf, adjusted to reflect 50% sponsored by provincial government
[4] 2010 OMERS Annual Report. http://www.omers.com/pdf/OMERS2010COMBINEDAnnualReport.pdf
[5] Union of Quebec Municipalities
[6] Statistics Canada. *Table 280-0026 - Registered pension plans (RPPs), contributions to registered pension plans, by sector, type of plan and contributory status, annual (dollars),* CANSIM (database). (accessed: 2012-05-03)

Table 1: Financial position of public sector employee pension plans, Public Accounts and Census of Trusteed Pension Funds

	Benefit obligations (Present value)	Plan assets	Unamortized adjustments	Net Unfunded pension liabilities (Present value)
		$ millions		
Federal	213,341	54,008	13,198	146,135
Prov. & Terr.	317,015	259,445	17,271	40,298
Newfoundland & Labrador	11,434	7,412	1,356	2,667
Prince Edward Island	1,783	1,528	279	-25
Nova Scotia	7,649	6,772	836	41
New Brunswick	8,896	8,387	729	-220
Quebec	80,051	41,276	9,725	29,050
Ontario	95,431	101,221	-4	-5,786
Manitoba	7,118	4,828	518	1,772
Saskatchewan	7,361	1,217	139	6,005
Alberta*	47,493	37,571	0	9,922
British Columbia	49,560	49,052	3,678	-3,170
Yukon	162	134	13	15
Northwest Territories	66	43	2	21
Nunavut	11	5	-0	6
Total Public Accounts	530,356	313,453	30,469	186,433
Census of Trusteed Pension Funds (public sector, 2010)	NA	673,070	NA	NA

* Alberta's total liabilities are imputed by combining unfunded liabilities with assets under administration

Sources: Federal, Provincial, Territorial Public Accounts 2010-11; Statistics Canada, *Table 280-0002 - Trusteed pension funds, book value of assets, by private and public sector category, Q1 2011 (dollars),* CANSIM (database). (accessed: 2012-05-03)

Even with the unfunded liabilities reported, there are questions to their true levels. Present value calculations on future pension liabilities are highly dependent on interest rate assumptions. Michel St-Germain of the Canadian Institute of Actuaries estimates that a drop of 1 percentage point in interest rates will increase the cost of supporting pension plans by about 15%-20%.[7] Alexandre Laurin and Bill Robson at the CD Howe Institute have written on how federal government employee pension plans are using dangerously high interest rate assumptions to present a state of financial health far better than what private sector pension reporting rules allow.[8] Considering that official federal Public Accounts numbers paint a dismal $146.1 billion unfunded liability in fiscal year 2011, it makes a big problem even bigger.

Buried within federal government pension plan assumptions are an expected annual rate of return of between 5.8% and 6.2%, depending on the specific plan in question, or in the neighbourhood of 4% once inflation is factored out. The trouble is, long

[7] *L'Actualité, February 2012*

[8] *Ottawa's Pension Gap: The Growing and Under-reported Cost of Federal Employee Pensions, Dec 2011* http://www.cdhowe.org/pdf/ebrief_127.pdf

term inflation-protected bond rates (the way to put an ironclad guarantee on future pension benefits) have not been above 4% in over a decade, averaging only 2% in the latest ten year period and scraping bottom today at a mere 0.5%. Laurin and Robson used a real bond rate assumption of 1.15% (where they were in March 2011) to calculate a net unfunded liability closer to $227 billion, or about $80 billion higher than the government's Public Accounts estimates. Given that today's rates are more than a half-point lower, the CD Howe assessment of the pension gap looks conservative.

Those federal figures look bad enough on their own, but when one considers the additional $40 billion in provincial Public Accounts net liabilities—and the unknown UFLs from the broader public sector—the problem is likely much greater. It is true that provincial plans are better funded than the federal plans, and that much of their assets will include blue chips and higher yielding bonds from the past. However, they too use high real interest rate assumptions in estimating total future liabilities. For example, Prince Edward Island uses an unlikely annual rate of return assumption of 7.63 per cent—or well over 5 per cent per year once inflation is taken into account (see Table 2).

Table 2: Government employee pension rate of return assumptions, Public Accounts (2010-11 fiscal year)

	Future % inflation assumptions	*Future annual % rate of return, discount rate assumptions*
Federal government	*2.00%*	*5.00% - 6.50%*
Provincial governments*:*		
Newfoundland & Labrador	*2.50%*	*6.50% - 7.25%*
Prince Edward Island	*2.50%*	*7.63%*
Nova Scotia	*2.50%*	*7.00% - 7.11%*
New Brunswick	*2.50%*	*6.96% - 7.12%*
Quebec	*2.08% - 2.75%*	*6.08% - 7.25%*
Ontario	*2.50%*	*6.50% - 6.75%*
Manitoba	*2.00% - 2.50%*	*5.00% - 6.50%*
Saskatchewan	*2.50%*	*4.20% - 6.60%*
Alberta	*2.25%*	*4.50% - 6.50%*
British Columbia	*not provided*	*6.50%*
Yukon	*not provided*	*not provided*
Northwest Territories	*2.30% - 3.00%*	*5.10% - 6.30%*
Nunavut	*not provided*	*not provided*
Other major public sector plans*:*		
Ontario Teachers' Pension Plan**		*Real int. rates + 0.5%-1.4%*
OMERS	*2.25%*	*6.50%*

Sources: Federal, Provincial and Territorial government 2010-2011 Public Accounts, Annual reports

With the Public Accounts data pointing to combined government employee unfunded liabilities of more than $186 billion (from Table 1), using the CD Howe Institute's yardstick on modifying assumed rates of return, it is not unreasonable to suggest that combined federal and provincial net unfunded liabilities in Canada nears the $300 billion mark. If one attempts to include the broader public sector plans, we may be dealing with true unfunded liabilities well above that. The amounts are not trivial—a $300 billion unfunded liability scenario is equivalent to about $9,000 per capita or $100,000 per government employee plan member.

It is worth reminding people that unfunded liabilities are not the same as debt. The latter represents an objective payment obligation while the former depends on educated guesses on what might happen in the future regarding investment returns, salary adjustments, pension entitlement rules, employment levels, retirement patterns and so on. But in combination or alone, these liabilities can only be reduced in five ways: higher top-up payments from government employers (taxpayers), higher contributions from government employees, reduced pension benefits for government retirees, lower inflation/wage growth, or higher fund rates of return. The fifth path is impossible for fund managers to control, so barring a magical resurgence in fund earnings, the burden will ultimately fall on taxpayers and government employees.

Governments to date have placed far too much reliance on solving their pension UFL problems through the revenue route, asking taxpayers to kick in extra to fund shortfalls. Public sector pensions are looking like they are structurally unaffordable, sending tax costs higher, adding to public employees already high pension contribution obligations, or forcing governments to divert resources away from public services toward paying for retired employees. With public sector earners collecting 8-17% more in wages per year than private sector earners in the same kinds of jobs[9], and pension entitlements that generously lever off those earnings past retirement, it is time to deal with the cost side of the pension ledger.

The necessary first step needs be to be better disclosure of the state of public sector pensions. Requiring Statistics Canada to release the information it already has would be a good starting point. And, in order to make centralized, regular publishing of financial results meaningful, public sector employers must be required to adopt a common reporting standard to ensure comparability and consistency over time. Beyond that, government plan managers must also be required to disclose net pension balances under a range of reasonably possible rate-of-return assumptions. No one can predict future fund performance with certainty, but the public should at least be given the opportunity to see the scenarios where risks could become unmanageable.

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[9] Canadian Federation of Independent Business, *Wage Watch: A comparison of public-sector and private sector wages*, Dec 2008. http://www.cfib-fcei.ca/cfib-documents/rr3077.pdf