

# **Building on what works: Dispelling pension myths and outlining a vision for improved retirement income security for all**

## **A briefing for PSAC members**

There have been many attacks on our pension plan in the media recently. These attacks often misrepresent the facts about our plan. There is a clear agenda behind some of these attacks to scapegoat public sector workers. This document debunks those myths and provides some clear facts about the federal public service pension plan (superannuation).

### **Myths and responses:**

**Myth #1: Defined benefit pension plans such as the ones enjoyed by many public sector employees are overly generous.**

**Reality: Defined benefit plans offer good, stable and predictable retirement income. This is in part because public sector workers pay a significant portion of their salary towards their retirement income.**

It is important to recognize that these pensions are jointly funded. Workers with defined benefit plans put a significant portion of their incomes into having a good retirement.

For example, in 2010 federal public sector workers will contribute 10.45% on every dollar they make under \$47,200 and 8.4% on every dollar above \$47,200 of their income towards their retirement pension plans which is a combination of CPP and the federal public service pension plan. The 10.45% figure is scheduled to rise to 11.35% by 2013.

In short, the fact that public sector pension plans provide adequate funding relative to other retirement savings is directly related to the fact that workers contribute a significant portion of their pay towards these plans.

You don't fix a problem by getting rid of the only model that is working. Defined contribution plans such as RRSPs have taken a significant hit and failed to provide the stable, predictable retirement income that many defined benefit public and private sector pension plans do. Politicians should be looking at ways to emulate rather than destroy the plans that are working. For example,

politicians should be focusing on improving the CPP and OAS so that all Canadians can expect a reasonable pension when they retire.

A decent pension plan is a key element that helps attract new employees into the public service. There is a looming recruitment crisis for the public sector as baby boomers retire. One crucial factor in being able to attract talented and skilled workers to the public sector is a stable, predictable pension income. Introducing benefit reductions will have a stifling effect on the ability of the public service to attract high quality employees in the coming years.

**Myth #2: The cost of public sector pensions is spiraling out of control.**

**Reality: The latest actuarial report tabled in Parliament in November 2009 shows that the federal public service plan is adequately funded and has a surplus. Costs to the government may eventually increase somewhat, but if they do, it will only be by a small and sustainable amount.**

One claim that has recently been made is that the federal government is understating the actual cost of the pension plan for public service workers by costing it at a “going-concern” rate rather than using “solvency funding” (see the box below for an explanation of these terms). Private pension plans and municipal pension plans are required to value their pension plans using both of these methods. The federal government, by law, is only required to use going-concern funding.

Private sector pension plans need to be valued using solvency funding because there can be no guarantee that the sponsoring employer will still be around when staff retire. Solvency funding ensures that there’s enough money to pay for pensions in the event of a bankruptcy. The federal government, on the other hand, will exist in perpetuity and, just like in other countries such as the USA and the UK, the federal government does not fund its pension for solvency since bankruptcy for the federal government is an unrealistic scenario.

Other attacks on public sector pensions give a huge number for the cost of future liabilities. But they rarely explain what this means.

Public sector pension liabilities go a long way into the future. Young people at work today building up a pension could well live for another eighty years. If you estimate the costs of all public sector pensions for decades into the future and then present it as a bill that has to be paid immediately, then it is hardly surprising that you end up with a frighteningly big number.

But these figures do not mean very much. This is just another attempt to work out the total cost of public sector pensions going for decades into the future and

expressing it as if it all had to be paid at once, rather than over the decades that contributions are made.

Another way of looking at the cost of pensions is known as the “net public service pensions” cost. It is the difference between benefits paid out to today’s pensioners and current contributions paid by current staff. In the most recent actuarial valuation for the fiscal year ending March 31, 2008, this difference was estimated to be \$634 million.

This is eminently affordable, but the figure can change a lot from year to year. This is not because of bad planning or anything being “out of control”. It is simply because it is the difference between two very big numbers that are not linked to each other in the short term.

These big numbers are:

1. The costs of pensions paid out each year – and pension levels are linked to the cost of living; and
2. The total contributions paid by staff and employers in the public sector, which is linked to the number of staff and yearly pay increases.

Over time earnings tend to go up more than prices so this will tend to reduce the net cost of pensions. But there can be sharp variations from year to year. For example, variations can occur when pay in the public sector has been capped or frozen by politicians and then catches up later to respond to recruitment and retention problems caused by the freeze.

In 2008, for example, the increase in the cost of benefits was determined largely by the 2.3% increase in the cost of living (CPI), as of September 2007. But the increase in contribution income was largely determined by the size of pay increases in the public sector during 2008, which were capped at 1.5%. So when politicians freeze public sector pay below inflation it has the odd effect of appearing to make pensions more expensive, even though those extra costs are more than met by reduced expenditure on the wider wage bill.

Of course other factors will also affect the cost of pensions. For example, how many people retire each year and how long pensioners live will affect the cost of pensions and the number of current staff and what they are paid will determine the income figures. But these change relatively slowly over time and don't produce the big changes between years that critics seize on.

## **Pension Definitions**

### **Defined Benefit and Defined Contribution Pension Plans**

**A Defined Benefit** plan offers a defined or predetermined level of pension benefit. The benefits are expressed as a percentage of the final salary for every complete year worked for the organization.

**In a Defined Contribution** plan (also known as a money purchase plan), a pension fund is built up using employee and employer contributions. The pension available at retirement depends on the level of contribution paid, investment returns earned over time and the cost of purchasing the pension at retirement. These things are not known in advance. Therefore the pension it produces cannot be known. The contribution is defined, but not the pension.

### **Funding and valuation terms**

**Going Concern Funding** assumes that a pension plan will continue indefinitely. When this type of valuation is performed, an actuary will estimate how much money is needed in the pension account, and the level of future contributions required to continue paying pensions into the future. This estimate is based on many factors including interest rates, inflation, demographics, and mortality rates.

**Solvency Funding** assumes that the pension plan will terminate – that the employer will go bankrupt or end the pension plan. This type of valuation is performed to assess how much money the plan needs to pay pensions that are owed to everyone who has paid into the plan in the event of termination. A recent C.D. Howe Institute report uses this method – which they call “fair-value” accounting – to incorrectly claim that the federal pension plan has a huge deficit.

**Myth #3: Defined benefit pension plans have been unfairly sheltered from the recession.**

**Reality: Defined benefit plans in the public and private sectors are designed specifically to better withstand economic downturns.**

The idea behind defined benefit plans is to pool everyone’s risk together. Plans accumulate surpluses during boom cycles and draw down those surpluses during recessions. It has become clear that defined benefit plans have not been allowed, by law, to accrue sufficient surpluses that would allow these plans to offset major recessions and declining returns on investment.

The recession has certainly caused some negative consequences to defined benefit plans, but these plans are still in a superior position to provide stable income to its participants during a down cycle relative to other retirement income

vehicles. RRSPs and DC schemes force each individual to take on investment risk entirely on their own. As such, many savers in DC schemes have seen the value of their pension accounts drop dramatically.

**Myth #4: The federal public service pension plan is rich relative to provincial public pension plans.**

**Reality: The plan is very similar to what is offered by most provinces.**

There is a significant variety between provincial plans, therefore broad conclusions on superiority or inferiority tend to be selective and pulled out of context.

For example, public sector workers in Nova Scotia can retire without penalty based on a rule of 80 (years of service plus age), and PEI has a pension formula that is based on a best three-year earnings average.

Focusing on contribution rates can also be misleading as an indicator of quality of pension plan. Current contribution rates are reflective of a number of factors including demography (ages, marital status, etc. of plan members), previous decisions related to funding (e.g. the federal government took out a \$30 billion surplus from the federal pension plans), performance of investments, and administrative costs (e.g. it probably costs PEI more per participant to run its plan because it has fewer members).

**Myth # 5: Most public sector workers retire at 55 on a full pension.**

**Reality: The majority of workers joining public sector pension schemes will retire near age 60 and they are paid nowhere near 70% of their salary.**

Many reports about pensions would lead you to believe that most public sector workers retire at the age of 55 on a full pension - 70% of their salary. In fact, this only applies to the very few people who work in the public service for thirty-five years or more. The age when public sector workers are eligible for an unreduced pension has always been 60.

The average annual pension received by retired public service workers in 2008 was \$23,422. For those who retired in 2008, the average annual pension received was \$33,519.

**Myth #6: The discrepancy between private and public sector pensions needs to be addressed by punishing the public sector.**

**Reality: We should level up pensions – not level them down.**

Many justify attacks on public sector pensions by the decline in the number and quality of private sector defined benefit pension plans.

Around 82% of public sector employees are members of an employer-sponsored pension plan, most of which are defined benefit plans. However, in the private sector 24% of employees are members of an employer-sponsored pension plan but only 17% of employees are active members of a defined benefit plan.

Private sector employees have been hit hard by employers' retreat from good pensions. But this does not justify punishing public sector workers. Two wrongs do not make a right.

Public sector pensions provide distinct advantages to lower-paid and average-paid members of the workforce. Well-paid private sector employees are likely to get a decent pension on top of their pay. The real difference between public and private sectors is among the low and average paid. The attack on public sector pensions may be wrapped up in rhetoric about fat-cat public servants, but it is really an attack on the lower-paid workers in the public sector.

**Myth #7: The private sector props up the public sector.**

**Reality: Canada depends on a strong public sector as well as a strong private sector.**

It is not a one-way street. It's actually a complex relationship between public and private sectors.

Without an effective public sector, the private sector would be far less productive. It directly benefits from the public sector through transportation and information infrastructure and an educated workforce, whose social and health and welfare needs are attended to by the public sector.

It is also true that all workers pay for everyone's retirement income in one way or another. Private sector pensions are paid for through the price we all pay for goods and services. Public sector pensions are partly funded by the taxes that pay for public sector salaries (which allow employees to make contributions) and fund government contributions.

In short, the private sector could not function without the public sector and vice versa. The public sector contributes significantly to our Gross Domestic Product (GDP) and it is entirely unfair to suggest that the public sector is any way a drain on the private sector.

Public sector pension plans also play an important economic role in other ways. For example, funded public pension funds provide billions of dollars worth of investment in the Canadian economy. Pensions are also an important element of the compensation package and an essential recruitment and retention tool to attract people to deliver our vital public services. In addition, they play an important role in ensuring individuals have a reasonable income in retirement. They are an effective way of encouraging saving for retirement among a large part of the workforce, particularly at times of turbulence and uncertainty.

## **Conclusion**

The economic crisis and the recent government deficit are being used by some as an excuse to attack public sector pensions. The key issue about pensions is ensuring every worker has access to a decent pension plan; about leveling up, not down. Public sector pension schemes are of good quality and this should be applauded. We need good pensions for all Canadians, not lower pensions and poverty in old age for all. Society depends on public services, delivered by public sector workers who work hard for decent pay and decent pensions.