What's Good for the Goose isn't Good for the Gander:

The need to Reduce Inequity between Public and Private Sector Pensions

Approved by the NLEC Board of Directors on March 23rd, 2012

The increasing growth of the unfunded liability for public sector pensions is becoming too large for taxpayers and business owners to foot the bill. Currently the Federal unfunded liability of public sector post retirement benefits sits at $227 billion, while provincially it is $5.08 billion, 66% of the total provincial net debt. Further, many private sector employees do not have a pension plan themselves and are forced to work later into their careers. Government must rectify this inequality and restore a balance. A public review on public sector pensions is needed to ensure these pensions are financially sustainable, fair and comparable to what private sector employees receive and do not negatively impact funding governments can put toward social programs.

The NLEC is recommending that these reviews should explore all options for pension reform including shifting away from *defined benefit (DB) to defined contribution pensions (DC)* for new employees, increasing the age of retirement to reflect the standard in the private sector and changing the pension compensation regime from the highest grossing years to a career average. These options will allow for more sustainability and a more accurate depiction of employee earnings.

Current State of Pensions

Increasing demographic and economic changes has lead to unsustainable pension systems in Canada. The unfunded liability in public sector pension plans is increasing at an alarming rate and is putting financial strains on an already burdened system.

Economic Uncertainty

Pension plans are vulnerable to economic changes which impacts the net gains associated with those pensions. When the economy is in a vulnerable position, the return on investment is reduced resulting in lower rates of return. In other words, when the economy is slow so too is the inability of these pensions to make money.

Age & Increasing Longevity of Retirees

As the first class of baby boomers is beginning to exit the workforce there will soon be a retirement influx. For example, the number of federal public sector retirees is growing at an increasing rate. With increasing numbers of retirees each year, the current system will become extensively burdened.

Year	Percentage of Total Workforce Retiring
2005 – 2006	***2.8***
2009 – 2010	***3.1%***
2013 – 2014	***3.4%***

Source: Treasury Board of Canada Secretariat

Further, as technological and medical advancements increase, so too does the quality and longevity of the lives of all individuals. Currently in Canada the life expectancy has risen to 82 years, comparable to just 72 in 1966. This means that retirees are living 10 years longer than was previously planned when most of these pensions were established. Pension reform is needed to help offset these changes burdening the pension system.

Defined benefit plans were historically used as a primary pension system in both the private and public sector. Due to the financial instability of these plans, the private sector began to shift away from this compensation scheme, while the public sector remained unchanged. Initially this was used in the public sector as an employment incentive for uncompetitive wages. While defined benefit pensions have remained common in the public sector, the private sector has shifted to a more stable pension plan; the defined contribution plan. Therefore, public sector pensions should be changed in order to bridge the gap between the sectors.

Defined benefit pension plans (DB) function by giving each retiree a monthly benefit that is based on a funding formula, rather than a return on investment. This formula is based on the years of service contributed and the employee's earnings history. This earnings history is typically either the final salary upon retirement or the gross average of the employees highest 3 or 5 years of service.

Defined contribution pension plans (DC) operate on specific annual contributions by employers and employees. Individual accounts are established and benefits are calculated through money credited into each account. This money is then invested and any gains are credited to the individuals account. Therefore, the only guarantee in this plan is the money contributed, not the return on investment.

Within recent years, many private sector companies have made the switch to DC pension plans, due to the high costs and unfunded liability risks associated with funding the plan. However, the public sector has increased the enrollment in its defined benefit plans by 15.7% since 2005. DB pension plans are unsustainable at best and as more public sector workers join, the unfunded liability will intensify.

Private Versus Public Sector **Canada**			
Defined Benefits	**2005**	**2010**	**% Change**
Public	2,456,280	2,841,155	15.7%
Private	2,149,321	1,687,904	- 12.5%
Defined Contributions	**2005**	**2010**	**% Change**
Public	152,828	143,364	- 6.2%
Private	733,012	818,481	- 11.2%
Labour Force	**2005**	**2010**	**% Change**
	17,342,600	17,338,700	< 0%

Source: Statistics Canada

The average age of retirement is another disparity helping to widen the gap between these sectors. The average retirement age in the private sector is 65, compared to 58 in the public sector. As a result, public sector employees will receive 7 extra years of pension benefits, furthering the financial burden on an already strained system.

Changing the Sustainability of the System

There is a global urgency to address these underfunded pension systems. These pensions are financially unsustainable and can barely compensate current beneficiaries. How can an already burdened system accommodate an influx of baby boomer retirees? Further, why should taxpayers have to fund such a lucrative pension system, when 60% of them do not even have one? With unfunded liabilities at an all time high it is taxpayer dollars that will be used to balance this debt. As stated previously, the unfunded liability for the federal public sector currently sits at $227 billion, while the public sector of Newfoundland is $5.08 billion. Should tax dollars go to fund these pensions, resulting in less money for social programs that benefit society in its entirety? Pension reform must occur out of pure mathematical necessity.

Recommendations for Change:

1. **Shift away from the Defined Benefit pension to a Defined Contribution pension for new hires.**
2. **Change the calculation of compensation.**
3. **Increase retirement ages/Remove early retirement incentives.**

Shift away from the defined benefit pension to a defined contribution pension for new hires.

This shift will reduce the high unfunded liability in public sector pensions. All new public sector employees would receive defined contribution pension plans, with both the employee and employer having an equal contribution rate. Existing employees should have the option to change from a DB to a DC pension plan, allowing them to administer their own pension and investment options.

Change the calculation of compensation.

Currently defined benefit pensions in the public sector are based on either a final salary scheme or the average of the employee's best 3-5 years of service. Under defined benefit plans in the private sector, employees typically receive a benefit based on their career average. Therefore, in order to close the gap and reduce liabilities, public sector pension plans should be calculated to reflect the employee's career average.

Remove early retirement incentives.

As stated previously, life expectancy is increasing and coupled with global market instability, workers in the private sector have to work beyond age 65. By comparison, the average retirement age of a public sector employee is 58. Therefore, the standard for retirement should reflect the standard set by the private sector. Taxpayers should not have to fund a system, which allow public sector employees the ability option of retiring 7 years earlier.

Reliance on the status quo has lead to the disastrous growth of the unfunded liabilities for public sector pensions. Changes must occur to alleviate the financial burden on taxpayers, who struggle to fund their own retirements. Antiquated DB pensions must be phased out in order for cost effective DC pensions to successfully manage this unfunded liability. Coupled with increasing the retirement age and changing the compensation regime to reflect career average salaries, these proactive measures will bring this erroneous system back to a funded position.