EXECUTIVE SUMMARY

Risk and Reward in Public Sector Pension Plans: A Taxpayer's Perspective

by Malcolm Hamilton and Philip Cross

The most striking feature of Canada's retirement system is arguably the large and growing gap between pensions in the public and private sectors. Eighty percent of public sector workers participate in defined benefit (DB) pension plans. Only ten percent of private sector workers can make the same claim.

With the collapse of interest rates in the early 2000s, DB plans became prohibitively expensive in the private sector, yet they flourished in the public sector. If private sector employers can no longer afford even modest DB plans, how can public sector employers afford much more expensive plans—plans with larger pensions, earlier retirement, and full inflation protection?

Canada's public sector DB plans frequently attribute their success to the "Canadian Pension Model." A recent World Bank study identifies superior governance, economies of scale, innovative investment practice, responsible funding, and visionary leadership as important features of this model.

Without disputing the virtues of the Canadian Pension Model, we attribute the success of Canada's public sector DB plans to large public subsidies made possible by practices that are neither admirable nor virtuous: bad accounting, poor governance, imprudent risk taking, and inadequate financial disclosure. Responsibility for these failings lies not with the pension boards who administer the plans but with the employers who sponsor them. These employers, usually governments, fail to represent the public interest when it conflicts with the interests of their employees.

The narrative advanced by Canada's public sector DB plans raises a perplexing question. If innovative investment strategies abetted by good governance explain their success, why don't private sector employers adopt the Canadian Pension Model and provide comparable pensions to their employees? Our answer is that Canada's public sector DB plans do things that private sector DB plans are prevented from doing for good reason. In particular, public sector accounting standards allow public sector employers to materially misrepresent the cost of their pension plans. Private sector employers are prevented by private sector accounting standards from doing the same thing.

Taking investment risk is a legitimate tactic provided that those who bear the risk also reap the reward. This is not what happens in Canada's public sector DB plans. Consider the plans covering employees of the federal government. Plan members, whose interests are ably represented by powerful public sector unions, are handsomely rewarded for investment risk taken by their pension plans and borne by the public. The public, whose interests are poorly represented by the federal government, receives no reward for bearing this risk.

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Public sector DB plans cite their independence from government as a key to their success. We argue that this independence is a flaw, not a virtue, of public sector pension governance. The plans take investment risk to advance the interests of plan members while the interests of taxpayers, who ultimately bear this risk, are ignored. These practices are best described as moral hazard, not good governance.

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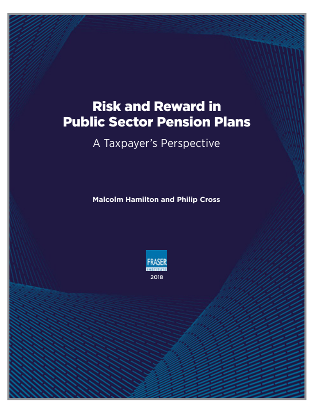
This paper questions whether Canada's public sector pension plans have discovered a formula that makes them a model for the world to emulate. The exceptional feature of Canada's public sector DB plans is not "world-beating" investment strategies or good governance. It is the ability to enrich public employees by shifting large, undisclosed investment risks to taxpayers without fair compensation. By our estimate, this provides an unacknowledged $22 billion annual subsidy to Canada's public sector DB plans and, ultimately, to the members of these plans. This large public subsidy, not the virtues of the Canadian Pension Model, explains the plans' success. Without it, public sector DB plans would be no more viable than private sector DB plans.



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