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Solutions for Municipal Pension Plans

by Youri Chassin

The pension plans of municipal employees across the province of Quebec face deficits totalling $3.9 billion.[1] For certain municipalities, pension plan contributions have exploded over the past few years (see Figure 1). The Quebec government recently introduced a bill whose purpose is to ensure the sustainability of these plans, but which does not call into question their underlying principles. This *Economic Note* explores the causes of municipal pension plan deficits and proposes solutions that are missing from the current debate and whose aim is to prevent future deficits and save taxpayers from having to shoulder the burden.

Like many other public sector entities, municipalities provide defined benefit pension plans for their employees. The income received by a retiree is calculated based on the number of years of service and the salary earned during the best years of his or her working life. Employees and employers contribute to a pension fund in order to capitalize it, that is, to accumulate enough money to cover all future financial obligations to retirees.

If pension plans are undercapitalized, due for instance to the poor returns earned by various investments, an unfunded actuarial liability is created. This expression refers to the fact that there exists an imbalance between the sums accumulated and future pension plan obligations. The hypotheses of actuaries regarding future returns, longevity, inflation, salaries before retirement and retirement ages produce estimates of the amounts that will be needed to honour commitments to retirees. With most defined benefit plans, employers are solely responsible for reducing such unfunded liabilities until those plans are fully funded.

Three Factors Explain Unfunded Liabilities

Defined benefit pension plan deficits, including those of Quebec municipalities, can be explained by three phenomena that were underestimated: increasing life expectancy, the drop in rates of return and the generosity of plans.

1. Over the past thirty years, life expectancy at age 65 for Quebec women has increased by 3.3 years, from 18.8 to 22.1 years, while for men it has grown by 5 years, from 14.2 to 19.2 years[2] (see Figure 2). For defined benefit pension plans, this faster than anticipated increase in longevity puts upward pressure on costs, as benefits must be paid out for longer.

The problem is exacerbated by the fact that some plans allow employees to retire as of age 55, and even sooner for certain trade groups like firefighters and police officers. With increasing life expectancy, retiring so young means that one's retirement sometimes lasts longer than one's working life on the labour market.

This *Economic Note* was prepared by **Youri Chassin**, Economist and Research Director at the Montreal Economic Institute who holds a master's degree in economics (Université de Montréal).

2. The recent drop in financial market rates of return, due among other things to the financial crisis of 2008 and the low interest rates favoured by central bank policies since then, was not predicted by actuarial projections.[3] This likely encouraged the use of more optimistic returns hypotheses and/or the use of surpluses to make plans more generous.[4]

3. The generosity of plans has grown over time. For example, in addition to the fact that defined benefit plans by their very nature guarantee an annual income and often make employers bear all of the risk of poor returns, other additional benefits include:

- early retirement benefits often without penalty, thus fully subsidized;
- the calculation of benefits based on the best-paid years;
- full indexation of pensions to the consumer price index.

Bill 3 and the Two Sides of the Debate

Because the sustainability of municipal plans in their current form cannot be guaranteed, the Quebec government introduced Bill 3, which among other things imposes the sharing of past and future liabilities with employees and caps the cost of the plans for municipalities at 18% of payroll (which is equivalent to the RRSP contribution limit).[5]

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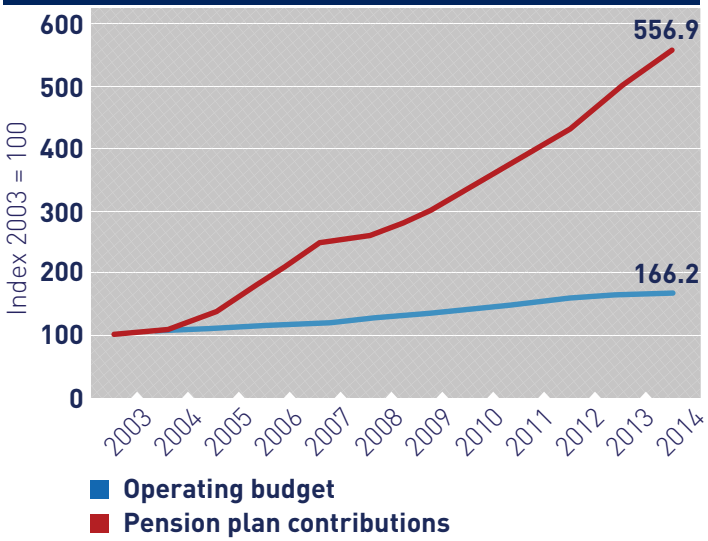
For its part, the coalition of unions wants the sharing of contributions between cities and employees to be the result of a "free negotiation" as was the case previously, instead of being imposed, and wants this to be applied only once current collective agreements have expired. It is also requesting that the bill not apply to plans whose capitalization rates are above 85%,[6] and that the cost of pension plans not be capped at 18% of payroll.

Figure 1 — Growth of Quebec City's contributions to employee pension plans



Source: Ville de Québec, *Budget 2014*, pp. 129, 131.

Furthermore, the clause imposing an equal sharing of responsibility for past deficits has antagonized the unions because it entails the reopening of already signed agreements. This argument has merit since respect for contracts is one of the pillars of a society based on the rule of law.[7] We can, however, respect existing commitments without these being considered future entitlements.

The reform put forward in Bill 3 certainly reduces the cost of municipal plans for taxpayers, but it does not protect them from another crisis resulting from disappointing returns or a greater than anticipated increase in longevity. It is possible, however, to imagine solutions that have the advantage of gradually requiring taxpayers to bear less risk without retroactively reneging on past agreements.

Adopting Defined Contribution Plans

A first step would be to revise the current form of the plans. Employees would receive defined benefits for the commitments made until now, thus respecting their signed contracts. At a predetermined date (when it comes time to renew their collective agreements, for example), the "new" part would become a defined contribution plan, which is to say that contribution amounts would be set in advance, but not the level of retirement income, which would then depend on yields.

All employees, existing and newly hired after that date, would be treated the same way and be covered solely by defined contribution plans, thereby respecting the principle of intergenerational equity.

In other words, current retirees would not be affected whatsoever by these changes. New employees would be entirely covered by the defined contribution plan. As for employees on the job when the reform comes into effect, they would have two plans: a defined benefit plan for the years worked until the date of the change, and a defined contribution plan for subsequent years.[8]

Nor is this kind of reform without precedent. Indeed, certain governments elsewhere in North America, including those of Rhode Island and New Brunswick,[9] have adopted reforms relying more on defined contributions or having contributors pay higher premiums in order to better share the risks. In the case of Rhode Island, the reform not only safeguarded retirement incomes and jobs, but also allowed municipalities to save an estimated US$100 million in 2013.[10] Aware of the urgent need for action, the great majority of the population supported the reform.[11]

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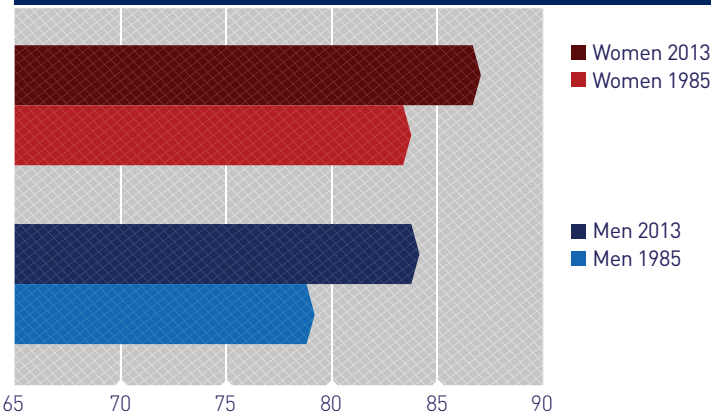
Some contributors prefer to have the guaranteed pension benefits of a defined benefit plan, which is understandable. They could always obtain this guarantee through the purchase of life annuities from a financial institution, perhaps through an organized group, for example under the auspices of their union, and following whatever management principles they like. They could then continue to benefit from a predictable income, but would take on the risk themselves instead of passing it on to taxpayers.

Adjusting to Increasing Life Expectancy

Municipal employees sometimes spend more time in retirement than on the labour market. Consequently, the second reform, which complements the first, would consist of revising the normal retirement age, which is to say the age at which a worker can retire with a full pension, and then indexing this age as a function of increasing life expectancy.[12] Today's workers are in better health and can keep working longer. Even police officers and firefighters close to retirement can carry out less physically demanding tasks (prevention, office work, etc.).

Figure 2 — Changes in life expectancy at retirement (age 65)



Source: Institut de la statistique du Québec, Espérance de vie à la naissance et à 65 ans selon le sexe, Québec, 1975-1977 à 2013.

The retirement age should be gradually raised in order to rebalance working life and retirement periods so that on average, people would work two years for each year of retirement. It will then be important to establish an automatic indexation formula for the normal retirement age as a function of the increasing life expectancy of Quebecers so as to divide longevity gains proportionally between retirement and working life.

In several countries, the movement toward the automatic indexation of the retirement age as a function of increasing life expectancy has already begun. The European Commission recently proposed such a reform to its member states, some of which have already adopted it. The United Kingdom is also considering it, based on the principle according to which it is important to maintain a ratio of two years worked for each year of retirement in order to re-establish actuarial balance in public sector employees' pension plans.[13]

This approach avoids the uncontrolled growth of expenditures for cities and their taxpayers, avoids sudden hikes in the normal retirement age, and ensures the viability of pension

plans and the security of retirement income for employees and retirees. This solution also has the advantage of depoliticizing the establishment of the retirement age.

Conclusion

The adjustments proposed above would allow us to tackle the problem of pension plan liabilities while at the same time respecting the agreements that were signed and the ability of taxpayers to pay. Municipal employees would continue to enjoy favourable salary conditions.[14] The passage from one plan to the other would certainly have transition costs, in particular a temporary increase in contributions for the youngest employees.[15] Nevertheless, the principle remains: These two solutions would ensure the sustainability of municipal pension plans, contrary to Bill 3.

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Finally, public pension plan deficits are not an issue just at the municipal level. These reforms should be applied to the other levels of Quebec's public sector, whose pension plans have unfunded liabilities that are even more of a cause for concern.

References

1. Régie des rentes du Québec, "Le projet de loi concernant les régimes de retraite du secteur municipal est présenté," Press release, June 12, 2014.
2. Of course, we must distinguish life expectancy at birth (which is the more commonly mentioned statistic) from life expectancy at age 65, which is the number of additional years that one can expect to live when one has reached the age of 65. This latter statistic necessarily gives a higher total since it excludes everyone who died before the age of 65. Its use is standard when it comes to analyzing the issue of retirement in the actuarial profession. Institut de la statistique du Québec, Espérance de vie à la naissance et à 65 ans selon le sexe, Québec, 1975-1977 à 2013.
3. Member Services Council, "Report on Canadian Economic Statistics 1924-2013," Canadian Institute of Actuaries, May 2014, p. 28.
4. It is true that certain municipalities took contribution holidays in the past, but these same municipalities spent even more absorbing deficits during bad years. Moreover, employees obtained improvements to their plans equivalent to the contribution holidays. On this topic, see Francis Vailles, "Le mythe des congés des patrons," *La Presse*, July 10, 2014.
5. This amount is 20% for police officers and firefighters. Modifications to the bill have made this cap more flexible. Bill 3: An Act to foster the financial health and sustainability of municipal defined benefit pension plans, Introduced by Mr. Pierre Moreau, Minister of Municipal Affairs and Land Occupancy, Quebec Official Publisher, 2014.
6. A report prepared by the French CBC shows that out of 154 municipal pension plans affected by the bill, 70 have capitalization rates above 85%. See "Les régimes de retraite ne sont pas tous mal en point," Radio-Canada, August 11, 2014.
7. See in this regard Michel Kelly-Gagnon, "Lettre à mes amis qui appuient le projet de loi 3," *La Presse*, September 18, 2014.
8. Obviously, for current employees, retirement income from defined benefit plans would be calculated based on the best years preceding the reform instead of the best years of their entire careers, which means this income will be less generous.
9. Pensions and Employee Benefits Division, Department of Human Resources, New Brunswick, *Public Service Shared Risk Plan: A Guide for Plan Members*, June 2014.
10. State of Rhode Island, Office of The General Treasurer, "Local Pension Plans."
11. Allysia Finley, "The trial of a democratic pension reformer," *The Wall Street Journal*, September 4, 2014.
12. Note that in many countries including the United States, Great Britain and Germany, plans are moving toward retirement ages of 67 or more. Also, Canada recently increased the age of eligibility for the old age pension from 65 to 67. OECD, *Pensions at a Glance 2013: OECD and G20 Indicators*, 2013.
13. See among others: Iain Duncan Smith and Steve Webb, "Reviewing the State Pension Age," Department for Work and Pensions, Government of the United Kingdom, December 5, 2013.
14. Indeed, according to the Institut de la statistique du Québec, municipal employees are better paid than the Quebec civil service for similar jobs. Institut de la statistique du Québec, *Rémunération des salariés. État et évolution comparés, 2013*, 2013, p. 122.
15. In defined benefit plans, young employees generally pay lower contribution rates than their older colleagues, while contributions are the same across the board for employees in determined contribution plans.

910 Peel Street, Suite 600
Montreal (Quebec) H3C 2H8, Canada
Telephone: 514-273-0969
Fax: 514-273-2581
Website: www.iedm.org

Illustration: Ygreck