Montreal Economic Institute
Ideas for a More Prosperous Nation

ECONOMIC NOTE

March 2010

Are Public Sector Pension Plans Too Generous?

Supplemental pension plans provided by employers are a key fringe benefit to bear in mind when looking at overall compensation. In the private sector, pension plans have been going through a financing crisis in recent years. In the Quebec public sector, on the other hand, the government's ability to pay is not at issue, and pension plans remain very generous. With negotiations under way between the government and the "Common Front" of public sector unions, there is reason to look into this matter and to ask if public sector pension plans are too generous compared to those in the private sector, taking account of taxpayers' ability to pay.

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The cost of retirement

Before answering this question, we will look briefly at what retirement costs. How much must someone have on hand to retire comfortably? How much should we save each year?

To determine the cost of retirement, we first have to know the amount of revenue a person will need upon retirement. This depends both on pre-retirement income and on the desired standard of living. A common rule of thumb is that revenue equal to 70% of pre-retirement income will enable a person to enjoy the same standard of living after retirement.

Without public pension plans, a person earning the average annual wage (approximately $40,000 in Quebec in 2009) would have to accumulate amounts easily surpassing a million dollars, requiring more than 15% in annual contributions over the person's entire career in order for him to retire at age 60.

Compulsory contributions to public plans reduce the amounts that individuals have to put aside. The federal old-age security pension, available starting at age 65, provided $6,200 a year in 2009. Payments under the Quebec Pension Plan are available starting at age 60 for those who so desire and who agree to accept reduced amounts. The maximum amount payable in 2009 at age 60 was $7,634 per year.

It is thus necessary to have other sources of income after retirement. Employer-sponsored supplemental pension plans may be a substantial source of income. But they vary greatly depending on the employer (according to size, area of activity, etc.).

How pension plans have evolved

There exist two major categories of pension plan, with very different means of financing. On the one hand, defined benefit pension plans establish the retirement income pledged to participants in advance, based on a specific formula. Most of the time, the employer assumes the financial risk that this type of plan involves.

On the other hand, defined contribution plans do not set the amount pledged in advance. Contributions from employees and employers are determined by negotiation, and the income provided depends on the returns from the amounts invested. In these instances, employees assume a plan's entire financial risk since the income level is not guaranteed.

Pension plans have evolved very differently in the private and public sectors since the 1960s. Defined benefit pension plans, found in most large private sector companies in the early 1960s, are in the process of disappearing, either because they are being ended or because they are closed to new participants, who are offered defined contribution plans.

Meanwhile, in the public sector, defined benefit plans are increasing their coverage. The Quebec government recently established a defined benefit retirement plan for childcare workers as well as for ambulance technicians.

According to a recent Régie des rentes du Québec study,[1] coverage of public sector employees stands at 99% and, apart from some municipal employees, they all benefit from defined benefit retirement plans, in other words the type where it is the employer – meaning the government – rather than employees who take on most of the risk.

The proportion of private sector employees covered by supplemental pension plans is barely 25%.[2] This proportion rises to 44% if we add people participating in group RRSPs or deferred profit-sharing plans, which are defined contribution plans.

It is obvious that public sector employees are a favoured group in terms of retirement plan coverage compared to private sector employees, with far fewer of the latter benefiting from coverage. But are public sector employees favoured to the same extent when it comes to the income they will be getting from these plans?

The advantages of the government employees' plan

In Quebec, the Government and Public Employees' Retirement Plan (*Régime de retraite des employés du gouvernement et des organismes publics*, or RREGOP) is the sort of pension plan everyone dreams about. Here are its main attributes:

- Benefits equal to 2% of average annual salary in the five best years, per year of service;
- Early retirement starting at age 60, or at age 55 after 35 years' service;
- Coordinated with the Quebec Pension Plan starting at age 65;
- Income indexed to 50% of inflation or inflation minus 3%, whichever is higher;
- 50% income for a surviving spouse, with no reduction in pension benefits.

A person covered under this plan who works from age 25 to age 60 will have 35 years' service and will receive 70% of his average salary during his best five years. How much is this worth? We did an actuarial projection to determine its value.

Our civil servant will be earning $164,170 at the end of his career.[3] He will have a five-year final average salary of

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1. Régie des rentes du Québec, *Portrait du marché de la retraite au Québec*, December 2008 (available in French only), p. 48. This proportion includes employees in the Quebec and federal public and para-public sectors as well as employers of municipalities, universities, childcare centres and government-owned corporations.
2. *Id.*, p. 49.
3. Although this amount may look very high today, it must be understood that, because of inflation, purchasing power in 30 years will not be the same as it is today. In any event, absolute amounts are not important for purposes of comparison. What really counts are the proportions.

$153,941. This will entitle him to a pension of $107,759 per year starting on his 60th birthday. Upon his death, his spouse will receive 50% of this amount, which will be indexed to 50% of inflation both for him and his spouse.

The capital required at age 60 to guarantee payment of this pension is $1,467,280.

How is our private sector worker doing? To compare, we have used the most favourable scenario. This assumes the best possible retirement plan for private sector workers, with a plan identical to the government employees' plan as our hypothesis. Of course, as we have seen, this scenario is not realistic; the private sector worker will almost systematically be in a less favourable situation in real life.

Thanks to job security, public sector employees are able to get the full benefit of their defined benefit pension plan, which is not the case for private sector employees, even with an identical plan.

We have given the hypothetical private sector worker the same salary as his public sector counterpart. However, since the private sector worker does not have the same job security, we have hypothesized that he will have three employers during his career. He will work 10 years for the first employer, 15 years for the second one, and 10 years for the last one. All three employers provide a retirement plan identical to the government employees' plan. Is our private sector worker really doing very well? Less than the public sector worker, in spite of everything.

The total value of his three retirement plans is $1,040,484. The value of the public sector worker's plan is thus 41% higher. To make up for this loss, the private sector worker must contribute 5% of his salary throughout his career in addition to the assumed 6% contribution to his retirement plan. Very few people in Quebec save 11% of their salaries for retirement.

The job security that many public sector employees enjoy makes all the difference. The five best years providing the basis for the pension are those late in their careers, when their salaries are at their peak. In contrast, the salaries for the five best years in the three different jobs held by the private sector worker are necessarily lower. This reality means that public sector employees are able to get the full benefit of their defined benefit pension plan, which is not the case for private sector employees, even with an identical plan.

Public sector retirement plans are much more generous than private sector plans from every standpoint. This situation is unfair to private sector taxpayers, who in a sense are paying for the generous public sector plans while being denied similar advantages themselves.

How can balance be re-established?

At a minimum, the government must always take account of the generosity of retirement plans in its negotiations with public sector workers. The Common Front of unions normally mentions only the wage lag of public sector employees in its arguments.[4] According to a recent study from the Institut de la statistique du Québec, although employees of Quebec's public administration have a 6% wage lag compared to private sector workers, they are ahead by 3.6% in terms of overall compensation, including employer contributions to the retirement plan.[5]

Any comparison should also consider that public sector employees have working conditions that enable them to be part of the same pension plan throughout their careers while private sector workers are more likely to have several jobs during their careers.

4. See, for example, this news item on the site of the FTQ (Quebec Federation of Labour): *Négociation secteurs public et parapublic – Le Front commun en tournée partout au Québec*, October 13, 2009.
5. Institut de la statistique du Québec, *Rémunération des salariés. État et évolution comparés 2009 – Faits saillants*, 2009, p. 3.

In the long term, the government should consider the possibility of reviewing provisions in its employee retirement plan to bring down its costs and to make it more comparable to retirement plans provided by the private sector.

There are signs on the horizon of proposals to establish a compulsory supplemental retirement plan for all employers. An employer would be required to make minimum payments into this plan if it does not provide an "equivalent" plan.

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The government should not move in that direction. A compulsory plan would raise payroll taxes that are already too high and that damage the competitiveness of Quebec companies. Establishment of a supplemental pension plan should be left to employers' discretion based on the form of overall compensation they see as most appropriate for attracting and retaining employees

Creating a new retirement savings vehicle would not improve the situation, either. The great majority of workers are not using current plans to the maximum and have plenty of unused space in their RRSP limits. Creating a favourable climate for wealth creation is what can ensure that more of this wealth can be set aside in retirement savings on a voluntary basis.

There is no magic solution. Private sector workers must ensure that they have a retirement savings plan that will let them maintain their standard of living upon retirement. They alone are responsible for the level and security of their income when they retire. By contrast, most public sector employees will never have to worry about income security in their retirement years. This flagrant imbalance must be recognized by the government and taken into account when public sector employees' working conditions are being negotiated.

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The MEI is the product of a collaborative effort between entrepreneurs, academics and economists. It does not accept any government funding.

Printed in Canada

Illustration:
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Graphic Design:
Valna inc.