Intelligence MEMOS

From: William B.P. Robson

To: Canadian Taxpayers

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Re: **OTTAWA COMES PART-WAY CLEAN ON ITS PENSIONS**

The federal government just released its financial results for the 2017/18 fiscal year, showing a deficit that was worse, and debt that was higher, than anticipated in the 2017 budget. That looks like bad news, and it is. More debt is a bad thing.

Read Ottawa's annual report itself, however, and you will see that about $1 billion of the larger reported deficit, and about $20 billion of the larger reported debt, reflecta more realistic measurement of the value of the pensions for federal employees. We are now seeing a liability that was previously hidden. More transparent reporting is a good thing. And even more of it would give Canadians further valuable information about the true costs of the federal government, and some of the bills they will have to pay in the future.

Pensions often figure in corporate financial disasters – think Stelco, Nortel and Sears – and are emerging as a big problem in the public sector as well – think of the bankruptcies of US cities such as Stockton, Vallejo and Detroit. A major reason for these nasty surprises is that pensions, like other deferred compensation, will be paid in the future. A dollar paid in the present is obviously worth a dollar, whereas a dollar that will be paid in the future is worth less than that, and how much less depends on what discount rate is used. All too often, the people who ought to be reporting meaningful estimates of that future value yield to the temptation to use a high discount rate to shrink its value. Doing that makes the liability of the future payments look smaller, exaggerating the pension sponsor's net worth, and making current compensation look cheaper, boosting the annual bottom line.

The justification for using these high discount rates is typically that pension promises are backed by assets, and that assets will earn whatever return the people putting the financial statements together assume. But a pension promise like Ottawa's is unconditional: it is like any other government debt, and the appropriate discount rate to use in valuing those promises is the yield on similar federal government debt.

As Alex Laurin and I pointed out earlier this year, using bond yields to value federal pensions showed that the unfunded pension liability in Ottawa's 2016/17 financial statements should not have been the $150 billion reported, but at least $246 billion. And the value of pension benefits accrued by federal employees that year was more than double what showed in Ottawa's expenses. The changes to this year's financial statements bring part of that understatement to light.

The real bad news is not the bumps to the deficit in 2017/18 and the higher debt. It is that Ottawa did not go far enough. The federal government's pension plans were all unfunded until 2000. The plans for members of Parliament and judges are still totally unfunded, but the plans for public servants, the Canadian Forces and the RCMP have accumulated some assets since then. The government has only applied bond yields to the pension promises before 2000. It continues to use an assumed rate of return on assets that, in underfunded pension plans, may not even exist, to shrink the reported value of pension promises accrued since 2000. If it had followed the logic of valuing promises like other government debt all the way, the deficit and debt numbers in the 2017/18 financial statements would have been many billions worse.

The good news for Canadian taxpayers is that they now have more of the picture of the commitments Ottawa is making on their behalf, and how much of the bill will come due in the future. This is a step forward for transparency. A key task that remains is to demand that the government come clean on the value of all its pension promises. We now see part of the previously hidden costs of federal employee pensions. It is time to see them all.

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