Executive summary

What would be the impacts and implications of converting many of Canada's major public sector pension plans from their current arrangements into individually controlled *defined contribution* (DC) *plans*? This is a worthwhile question to ask because several provincial-level political parties and a few policy advocates have been calling for a wholesale conversion of public sector pension plans to DC arrangements.

Fortunately there is considerable experience and evidence from other jurisdictions and a deep body of theory and literature that can help us anticipate the likely consequences of such a conversion. This paper draws from the literature and theory to anticipate issues and implications that would arise from converting major pension systems to DC. It also reviews the experience and history in other jurisdictions where large public sector pension plans have been converted to DC and in other jurisdictions that investigated converting to DC but then rejected the idea.

Finally the study models the potential quantitative impacts of converting a fairly typical large jointly sponsored public sector pension plan with primarily defined benefit (DB) pension arrangements to a DC structure. It is widely recognized within the pension industry that DC pension plans are less efficient generators of pension income than are DB arrangements or other pension design alternatives. The purpose of our modelling segment is to provide a salient demonstration of the cost and benefit implications of this reduced efficiency that is associated with DC pension plans.

Throughout the analysis we strive to keep in mind the broad array of stakeholders affected by public sector pension plans including: public sector employers and governments, employees and their dependants, taxpayers, future generations and society at large. All five of these stakeholder groups benefit from efficiency in a pension system; that is, the ability to squeeze the most benefits from a given level of contributions. The harder the money works, the easier it is for everyone involved.

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The conclusions of the study are as follows:

1. The perceived advantages to closing DB pension plans in the private sector do not translate directly into the public sector. While the shareholders of private corporations are primarily focused on profits, the shareholders of public corporations have other needs to consider.

   While private corporations are able to off-load costs without being concerned about who has to pick them up, public sector employers who off-load costs in many cases are off-loading costs that have to be picked up in some other form by their shareholders, i.e., governments and ultimately taxpayers. Canadians unable to save enough directly or through workplace pensions while they are working become a burden in retirement for taxpayers.

2. Several U.S. states that have looked at converting DB plans to DC have concluded that it would cost considerably more to maintain similar benefits. Two states that had converted to DC at least partially converted back because of concerns over how little income they were producing for retirees (Nebraska and West Virginia).

A DC plan can be designed that will be better than most of those existing in Canada today, but experience and modelling show that it will still be a more expensive way of producing retirement income than a large, well-run DB plan. This would also require changes to the tax laws and most provincial pension legislation.

3. Our modelling has shown us that for an efficient $10-billion DB plan, converting to individual-account DC arrangements to provide the same value of pension benefit would increase the ongoing cost of the plan by about 77 per cent and increase the required contribution rates accordingly. The portion of the final benefit coming from investment returns would drop from 75 per cent to 45 per cent. Using a pooled DC pension arrangement would still increase the plans costs substantially but the ongoing cost increase for the new DC plan would be reduced from 77 per cent to 26 per cent.

4. In addition to bearing perpetually increased costs for the new DC plan, the post-transition plan sponsor (often government) would face an increase in financial risk coming from the closed DB plan that would run parallel to the new DC plan for many decades. Over the first few decades, while these increased risks would be large, government could choose to bear higher costs for the closed DB plan rather than higher risks. This could be achieved by partially de-risking the closed plan's investment portfolio, but doing so would increase the cost of running the closed plan by about 38 per cent for those first few decades after the transition.

5. If the motivation for a conversion to DC is to reduce costs, then it should be noted that shifting to DC actually increases the cost of delivering a comparable pension benefit.[1]

6. If the motivation for a conversion to DC is to reduce the government's exposure to the financial risks associated with sponsorship of the pension plan, then it should be noted that other plan design options are available for reducing or transferring risk that do not require sacrificing the plan's investment efficiency. Many of Canada's large public sector plans have already employed features such as joint sponsorship and/or contingency of non-core benefits in order to share and reduce risk. From this starting point, governments cannot benefit a second time by shifting again risks that have already been transferred to members. It is not clear that many Canadians appreciate this evolution.

7. If the motivation for a conversion to DC is to address an existing unfunded liability, then it should be noted that converting to DC does nothing to address the past-service unfunded liability that a plan may have accumulated. Converting to DC makes the management of a legacy-unfunded liability more risky and difficult. It also does not freeze the existing liability. In several of the cases that we examined, the past-service unfunded liability continued to grow for decades after the conversion. Ultimately, a conversion to DC will lead to a situation where the past unfunded liabilities have been extinguished and no new unfunded liabilities can be created. However, it would typically take about a century to get to that state. Extra costs and risks would be borne in the interval and the extra costs associated with the loss of investment efficiency would go on as long as the DC plan exists.

1 See Appendix 3, sections on Nebraska or West Virgina for examples