

THE REALITIES OF ONTARIO'S PUBLIC SECTOR COMPENSATION



The Institute for Competitiveness & Prosperity is an independent not-for-profit organization established in 2001 to serve as the research arm of Ontario's Task Force on Competitiveness, Productivity and Economic Progress.

The mandate of the Task Force, announced in the April 2001 Speech from the Throne, is to measure and monitor Ontario's competitiveness, productivity, and economic progress compared to other provinces and US states and to report to the public on a regular basis. In the 2004 Budget, the Government asked the Task Force to incorporate innovation and commercialization issues in its mandate.

Research by the Institute is intended to inform the work of the Task Force and to raise public awareness and stimulate debate on a range of issues related to competitiveness and prosperity. It is the aspiration of the Task Force and the Institute to have a significant influence in increasing Ontario's and Canada's competitiveness, productivity, and capacity for innovation. We believe this will help ensure continued success in creating good jobs, increasing prosperity, and building a higher quality of life. We seek breakthrough findings from our research and propose significant innovations in public policy to stimulate businesses, governments, and educational institutions to take action.

Comments on this report are welcome and should be directed to the Institute for Competitiveness & Prosperity. The Institute is funded by the Government of Ontario through the Ministry of Economic Development, Trade and Employment.

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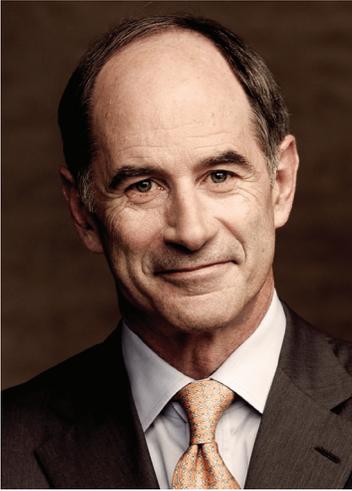
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I AM PLEASED TO PRESENT WORKING PAPER 19 of the Institute for Competitiveness & Prosperity. As the Ontario Legislature prepares for the presentation of the Budget, it is important to consider how public dollars are spent, especially as salaries form a significant part of government expenditures, and pensions are a long-term financial commitment. Therefore, in this Working Paper, we examine the differences in public and private sector compensation and the potential impact they have on government budgets.

The debate on this topic has been fraught with rhetoric, prone to hyperbole that often stokes compensation and pension envy. This is not particularly helpful. At some point the conversation needs to move from the inflammatory question “Can you believe that salary?” to the substantive questions: “What is an appropriate salary? What are we willing to pay?”

The Task Force decided it was time for us to look at this subject to get a better sense of what is happening in Ontario. This paper does not wish to judge whether compensation decisions were correct or incorrect, but rather to bring them to light. It could be argued that the labour peace and improved public services in areas like health care and education are a direct result of the compensation decisions. This paper aims to make sure those decisions are fully understood, with an eye to comparing what is happening in Ontario’s public sector to what is happening in the private sector and in other Canadian jurisdictions. The Task Force hopes that this paper begins an informed conversation on compensation and benefits into the public realm.

“It is important to consider how public dollars are spent, especially as salaries form a significant part of government expenditures and pensions are a long-term financial commitment.”

At the Institute, we struggled to find accessible information on pension levels and liability. As this issue is only growing in importance, we strongly recommend that this information become more transparent so thoughtful policy options can be considered. Policy making by anecdote, rather than fact, is folly.

The Institute gratefully acknowledges the ongoing funding support from the Ontario Ministry of Economic Development, Trade and Employment. We look forward to sharing and discussing our work and welcome your comments and suggestions.



Roger L. Martin

Institute for Competitiveness & Prosperity



THE REALITIES OF ONTARIO'S PUBLIC SECTOR COMPENSATION

AN OLD ADAGE THAT IS OFTEN THROWN AROUND IS: “You can make money or you can make a difference.” In the past, this seemed particularly true for those who chose to enter the public sector. There were four main components to the bargain made when entering the public service and the broader public service in hospitals and schools: You would make less money than you would in the private sector, but you would have more job security, generous pensions and benefits, and you would be directly serving the public interest.

OVER THE LAST TEN YEARS, the first component, the lower level of compensation, has changed, as wages and salaries have risen. Meanwhile, the aspects of job security and benefits and pension packages have become increasingly unique in a post-recession world. The result is that the overall compensation those in the public sector receive has come under greater critical scrutiny. Often, the criticism is heated and filled with anecdotes, rather than facts. Envy and anger seem to be at the core of some commentary, rather than an assessment of the rationale behind, and impact of, public sector compensation.

Our research shows that, over the last ten years, Ontario actually has been paying a “public wage premium.” Namely, the first component of the bargain described above, has flipped. Currently the cost of the public wage premium is over \$1 billion a year. As we dug deeper in to the facts, we found something even more interesting. Ontario is paying a public wage premium for those in clerical and administrative positions, but not for those in managerial or strategic positions when compared to the private sector. The result is that the public sector is attractive for an entry-level employee, but it may not be as attractive to those in senior decision making roles.

In addition, the Institute took a comprehensive look at the state of public sector pensions, including their impact on the provincial budget. As a result of a lack of data, this task proved difficult. We hope that this paper will be the launching pad for a greater sharing of information on this important fiscal, economic, and public policy issue.

RECOMMENDATIONS TO ADDRESS THE PUBLIC SECTOR PREMIUM IN ONTARIO



QUESTIONS

1

Is there a premium for working in the public sector that cannot be explained by workers' qualifications?

2

Are pension benefits more generous in the public sector than in the private sector?



FINDINGS

PUBLIC SECTOR WAGE PREMIUM

**+\$1
BILLION**

The public sector wage premium currently costs over \$1 billion.

5%

Ontario has a public sector wage premium of 5 percent, the largest premium among the four biggest provinces in Canada.

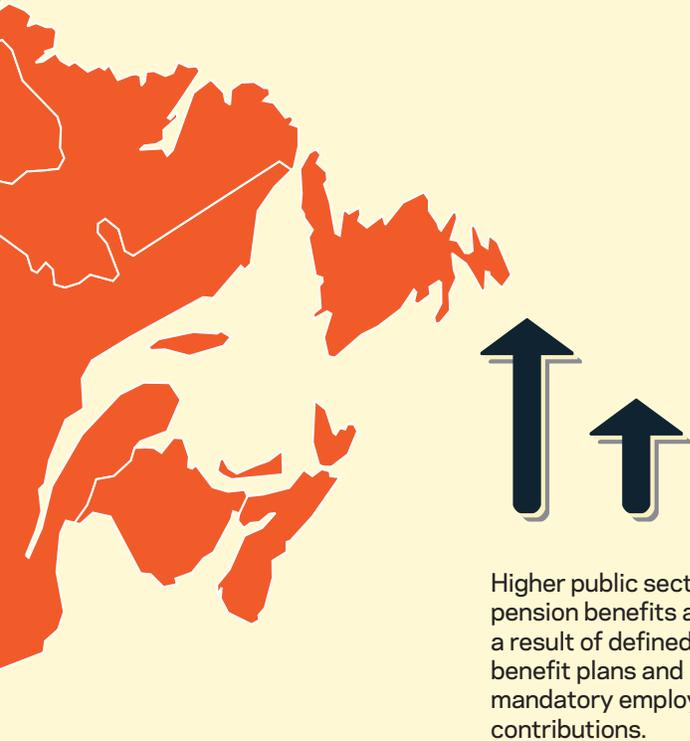


The public sector wage premium increased considerably over the past ten years for the four provinces, and Ontario experienced the highest growth from 1997-2012.

PUBLIC SECTOR PENSION PREMIUM

89%
— vs —
50%

Coverage ratio – the proportion of workers covered by registered pension plans (RPPs) – explains the difference in public and private plans for selected occupations.



\$\$\$ vs \$

The public sector wage premium differs across occupations: clerical and administration positions have a much higher premium than managerial positions.



RECOMMENDATIONS

- 1** Establish private sector comparators for public administration occupations.
- 2** Realign high and low ranked occupation compensation.
- 3** Emphasize the benefits enjoyed by public workers when negotiating with unions.
- 4** Split the burden of funding adjustments for defined benefit plans between employer and unions through union fees.
- 5** Improve pension mobility to encourage private sector pensions.
- 6** Cap government pension contributions to match employee contributions up to a maximum absolute value.



THE PUBLIC SECTOR COMPENSATION PREMIUM IS QUANTIFIABLE

THE INSTITUTE FOR COMPETITIVENESS & PROSPERITY'S Working Paper 16, *Making sense of public dollars*, showed that compensation of public workers, which includes both wages and pension benefits, represents roughly 50 percent of Ontario's provincial budget.¹ With constant efforts by policy makers to spend public dollars efficiently and the public's interest in identifying the effective use of public funds, it is reasonable to address questions about compensation levels in the public sector.

STORIES ABOUT generous pension plan arrangements and high wage levels in the public sector have emerged in the media recently, highlighting the need for a thorough and thoughtful analysis of the compensation packages offered to public sector workers.

Overall wages and salaries are a result of the bargaining process that occurs between employers and employees. But, in the practical hiring process, certain specific qualifications required by the position, such as ability to use spreadsheet software, affect the wage determination. In broader terms, some qualifications, such as education attainment, directly affect the wage levels that an individual can achieve. These can be called “wage-generating qualifications,” and they give rise to wage premiums – the extra wage, in percentage terms, derived from having a certain qualification as opposed to not having it. One common example is the premium for higher education attainment. Workers expect to get a higher wage for having a bachelor’s degree, and this extra wage is the premium.

These qualifications give rise to differences in wages, but the popular belief suggests that workers enjoy a premium simply by being employed by the government, directly or not, regardless of the other qualifications. This means part of the wage difference between public and private sector workers cannot be logically explained by wage-generating qualifications. The Institute’s objective is to quantify this premium, which we call the public sector wage premium, and determine whether this premium has been constant over time. Finding evidence of such a premium helps us quantify the extra cost to the government of holding wages above those found in the private sector.

The popular belief is that the premium is the result of the collective bargaining process. In fact, this Working Paper takes that result into account, so the premium is actually in addition to the negotiated wages and salaries. That premium is currently 5 percent.

Comparisons like this, however, are not new, and studies have shown that in Canada, apart from non-monetary compensation such as job stability, public employment also provides an inherent premium in monetary compensation. Two studies, using Canadian data, were the starting point for this analysis, and show that the average public wage premium was 6.2 and 8.6 percent for males and females respectively.² This public wage premium varies not only with gender, but also with government level. On average, federal employees had higher wages, but for male provincial employees, the premium was negative, meaning those public workers actually had compensation levels below those of their private sector counterparts. The studies also divided the data into income quartiles and found that the premium is higher at lower income levels.³ This finding is consistent with most studies using data from the United States.⁴

Although these studies, as well as other reports, present interesting findings, their analysis used Canada as whole. The disparity between Canadian provinces can create distortions in the data and the results. To overcome this possible issue, the Institute included data for only four provinces: Ontario, Alberta, British Columbia, and Québec. This was done because our focus is on the changes happening in Ontario, and the other provinces are the closest match to this province in population and economic activity. Another advantage of our study is that, while most of the papers used outdated information on wages, or did not have access to many years

of data, the Institute had access to detailed data from the Labour Force Survey from 1997 to 2012.

Despite the similarities of our results with those from other studies, this analysis uncovered important trends and patterns that can lead to significant impacts on public policy. The public wage premium in Ontario exists, but it is neither constant, nor longstanding. The premium changes considerably across occupations, something that other studies did not explore. In addition, the premium has increased considerably in last ten years and was practically non-existent and even negative in 1997.

The last part of this Working Paper compares pension benefits of private and public sector employees. Since the Canada Pension Plan (CPP) or Québec Pension Plan (QPP) rules are virtually the same for both sectors, we compared employer-sponsored plans, known as registered pension plans (RPPs). This part of the study was complicated by the lack of detailed data. Nevertheless, most of the differences between the sectors can be traced back to pension plan types and contribution regimes. The majority of the studies on pensions focus on either reforms to the Canadian Pension Plan/ Québec Pension Plan or evaluations

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- 1 Institute for Competitiveness & Prosperity, Working Paper 16, *Making sense of public dollars: Ontario government revenue, spending, and debt*, May 2013, p. 44.
 - 2 Morley Gunderson, “Earnings differentials between the public and private sectors,” *Canadian Journal of Economics*, 1979, Vol. 12, No. 2, pp. 228-42.
 - 3 Richard E. Mueller, “Public-private sector wage differentials in Canada: Evidence from quantile regressions,” *Economics Letters*, 1998, Vol. 60, No. 2, pp. 229-35.
 - 4 James M. Poterba and Kim S. Rueben, “The distribution of public sector wage premia: New evidence using quantile regression methods,” National Bureau of Economic Research Working Paper No. 4734, 1994.

of the appropriateness of retirement savings in Canada.⁵ The evidence for appropriateness of savings is inconclusive, and largely dependent on assumptions. By contrast, papers that advocate change in CPP or QPP, more often than not, prescribe expansions to this system.

Most of the public sector has higher wage levels than the private sector

Comparing the overall level of wages in the public and private sectors is problematic given the differences in the wage-generating qualifications. For example, the data show that the overall level of education of public workers is higher than that of the private sector. Knowing that higher

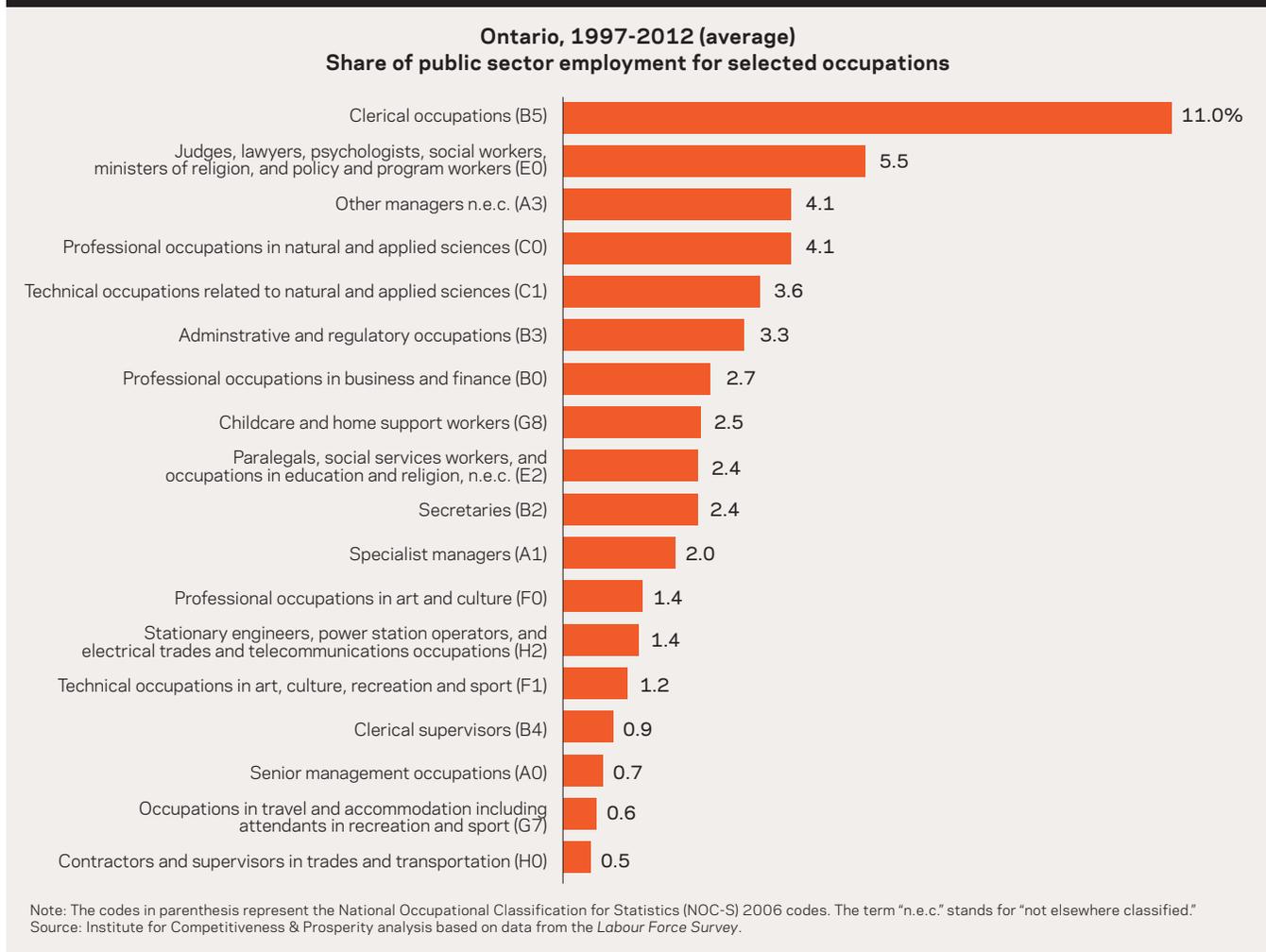
levels of education lead to higher wages, this difference in education attainment distribution would inflate the public wages and overestimate the public premium. Yet, this general approach to the problem can help demystify the public's perception of a high public sector wage premium.

To ensure analytical consistency and comparability, the Institute defined the “representative worker” as an employee with three main characteristics: non-student, single job holder, publicly or privately employed. Our study relies on accurate measures of hours usually worked and earnings. For that reason, the Institute narrowed the sample to single-job holders, because that guarantees the hours and hourly wages reported

correspond to one occupation only. By excluding self-employed individuals and students, the comparison is restricted to employees with standard labour agreements and individuals with jobs as their main occupation. All calculations used this definition of representative worker. For that reason, some of the statistics here might not match those from other studies.

5 Raj K. Chawla and Ted Wannell, “A C/QPP overview,” *Perspectives on Labour and Income*, 2004, Vol. 5, No. 1, pp. 19-27; Ted Wannell, “Public pensions and work,” *Perspectives on Labour and Income*, 2007, Vol. 8, No. 8, pp. 12-9; Karim Moussaly, “Participation in private retirement savings plans, 1997 to 2008,” Statistics Canada Pension and Wealth Research Paper Series No. 1, 2010; Michael C. Wolfson, “Not-So-Modest Options for Expanding the CPP/QPP,” IRPP Study No. 41, July 2013; Patricia Schembari, “Pension Plans in Canada,” Statistics Canada Pension and Wealth Research Paper Series No. 1, 2004.

Exhibit 1 Selection of 18 occupations ensures private and public sector comparability



Two additional aspects of the research need to be understood: public sector definition, and occupation matching. The definition of public sector might seem straightforward, but it can provide complications. Some individuals are directly employed by the government, whereas those in the broader public sector are paid by government funding but are employed by independent institutions. For example, nurses working in a hospital might not have contracts directly linking them to the government, but their payment comes from government funds that finance the health system. The Labour Force Survey (LFS) does not provide detailed information on this matter – the data depend on survey answers. Yet further analysis of those classified as public sector workers shows that both types are included.

The Institute also narrowed the occupation categories, selecting a set of occupations from the ones available from LFS (47 in total) to make the public and private sectors

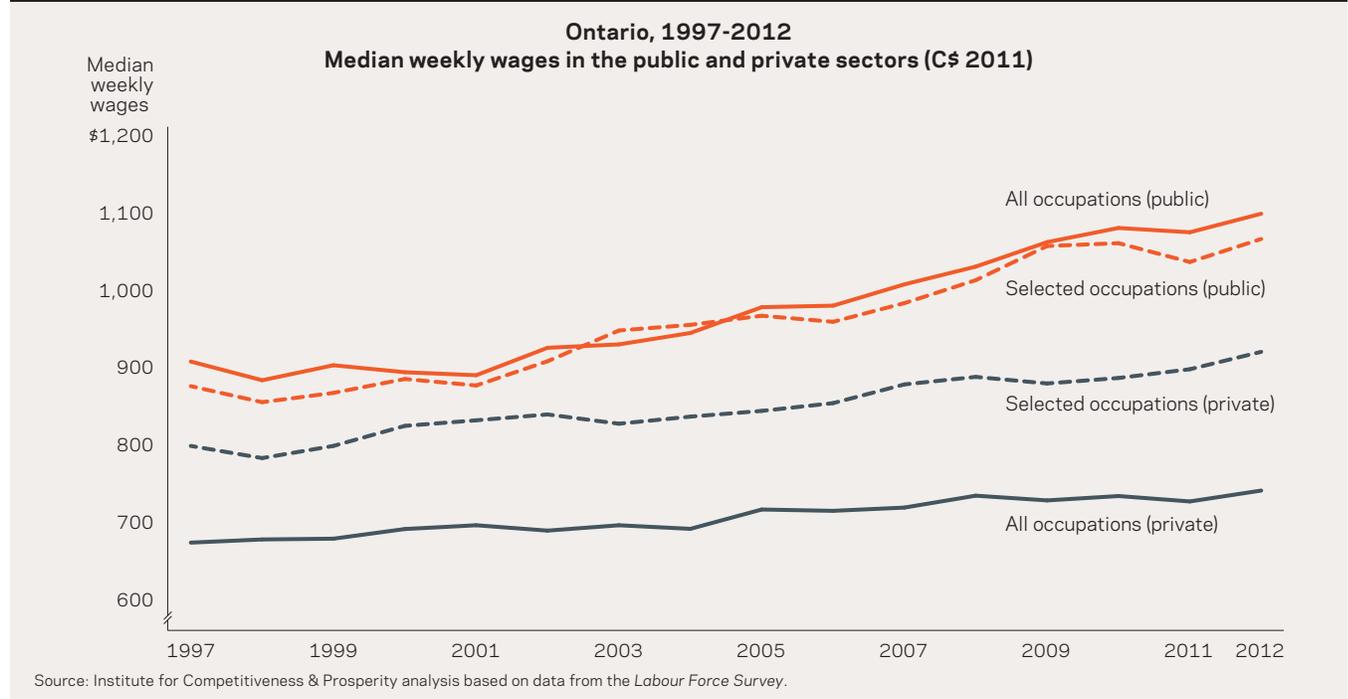
more comparable. Many occupations present in the private sector are not present in the public sector, and vice versa. In addition, although some occupations might be present in both sectors, they are not well-represented or equally distributed in them, which could cause distortions as a result of sampling errors. For example, one of the occupation groups available, machine operators in manufacturing, accounts for 5.4 percent of private sector employment on average, but only 0.2 percent of the public sector employment, with some years being zero percent. For the overall wage comparison, selected occupations are more pertinent for comparisons than overall occupations (Exhibit 1).

Both public and private wages have increased over time (Exhibit 2). But public sector wages were not only at higher levels overall, they also increased at a faster pace. The gap narrows substantially, however, when comparing the wages for the selected occupations, as opposed to all occupations. The selected occupations

represent roughly 50 percent of the public sector employment, and 43 percent of employment in the private sector in Ontario. Private sector wages are much higher for the selected occupations, whereas public sector wages are roughly the same. In Ontario, the selected occupations experienced real wage growth of approximately 21 and 15 percent for the public and private sectors, respectively.

The higher-than-average levels of public wages in Ontario may be detrimental to the province's economy, since the government could be taking the most qualified individuals out of the private labour market. Although having talent in government is desirable, there needs to be a balance, because if the private sector encounters difficulty in finding qualified workers, that can discourage companies from expanding in Ontario, or discourage new companies from moving to Ontario.

Exhibit 2 Ontario wages grew faster in the public sector than in the private sector, 1997-2012



It should be noted that a direct wage-to-wage comparison is an inappropriate way to derive the public wage premium. Because many different qualifications affect wages, they must be controlled for as best as possible so that comparisons are fair. For example, when comparing wages across sectors, education attainment and collective agreement qualifications need to be held constant so the actual public wage premium can be assessed. But to do that, other more sophisticated methods need to be applied.⁶ For a full explanation of the methods used in this study, please refer to the methodology appendix in the Institute's website.

The public wage premium is increasing

To estimate the public wage premium accurately, the Institute developed an econometric model that includes variables that influence wages to make sure that, when evaluating the public wage premiums, these quali-

fications have been held constant.⁷ Controlling for every qualification that affects wages is practically unfeasible – sometimes variables are not available in the dataset, or certain qualifications cannot be accurately measured. For example, in this study, one variable omitted that can possibly alter the results is immigration status. Some cited studies show that there is an immigrant penalty, or that immigrants experience an intrinsic loss in wages. But in other studies, the inclusion of immigrant status has little effect on the public wage premium. Unfortunately, the LFS does not provide information on this variable. The variables used in our model agree with most of the literature on the topic, and our purpose is not to produce an original model, but to apply known methods to the dataset at our disposal and frame the problem from the perspective of the province of Ontario (Exhibit 3).

The “class of worker” variable tells us the additional wage earned by a public sector worker compared to

a private sector worker with same wage-generating qualifications. The results show a positive and statistically significant public wage premium in Ontario, for most years included in the analysis.⁸ The other provinces, apart from Alberta, also show positive public wage premiums. Using all

6 A detailed literature review can be found in Morley Gunderson, *Public sector wage determination: a review of the literature*, Montréal: Institute for Research on Public Policy, 1977.

7 The model was based on Gunderson, “Earnings differentials between the public and private sectors,” *Canadian Journal of Economics*, 1979; and Mueller, “Public-private sector wage differentials in Canada: Evidence from quantile regressions,” *Economics Letters*, 1998. Other sources include: Alan S. Blinder, “Wage Discrimination: Reduced Form and Structural Estimates,” *Journal of Human Resources*, 1973, Vol. 8, No. 4, pp. 436-55; Jean Michel Cousineau, Robert Lacroix, and Paul Robillard, *Wage Determination in Major Collective Agreements in the Private and Public Sectors*, Ottawa: Economic Council of Canada, 1977; Joseph F. Quinn, “Wage Differentials Among Older Workers in the Public and Private Sectors,” *Journal of Human Resources*, 1979, Vol. 14, No. 1, pp. 41-62; Chris Robinson, “Union Incidence in the Public and Private Sectors,” *Canadian Journal of Economics*, 1995, Vol. 28, No. 4b, pp. 1056-76; Ronald Oaxaca, “Male-Female Wage Differentials in Urban Labor Markets,” *International Economic Review*, 1973, Vol. 14, No. 3, pp. 693-709.

8 Throughout the paper, the terms “statistically significant” mean that the results could not be rejected in favour of the alternative hypothesis of a zero premium at least at the 5 percent significance level.

Exhibit 3 Many qualifications influence an individual's wage level

Wage-generating qualifications		
Type	Variables	Description
Dependent variable	Weekly wages	Real (C\$ 2011) weekly wages
Variable of interest	Class of worker	Sector of employment: public, private
Other controls	Place of employment	Province of employment (Alberta, British Columbia, Ontario, or Québec)
	Occupation	Occupation categories based on National Occupational Classification for Statistics (NOC-S) 2006
	Union coverage	Covered or not by collective agreement
	Gender	Male or female
	Education	Highest education attainment: less than high school - university: graduate degree
	Age	Five-year age groups (15-70+)
	Marital status	Marital status of respondent: single, married or common-law, separated/divorced
	Job status	Status of position: full-time, part-time
	Job tenure	Job tenure in months
	Job type	Type of position: permanent, temporary/casual
	Establishment size	Number of employees at workplace: less than 20 - more than 500

Source: Institute for Competitiveness & Prosperity model based on data from the *Labour Force Survey*.

occupations gives us a larger premium than using only the selected ones. For example, in 2012, the public wage premium in Ontario was roughly 7.1 percent for all occupations, but the same premium was calculated to be 5 percent for selected occupations. This finding is true for the other provinces as well (Exhibit 4).

The public wage premium increased considerably over time for the provinces in the analysis, with the exception of Québec. Ontario and British Columbia show similar trends, especially for the selected occupations. In Ontario, the premium increased by approximately 7 percentage points from 1997 to 2012, with a sharper rise after 2002. Political differences may explain some of the premiums. For example, Ontario and British Columbia are governed by political parties that are liberal in the political spectrum, whereas Alberta is governed by a conservative party. Québec has seen changes over time in the political ideology of its governing party. But

political reasons cannot explain completely the evolution of the public wage premium, since Alberta shows a similar trend, only at lower (or negative) premiums. Therefore, we see that the increase in premium over time is a trend among three out of the four biggest provinces in Canada.

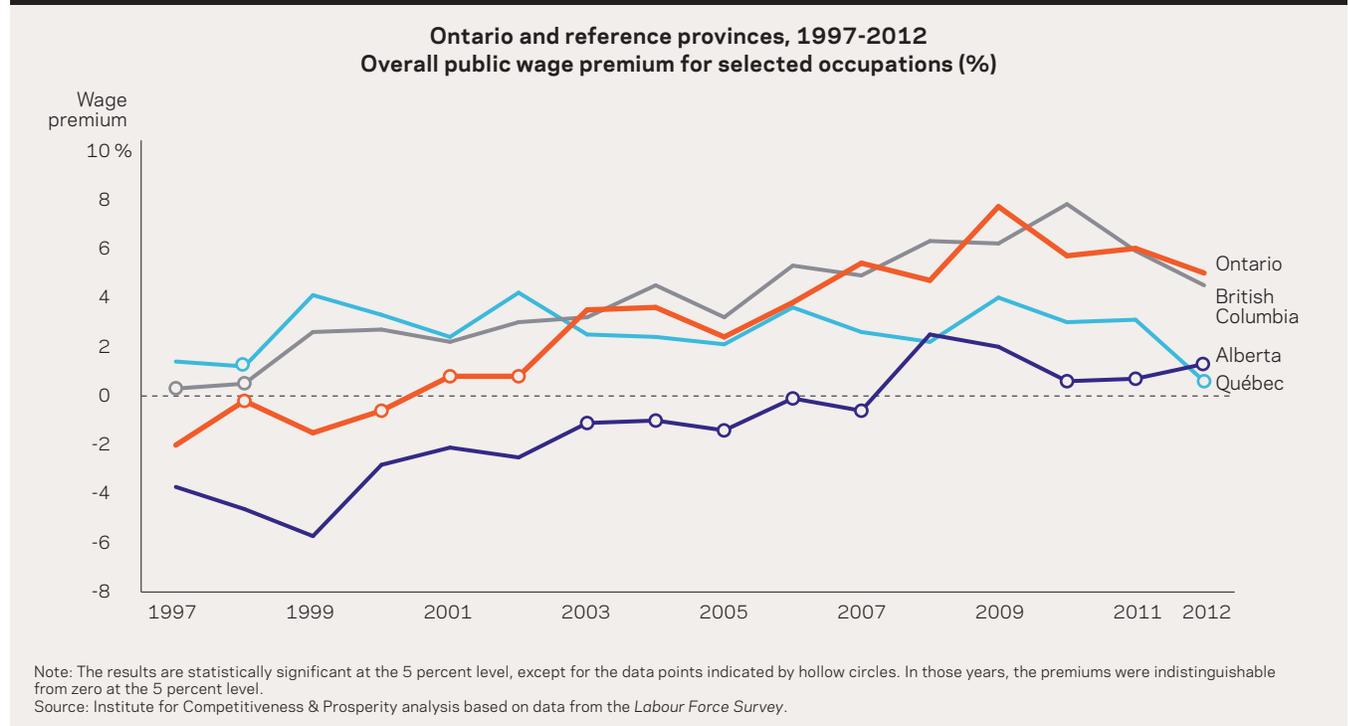
The trend in the provinces is similar, but the public wage premium in Ontario shows the largest change during the 1997-2012 period. In addition, in both overall and selected occupations, Ontario has the highest public wage premium among the reference provinces, tied only with British Columbia. Moreover, the latest years of data were affected by the recession. For all reference provinces, the Institute found a spike in the wage premium during 2008-2009, the peak of the most recent recession. This increase was to an extent created by the negative effects of the economic downturn. While private sector wages decreased, public sector wages proved themselves to be recession proof by holding steady.

The public wage premium rose more steadily in Ontario than in other provinces. From 1997 to 2012, the difference between wages for the public and private sectors in Ontario increased considerably. Although our dataset does not have information further into the past than 1997, this premium might be a somewhat recent phenomenon. More precisely, we cannot determine if the premium is a new characteristic of Ontario's economy, but we can conclude that the premium has become larger and more prevalent than before, peaking in the past two years.

The public wage premium differs across occupations

Even though the overall public wage premium provides important insights, it can hide some of the real changes over time. Calculating the premium by occupation shows that this number is not constant: some occupations have positive public wage premiums, but other occupations have negative

Exhibit 4 Public wage premiums increased significantly in selected provinces, 1997-2012



premiums, or discounts (Exhibit 5). While the occupation categories provide detailed information about the premium, there is still variation within each category, and discrepancies between the sectors still arise. For example, the category “specialist manager” includes, among other occupations, human resource managers and advertising managers. Even though the first group might be equally represented in both sectors, the second group is not as big in the public sector as it is in the private sector. This means the distribution within each category is different, and if wages are considerably different among occupations within a category, this could influence the results. Nevertheless, given the classification scheme of National Occupational

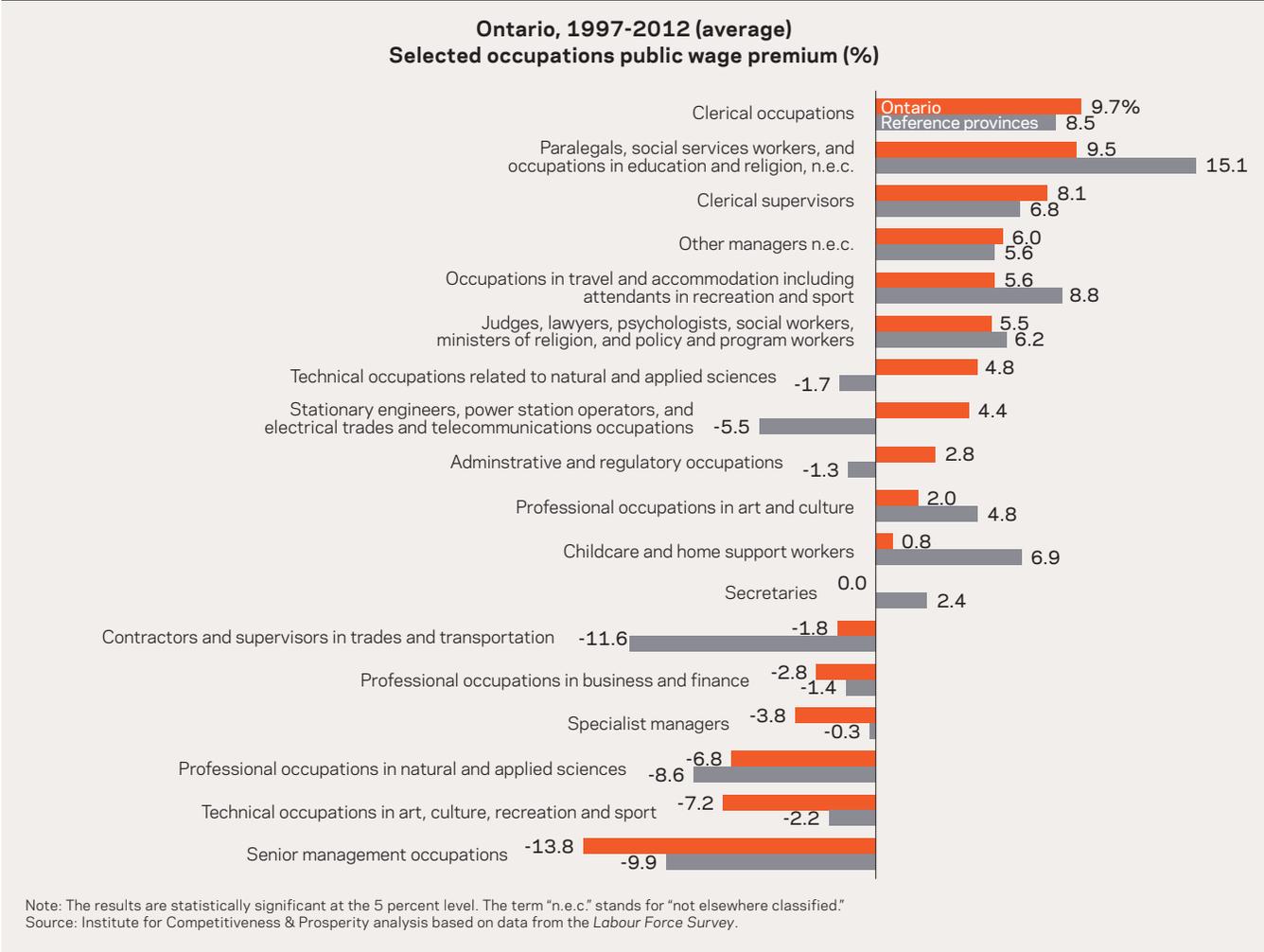
Classification for Statistics (NOC-S), the Institute is confident that the aggregation of the occupations leads to at least similar wage bands for the different occupations, regardless of their operational differences.

One important finding is that managers in the public sector have a large negative premium. This finding is even more significant for senior managers, who on average experienced a discount of 13.8 percent in Ontario. That means workers in high-ranked managerial positions in the government earn on average 13.8 percent less than their private sector counterparts, given similar wage-generating qualifications. It is crucial to note that this discount varied over time,

ranging between 0 and 34.3 percent. Interestingly, this discount is responsive to business cycles – it becomes smaller during recession years, and bigger during growth years.

The occupation category “specialist managers” also had discounts, with the average being 3.8 percent. There is a trend, however, for discounts to decrease over time in this category, with the numbers becoming premiums in recent years, which was not found for senior managers. The third category that includes managerial positions, “other managers n.e.c.,” shows positive premiums, but this category is troublesome. Because of its broader spectrum of occupations, conclusions regarding this category might not be as valid.

Exhibit 5 Some occupations are responsible for the overall public wage premium



Disregarding the findings for the latter category in managerial occupations, the public wage premium disappears, and even gives way to a public discount, or penalty. The public wage premium is higher at lower ranked positions, while hierarchically higher positions in the government experience low or negative wage premiums. This suggests that the government could be undesirably serving as an “employment incubator” when workers at lower levels take advantage of the higher wages, but leave the public sector just when they achieve managerial positions that are crucial for the functioning of the government. Even though this analysis cannot indisputably prove this hypothesis, the existence of a rank-dependent premium opens the possibility for such an effect.

Meanwhile, public debate at Queen’s Park focuses on the very individuals who are affected, namely those on the “sunshine list” and senior leaders making “more than twice the premier.” Again, this rhetoric would reinforce the “employment incubator”

model that Ontario seems to have unwittingly created. Not only are managers paid less than their counterparts in the private sector, but they are also publicly denounced for earning seemingly high wages.

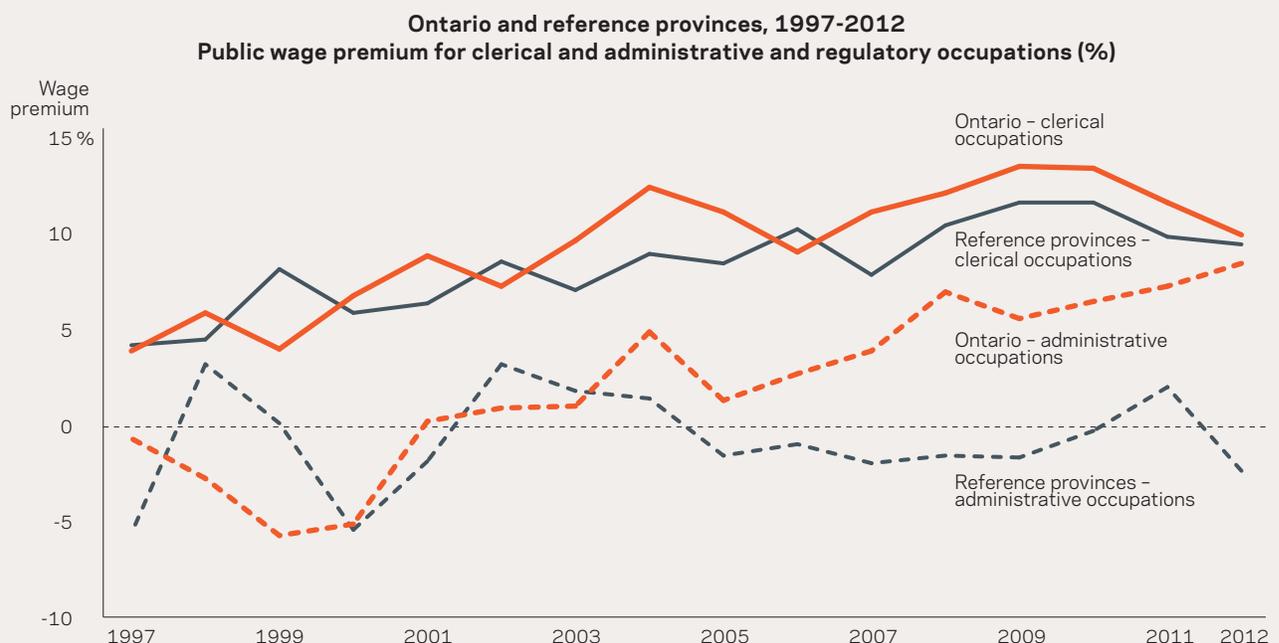
It is important to note that the senior managers’ category might be broader in the private than in the public sector. In the private sector, the senior manager category includes positions, such as CEOs, who earn disproportionately higher wages, but are not found in the public sector. This can lead to an under estimation of the premium for that category. In addition, if the senior and specialist manager occupations are summed together, they represent only 3 percent of the total employment in the public sector, and 5.5 percent of the employment in the selected occupations. Even if they experience wage discounts, these occupations do not represent a large proportion of the public employment, and do not contribute much to changing the public’s perception of the public wage premium. Lastly, if federal

occupations are excluded from the analysis, the discount increases further for all managerial groups, which indicates that federal workers at managerial levels earn higher wages than provincial and local ones.⁹

The argument that lower ranked positions in the government experience larger wage premiums is true. One crucial class of occupations in the government, however, drives most of the overall premium, and consequently helps shape the general perception of the public sector compensation. The category named “clerical occupations” showed the largest premium among the selected occupations, with the average being 9.7 percent. More important, the evolution of the wage premium in these occupations is very similar to that for the overall premium (Exhibit 6). This is expected as these occupations account for 11 percent of

⁹ This finding is true for most occupations in this analysis, but the results are more prevalent for managerial positions. That is, the difference in premium levels is larger for managers, and most often this difference is statistically significant.

Exhibit 6 Administrative and clerical positions show large increases in wage premiums



Source: Institute for Competitiveness & Prosperity analysis based on data from the Labour Force Survey.

the total public sector employment, and roughly 22 percent of the selected occupations' employment. Nevertheless, the wage premium increase is dramatic, going from 4 percent in 1997 to 10 percent in 2012.¹⁰ The group called administrative and regulatory occupations is also important. They displayed a zero percent wage premium in 2001, but by 2012 their wage premium reached 8.5 percent. Summed together, these two groups account for 17 percent of total public employment, and 34 percent of employment in the selected occupations. And, in both groups, the overall level of wages has either increased or remained constant in the private sector, indicating that the increase in wage premium is driven by higher increases in the public sector.

Other occupations that show interesting results are related to natural and applied sciences (Exhibit 7). There are two categories in this group: technical and professional occupations. The technical group

has positive premiums, while the professional occupations show negative premiums, or discounts. The difference between the two can be seen as a difference in required skill level. While professional occupations include many different types of engineers and scientists, the technical positions include mostly mechanics and technicians. If we consider the professional occupations to be more senior and skilled than the technical ones, this finding further corroborates the argument that public wage premiums are rank-dependent. As in the overall trend, the premiums for both categories have increased over time, but the technical occupations have always shown positive numbers, while the professional occupations have always shown discounts.

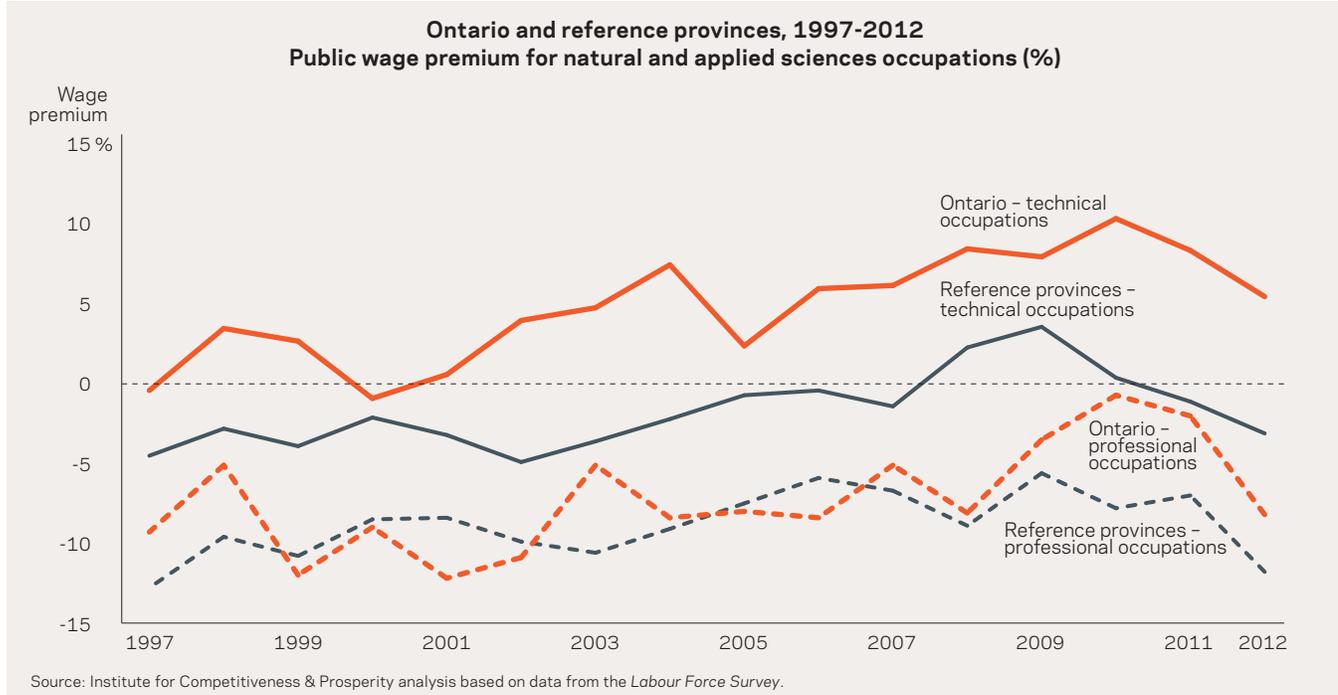
The occupational comparison reveals differences among Ontario and the reference provinces. As in Ontario, managerial occupations show negative premiums (except for "other managers n.e.c."), while clerical occupations show large positive premiums. But administrative and

regulatory occupations show a negative premium for the reference provinces. In fact, the trend for these occupations is substantially different in Ontario than in the reference provinces, with Ontario experiencing a rapid increase in the premium in the last ten years and the reference provinces showing a constant, near zero premium. More important, the rank-dependent trend is exacerbated in Ontario relative to the other provinces. The clerical workers premium is larger in Ontario, while the managerial occupations show lower premiums in Ontario relative to the reference provinces.

Technical occupations in natural and applied sciences experience a much larger wage premium in Ontario than in the other provinces. On average, this premium is actually negative in the other provinces, at -1.7 percent, while in Ontario the premium is positive, at 4.8 percent. Apart from the

¹⁰ During the period between 2008 and 2010, this premium reached 13.6 percent; however, those years might have great distortions caused by the economic recession.

Exhibit 7 Wage premiums are higher for technical than professional occupations



last four years, professional occupations in natural and applied sciences show similar premiums across provinces. But on average, the premium for these occupations is lower (or more negative) in other provinces than in Ontario.

The public wage premium is costly

By paying public sector workers 5 percent more in 2012 than their private sector counterparts, the government spent over \$1 billion more than it would if it were paying private sector rates.¹¹ The calculations are crude approximations that use only the selected occupations and assumptions of constant employment, but they point to potentially significant savings.

The result of the public wage premium is that the public is paying over \$1 billion more than they would for equivalent workers in the private sector. Furthermore, the public wage premium is being generated predominantly by administrative and clerical staff. Meanwhile, those in senior decision making roles are being paid less than their private sector equals, while also being publicly admonished for their supposedly bloated salaries.

11 This number is in 2011 Canadian dollars, and was calculated assuming 2012 average wage levels and employment, as well as a 50-week working calendar.



PUBLIC AND PRIVATE PENSION PLANS ARE MISMATCHED

THE ANALYSIS OF THE WAGE PREMIUM ACROSS SECTORS yields important results, but it is only one part of the compensation package for employees. It is also necessary to compare the benefits enjoyed by workers in the reference provinces, and across the two sectors: public and private. Coverage ratios, as well as the structural differences of the retirement plans in both sectors, explain and reaffirm the more generous compensation scheme enjoyed by public sector workers.

RETIREMENT SAVINGS in Canada can be seen as having three components. The first stream of retirement savings is public, which includes, but is not limited to, the Canada Pension Plan (CPP) or Québec Pension Plan (QPP). This plan involves mandatory contributions from employed individuals that are pooled together, and the benefits are calculated using the person's pensionable earnings. Second, individuals can also have private forms of savings that generally provide some type of tax-sheltering, such as Registered Retirement Savings Plans (RRSPs). Most of these are acquired through financial institutions. Third, pensioners can draw retirement savings from employer-sponsored pension plans, which are the focus of this study. These plans, which are registered pension plans (RPPs), involve contributions from the employer, as well as employees, depending on the plan.

This component of retirement savings is the only one that can be objectively compared. Analyzing CPP/QPP, as well as other plans such as the Old Age Security (OAS), would not be relevant in this analysis, because they do not differ across sectors or provinces.¹² In addition, the personal decisions to use private savings plans, such as RRSPs, are not directly part

of compensation packages, and could depend much more heavily on other circumstances, besides province of residence or sector of employment. Therefore, the relevant analysis is the comparison between private pension plans that are part of the compensation structure of employed individuals.

Comparing pension benefits across sectors is complicated by the lack of detailed data. Although Statistics Canada has the Pension Plans in Canada Survey (PPIC), which can provide information on a provincial level, the data from this survey are not available to the public. Only some tabulations of this survey, mainly containing national level data, are available. To complete this analysis, the Institute used two sources: the Survey of Labour and Income Dynamics (SLID) and national level data from the PPIC. Given that Ontario, as well as the other reference provinces, represent a large percentage of the Canadian economy, it is fair to assume that the national numbers are similar to those in these provinces. In addition, just as in the wage comparisons, the Institute applied the definition of representative worker, but that could only be done for the SLID data. In the case of nationwide data, the sampled population includes all types of

employed people, which includes the self-employed. Although this is not ideal, this is the best approximation available at this time.

Plan coverage is much higher in the public sector than in the private sector

The main difference between the public and private sectors with regard to RPPs is the coverage ratio, which measures how many employees in a certain group are covered by sponsored plans. The coverage ratio in the private sector is roughly half of the level found for three main categories of public sector employment: general occupations, health occupations, and teachers (Exhibit 8). These three categories were defined using the NOC-S codes, and were used to provide more detailed information for the public sector.¹³ Comparing the provinces, Ontario is on par with the other reference provinces, when it comes to public sector coverage. For general occupations in Ontario, an

¹² The exception is Québec which is under the Québec Pension Plan, and not the Canada Pension Plan. Nevertheless, the structure and functioning of these two plans are very similar, and analyzing their differences is not our objective here.

¹³ Health occupations refer to NOC-S codes D0 to D3; Teachers refer to code E1; and the general occupations refer to all other codes.

Exhibit 8 Pension plan coverage is much higher in the public sector than in the private sector

Ontario, 1997-2012 (average) Registered pension plan (RPP) coverage (%)

		Alberta	British Columbia	Ontario	Québec
Major categories	General occupations	86.2%	88.4%	88.3%	88.0%
	Health occupations	79.7	86.6	83.2	92.7
	Teachers	88.1	86.3	89.2	91.1
	Private sector	41.4	36.8	44.9	38.8
Selected occupations	Public sector	85.7	88.7	88.8	89.2
	Private sector	48.0	40.3	50.1	44.4

Note: Health occupations represents NOC-S codes D0 to D3, teachers represent code E1, and general occupations are the remaining occupations codes. Source: Institute for Competitiveness & Prosperity analysis based on data from the Survey of Labour and Income Dynamics (SLID).

average of 88.3 percent of workers are covered, whereas health occupations and teachers show averages of 83.2 and 89.2, respectively. In contrast, the private sector in Ontario averages 44.9 percent RPP coverage, and yet that is the highest coverage of all the reference provinces. These results mean public workers are more likely to have pension plans than private workers.

The average numbers, however, hide important trends in the data. According to the Ontario's Report of the Expert Commission on Pensions, one alarming trend is the gradual decrease in coverage in the province.¹⁴ This could represent a deterioration of retirement income outlook, and it surely represents a decrease in the overall largest pools of savings in the economy. These funds help finance many important investments, including public infrastructure. With the gradual decline in pension coverage, this crucial aspect of pension plans, and the economy in general, can be greatly affected.

The decline in coverage in Ontario was driven by changes in the private sector. While public workers experienced relatively constant coverage, private sector employees saw the coverage ratio decline 10 percent from 1999 to 2010. As also pointed out by the Expert Commission, the Institute found that the number of plan members increased, but not at the same pace as overall employment. Québec and British Columbia experienced similar trends, but with the decline being closer to 7 percent. By contrast, Alberta experienced a 13 percent increase in plan coverage for the private sector.

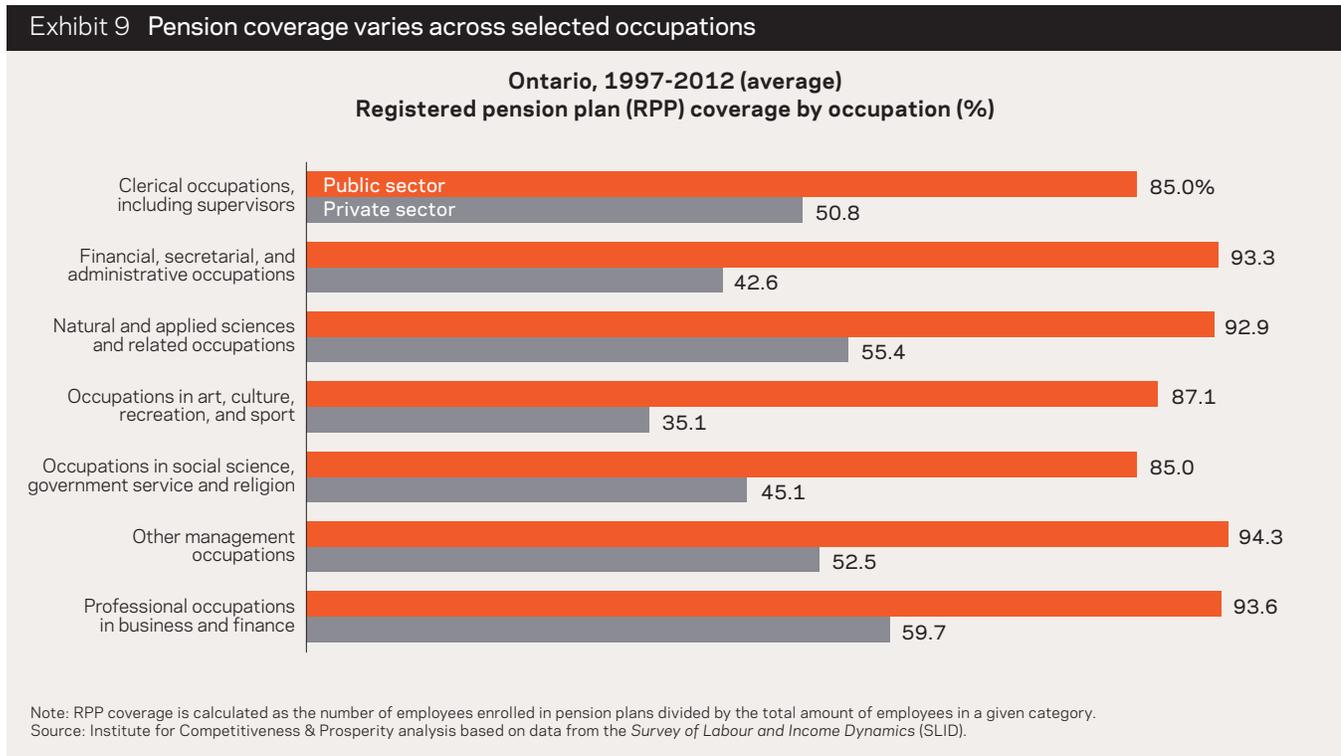
To deepen the analysis, the Institute once again divided the data into selected occupations that are well-represented in both the public and private sectors to provide a more accurate comparison. The occupational groups selected are slightly different from those used in the wage comparisons because of differences in the LFS and SLID.¹⁵ More precisely, SLID does not provide the same level of detail as LFS, and some occupa-

tions that were separated in the wage comparisons were summed together in this part – LFS provides 47 categories versus only 25 for SLID. Moreover, some occupations had a small representation in the sample and were dropped to avoid sampling variation errors.

For this narrower group, the Institute found similar coverage rates for the public sector, but increases for the private sector during the 1999-2010 period. For Ontario, the public sector coverage averaged 88.8 percent, while the private sector averaged 50.1 percent, a statistically significant increase from the 44.9 percent using all occupations.

14 Expert Commission on Pensions, *A Fine Balance: Safe Pensions, Affordable Plans, Fair Rules*, October 2008.

15 The selected occupations groups for the SLID dataset are the following: other management occupations (A111-A392); professional occupations in business and finance (B011-B022); financial, secretarial and administrative occupations (B111-B318); clerical occupations, including supervisors (B411-B576); natural and applied sciences and related occupations (C011-C183); occupations in social science, government service and religion (E011-E039, E211-E217); and occupations in art, culture, recreation and sport (F011-F154).



The Institute also calculated the RPP coverage for each individual occupation group for Ontario (Exhibit 9). The data show some variation in coverage across occupations. Contrasting with the wage comparisons, the RPP coverage does not show the pattern of higher ranked occupations being disadvantaged. That is, the lower ranked occupations, such as clerical or administrative occupations, do not have higher plan coverage than the managerial positions in Ontario. The coverage for the public occupations varies between 85.0 and 94.3 percent, whereas the rate of coverage for the private sector varies between 35.1 and 59.7 percent.

Interestingly, by narrowing the data, the Institute no longer found the decline in plan coverage. The selected occupations in the private sector did not experience a decrease in coverage, which means other occupations, mostly occupations not present in the public sector, are the main drivers of the overall decline in pension coverage in the private sector. Further analysis shows that most of the decline in coverage comes from occupations in wholesale trade, construction trades, transport and equipment operators, and labourers in processing and manufacturing.

Looking at plan coverage, it is clear that the greatest discrepancy is between public and private sectors rather than between occupations. An individual joining the public sector is more likely to become part of an RPP and, all else being equal, have a better retirement income outlook than an individual joining the private sector. This is likely a major contributor to the public's perception of generous compensation packages found in the public sector.

Plan structures determine differences in contribution rates

Another important aspect of pensions is the average employee contribution rate. This measures how much, in percentage figures, employees covered by RPPs contributed from their wages and salaries. The employee contribution rate for the public sector varies across the major groups (Exhibit 10). Teachers have a high contribution rate, close to 10 percent in most provinces with the exception of Québec. The trend found in all provinces is that private sector contributions are lower than public sector ones, regardless of the occupation group. The averages, however, conceal

some important trends over time in the contribution rates. For general and health occupations in Ontario, the contribution rates in 1999-2000 were in line with the rates for the private sector, but starting in 2002, just as in the wage comparisons, the contribution rates for these groups increased considerably. In the case of teachers, the contribution rate remained roughly constant until 2006, after which marked increases occurred. In contrast, the contribution rates in the private sector remained constant over time.

Narrowing the data to the selected occupations provides once again the expected result: the difference between public and private sectors is reduced. In Ontario, the public sector contribution rate sits at roughly 5.2 percent, whereas the private sector rate averages 3.4 percent. The temporal trends found before are also true for the selected occupations, with the public sector rates greatly increasing after 2002-2003; by 2010, the contribution rates for the public sector were around 6.5 percent, from a low of 3.9 percent in 2001. Breaking down the analysis by occupation shows that the rank-dependent argument cannot be stretched to the

Exhibit 10 Employee contribution rates are higher in the public sector than in the private sector

Ontario and reference provinces, 1997-2012 (average) Employee contribution rates (%)

		Alberta	British Columbia	Ontario	Québec
Major categories	General occupations	5.7%	5.8%	5.2%	4.4%
	Health occupations	5.5	6.0	5.1	3.9
	Teachers	9.1	7.5	8.3	4.7
	Private sector	3.7	3.8	3.3	3.6
Selected occupations	Public sector	5.8	5.7	5.2	4.4
	Private sector	3.7	3.9	3.4	3.7

Note: Health occupations represents NOC-S codes D0 to D3, teachers represent code E1, and general occupations are the remaining occupations codes. Source: Institute for Competitiveness & Prosperity analysis based on data from the Survey of Labour and Income Dynamics (SLID).

employee contribution rates (Exhibit 11). The rank-dependent argument cannot be stretched to the employee contribution rates.

The results indicate some important differences in pension plans between the two sectors. First, close to 100 percent of the RPPs in the public sector are contributory, while the private sector has mostly non-contributory plans. Contributory plans require both the employee and employer to contribute to the plan. In contrast, non-contributory plans only require the employer to contribute to the plan. Nevertheless, the data analyzed here only contain contribution rates for those employees who actually contributed to their RPPs, which means that the private sector tends to have lower contribution rates. This likely stems from the voluntary nature of the contributions, and perhaps lower wage levels.

Second, a larger proportion of the employees covered by RPPs in the public sector are part of defined benefit plans than in the private

sector. In defined benefit plans, the retirement income of plan members is determined using one of many available formulas, and the contributions are determined to ensure the plan is fully funded. Changes to the actuarial calculations that affect the plans' funding are corrected through contributions from the employers. In the case of defined contribution plans, the contribution rates are fixed, and the retirement income of members is determined by the total contributions and investment returns.

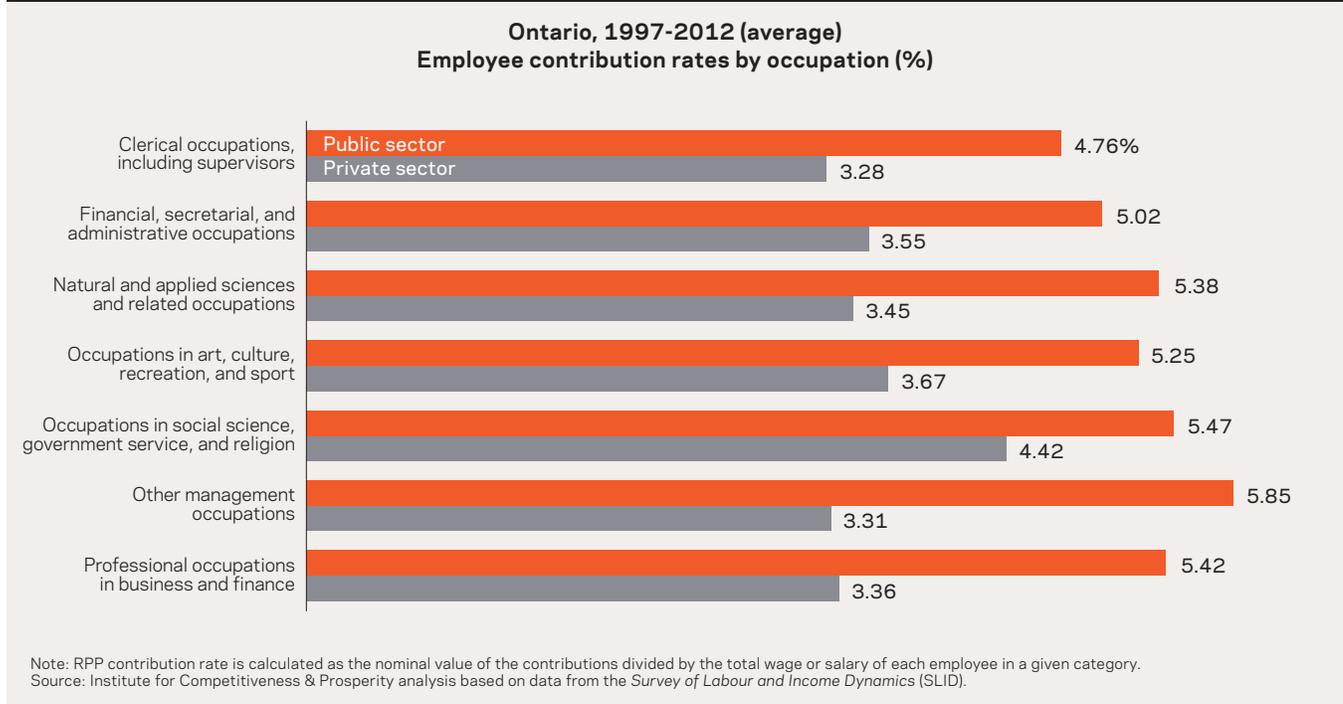
Using nationwide statistics, the Institute found that on average 95.2 percent of members are part of defined benefit plans in the public administration, 85.7 percent in education and healthcare, and 76.2 percent in overall private sector. Most important, the private sector experienced a large decline in defined benefit plans, dropping from 82.3 percent in 1999 to 67.9 percent in 2011, while public administration, education, and healthcare sectors experienced constant or increasing

proportions of members on defined benefit plans.

Knowing these fundamental distinctions, we can understand why the contributions are higher in the public sector. The defined benefit is to some extent a more secure retirement arrangement, since the future income level is somewhat guaranteed. But this makes these plans more expensive in present value terms than the defined contribution plans.

This aspect of the issue can be seen in the national level data. The asset value per plan member for defined benefit and defined contribution plans differs substantially in every industry. For example, in the manufacturing sector, defined contribution plans have a market value of assets per member of roughly \$43,000, whereas defined benefit plans in that sector have a value of \$225,000 per member. This difference is also very large for the public administration sector, in which defined benefit plans have a value of \$256,000 per member and defined contribution plans have

Exhibit 11 Contribution rates for selected occupations vary less in the public than the private sector



a value of \$71,000. Taking into account the coverage rates found in the public sector, it is clear that defined benefit plans could have a large impact on government budgets. Moreover, since changes in actuarial calculations – most important, in the case of unfavourable adjustments – are covered by the employer, or the government, the financial liability can be significant.

Despite the importance of these findings, they alone cannot show whether or not public sector workers enjoy more generous benefits than those in the private sector. Knowing the contribution rates of employees and the structure of RPPs is not enough to know the employers' contribution rates. All that is guaranteed from the Canada Revenue Agency is that the employer contribution needs to be at least 1 percent of the "total remuneration of the active members" for defined contribution plans.¹⁶ For defined benefits, the employer contribution is not fixed, since "the amount the employer contributes for future accruing benefits is based on how much the benefit is predicted to cost."¹⁷ This means the employer contribution can diverge from the employee's amount.

It is possible to compare the required employer contributions for current service of RPPs for both public and private sectors, but this has to be done at the national level. For Canada, employer contributions for the public sector are consistently above the contributions in the private sector. The average annual contribution for the public sector was approximately \$4,530 per member, while the private sector average contribution was \$3,230. The disadvantage of using the national numbers is that they do not differentiate among occupations, which means health occupations and teachers are mixed in with the general, public administration numbers. Moreover, the private sector data include all occupations. From the evidence, we can conjecture that the public sector numbers are overestimated, while the private sector numbers are underestimated, if we were to compare matching occupations.

The difference in average employer contribution can be partially explained by the differences in the proportion of defined benefit plans, especially given the decreases over time experienced by the private sector. Yet, the overall private sector contributions may be underestimated as the data are not disaggregated by occupations.

Public sector employees benefit more from pension plans

The mandatory contribution nature of public sector plans explains the higher levels of employee contribution, while the larger proportion of defined benefit plans might explain larger employer contributions. These findings cannot help us to conclude that the public sector pension plans are more generous per se. But two other aspects of the issue can lead to that conclusion. First, since the defined benefit plans offer greater security for the employees and the public sector has a greater proportion of those plans, it is fair to say that public employees enjoy on average better pension benefits than their private sector counterparts. Second, and most important, the coverage ratio is what really sets the two sectors apart.

Pension plans in the public sector are more encompassing than in the private sector, which means, for any occupation in the government, workers are more likely to be covered, regardless of how generous the plan is, if they join the public rather than the private sector.

16 Canada Revenue Agency, *Registered Pension Plan Guide*, 2007.

17 Financial Services Commission of Ontario, *Your Pension Rights: A Guide for Members of Registered Pension Plans in Ontario*, 2006.



RECOMMENDED ADJUSTMENTS IN PUBLIC SECTOR COMPENSATION OFFER BENEFITS

THE INSTITUTE'S RESEARCH SHOWS THAT ONTARIO HAS HIGHER LEVELS of compensation in the public sector than in the private sector, and this difference is on average greater than in the other provinces, with the exception of British Columbia. This public compensation premium in the province, however, is not a general premium. That is, depending on the occupation category, the premium can vary significantly.

THE COMMON TREND IN ONTARIO seems to be that higher-ranked occupations experience lower premiums, mostly negative, while lower-ranked occupations enjoy larger, positive premiums.

This argument needs refining. The public wage premium has been trending upward, beginning about a decade ago. In addition, not all lower ranked occupations display a larger premium. Occupations that can be considered administrative occupations, such as clerical and administrative positions, are the main drivers of the public wage premium. Given their relatively larger proportion of public employment, these occupations are the ones that also drive the general public's perception of the benefits of government employment. That is, the widespread idea of a substantial public employment premium most likely comes from the fact that these highly represented occupations enjoy a significant wage premium relative to their private sector counterparts.

Broadening the definition of compensation to examine pension benefits, the Institute found that a larger proportion of public workers have pension plans, which represents the most significant difference from the private sector. Structural differences between pension plans across sectors, such as the proportion of defined benefit plans and contributory regimes, explain some of the contribution differences for employees and employers. Part of the public premium in wages and salaries goes toward funding more generous pensions, as represented by the higher employee contributions in the public sector.

The Institute's evaluation of pension benefits in both sectors leads to two conclusions. First, the differences in contributions can be traced to structural differences in the plans in the two sectors. Second, the true generosity of the public sector employment comes from the higher coverage rates.

Given these important findings, the government needs to be aware of the major issues presented here. Compensation of public sector workers is not easily addressed because of the mechanisms behind wage and benefits negotiations, and the political impact of the decisions. It is important, however, for policy makers to be cognizant of the changes that have taken place in Ontario, and monitor the issue closely to avoid future surprises. Nonetheless, the level of detail of some of the results allows for equally detailed public policy recommendations. The Institute offers recommendations to address the public sector compensation system.

RECOMMENDED ADJUSTMENTS IN PUBLIC SECTOR COMPENSATION OFFER BENEFITS

1

Establish private sector comparators for public administration occupations.

It is clear that all occupations in the public and private sectors are not the same. Yet, some of the public administration positions, namely clerical (including supervisors), administrative, and regulatory occupations represent positions with transferable skills across sectors. Hence, to avoid the compensation discrepancies between sectors for these positions and to reduce expenditures, the Ontario provincial government should establish a set of closely matched positions in the private sector, and keep track of their compensation in the private sector to index their counterparts in the public sector. Using the latest numbers, the Institute estimated that by reducing the premium for these categories to the average wage premium for the public sector – from 9.7 to 5.0 percent – the government expenditures can be reduced by roughly \$350 million. These are crude calculations that assume a constant employment level, but they at least indicate non-negligible savings.

2

Realign high and low ranked occupation compensation.

An important finding is that managerial positions in the government tend to experience negative wage premiums, or discounts. This leads to the problem that workers may leave the public sector when they achieve higher ranked occupations, driven by higher wages in the private sector. Realigning the wages of lower and higher ranked positions can take advantage of the fact that senior managers and specialist managers represent a much lower proportion of employment in the government, which means only a fraction of the estimated savings from the first recommendation are necessary. To bring the negative premiums to zero for senior and specialist managers, the cost would be around \$180 million. Once again, these calculations are rough estimates, but they indicate a cost that is roughly half of the \$350 million recommended savings from the adjustment of the lower ranked occupations.

3

Emphasize the benefits enjoyed by public workers when negotiating with unions. One important finding in the literature of public compensation is that unionized workers not only enjoy higher coverage ratios for pensions, but they also receive more benefits. These comprehensive benefits need to be taken into account during wage negotiations with unions to keep the total compensation paid to public employees in check.

4

Split the burden of funding adjustments for defined benefit plans between employer and unions through union fees.

As this study and other reports have pointed out, the defined benefit plans enjoyed by workers, in both the public and private sectors, are tremendously important for the economy, not only for the plan members. Besides the fact that they are large pools of capital, they also reduce the need for social welfare programs and income supplement programs to support the elderly. Nevertheless, as it is also usually pointed out, these plans cost considerably more, and the liability caused by plan adjustments fall on the employers, which in the case of the public sector occupations is the provincial government.

One way to ease the liability for the government while maintaining these important plans is to share the employer contributions with the unions. By increasing union fees, the public wage premium will be reduced, and these extra fees can be used to cover part of the liability caused by plan adjustments. Alternatively, the liability for the government can be reduced by transforming part of the defined benefits plan into defined contribution plans to match the proportions found in the private sector. The sharing of employer contributions can still be applied to this scenario to reduce the negative impact of the transition for plan members.

5

Improve pension mobility to encourage private sector pensions.

Although it seems easy to argue that public sector employees enjoy large pension benefits relative to private sector workers, the argument can be seen from the opposite perspective: the private sector is not offering adequate compensation packages, and not contributing to the long-term well-being of its employees. This argument is less persuasive for private sector employers, since firms might not have employees' long-term well-being among their objectives.

Nevertheless, the Report of the Expert Commission on Pensions shows that private employers point to regulatory burden and portability issues as deterrents to provision of comprehensive plans. The complex tax treatment of pension plans discourages companies from providing plans. The tax treatment needs to be reviewed, but since it is part of the Income Tax Act, it mainly falls under the jurisdiction of the federal government. More important, one of the deterrents to providing

pension plans is the cumbersome process of reassigning the plans once employees change jobs and firms.

One solution to this is for the government to allow and provide financial incentives for the creation of industry-wide or occupation-specific organizations to deal with pension groups. That way, employees will not necessarily have individual accounts, but rather pools of capital confined to their respective industries to which employers can contribute and maintain. This would simplify accounting since the employers need to keep track of and meet their quota of contribution based on employment in a certain industry, rather than individuals, facilitating labour market mobility.

6

Cap government pension contributions to match employee contributions up to a maximum absolute value. An additional simple solution to reduce the future liability of the government on pension plans is to cap the employer contributions to match the employee's, but with a maximum level in dollar amount defined to each occupation group.

This serves two purposes. First, by capping the employer contribution, the liability incurred by the government is more manageable and certain. The problem of capping the contributions is that defined benefit plans require the plan adjustments to be covered by the employer. To implement this strategy, therefore, the cap must be applied only to "regular" contributions, and not plan adjustments. Second, it is possible that employees' voluntary contributions might decrease since they will no longer have the full matching system. This gives more room for decreasing the public wage premium.

Changes in the public sector compensation packages are not easily implemented. Although the government can indirectly affect the outcomes, the final values are stipulated through the collective bargaining process. To ensure long-term prosperity, however, some of the findings in this study must be taken into account. If the economic future of Ontario depends on government actions and effective use of the budget, considerations regarding compensation are crucial. Long-term adjustments in wages need to be made to avoid the disparities and possible unwanted pressures in the labour market. Moreover, the differences between public and private sectors, particularly in pensions, must be addressed by both sectors. The public sector must be aware of its spending, and monitor the changes in benefits packages to promote efficiency, while providing the correct incentives for the private sector to improve labour conditions. The private sector also needs to make conscious efforts to offer better conditions, which in turn can improve productivity.

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