The $30-billion question: Just who owns the federal workers' pension fund is a complex case involving vast sums of money -- and it puts Paul Martin's reputation in the line

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Paul Martin's legacy as the fiscal manager who saved Canada from financial ruin is tangled in an unprecedented court battle over who owns the $30-billion surplus that was scooped from federal workers' pension plans.

About 700,000 federal workers and pensioners say the surplus the former finance minister used to fight the deficit belongs, at least partially, to them. They allege the government was so bent on wiping out the deficit that it breached its "fiduciary" duty with employees and used an accounting sleight of hand to "steal" the surplus.

"There is such a mystique around Prime Minister Martin as the financial manager and fiscal genius who eliminated the debt but he did it on the backs of public servants -- and by using questionable methods," said Bill Krause, a retired economist and union leader who now sits on the pension advisory committee.

They want the money back. The lawsuit demands the government return $30.2 billion to the pension accounts of Canada's public service, military and RCMP. After that, the two sides can hash out whether to use it or stash it for a rainy day.

"The actions and interventions of the government with these pension funds ... was to extract substantial benefits from the surpluses to bring down government expenditures and the deficit," said James Cameron, lawyer for the giant Public Service Alliance of Canada. "You'll see the use of the surplus was quantified by senior officials as being the largest single deficit reduction option."

After years of deficits, the government turned its first surplus in 1998. But Don Drummond, a senior Finance Department official at the time, said the surplus was never part of any deficit-busting strategy. He said the government so far exceeded its debt-reduction targets that the surplus was "irrelevant."

"No one can spin a story that was necessary or part of a strategy to meet their targets because they blew their targets out of the water," said Mr. Drummond, who is now chief economist at Toronto-Dominion Bank. "It wasn't a big deal. I can assure you, having been there, it was not by design to reduce the deficit."

Other than aboriginal land claims, the lawsuit unfolding in Ontario Superior Court over the coming months will be one of the biggest the government has ever faced. The magnitude of the claims are unheard of in the pension industry.

The case stands out because of its complexity, uniqueness and the vast sums of money. The plans are among the largest in the world and are like no other. The government as lawmaker is like no other employer and has its own rules. A legion of accountants, actuaries and economists will be called to testify about thorny issues such as whether the pension surplus is real or imaginary, who owns it and who deserves it.

And if the 18 unions and retiree associations that launched the lawsuit are successful, the government will find itself with an additional $30-billion liability added to its national debt.

Such a victory would be a political nightmare for any government. With many private pension plans running short of funds, the gap between public and private pensions has never been wider. Canadians already resent the rich, fully indexed pensions of public servants and would fume at turning over billions of taxpayer dollars.

But Mr. Krause argues the country should be as outraged by the handling of the surplus as they were over the now defamed sponsorship program.

"It's about picking pockets," said Mr. Krause. "The government picked the pockets of its employees just like it picked taxpayers' dollars in the sponsorship program. In both cases, the Liberals took suspect, questionable actions. The cash grab of the surplus was unethical accounting for funds they didn't own -- like finding a wallet and taking it.

"This isn't whether Canadians believe the financial solvency of Canada is the better goal, but whether they can countenance such questionable ethics."

The case will also throw the spotlight on policy-making at the highest levels of government.

The 18 unions and pensioner groups that launched the lawsuit scored a significant win last week when an Ontario Superior Court judge ruled a stack of 128 internal documents could be admitted as evidence. These documents reveal some of the behind-the-scenes squabbles and policy-making that unfolded during the 1990s when the drive to wipe out the deficit dominated the national stage.

Part of those secret discussions revolved around plotting the government's strategy for negotiations with unions to privatize the pension plans and invest them in the financial markets.

Those ill-fated talks led to legislation in 1999 that created a new pension fund for public servants. It also unilaterally gave the government the right to the surplus from the old plans. What wasn't known then was that the government had all but consumed the surplus before the bill passed.

The documents show Treasury Board and the powerful Finance Department at loggerheads over who owned the surplus. Finance claimed the surplus as the government's. Treasury Board, however, said the ownership wasn't clear and a portion belonged to employees. One secret memo said then-Treasury Board president Marcel Masse -- who publicly said public servants would never lay a hand on the surplus -- privately felt employees had a claim to the surplus and the Finance Department's decision to use it to offset the deficit "was not right."

Lawyers for the 18 unions and pensioner groups spent a week last month arguing the documents should be admitted as evidence and their contents accepted as "truth." The government, however, argued the documents were hearsay and couldn't be taken at face value.

Judge de Lobe Panet ruled the documents were "reliable." He argued they were written to brief ministers and top bureaucrats so one could expect they were accurate and "put a premium on candour."

The documents, which include notes, reports, briefing papers, secret memos and other correspondence, shed light on the information and opinions that travelled up the hierarchy to some of the key players at the time, including then-Privy Council clerk Jocelyne Bourgon, Finance deputy minister David Dodge and Treasury Board secretary Robert Giroux.

But federal lawyer Donald Rennie had argued the accounting and legal issues were too complex to rely on the opinions and interpretations of public servants. Also, the rift between Treasury Board and the Finance Department is inherent in policy-making in government where departments often have conflicting mandates.,

"So how do you pick which one is right?" asked Mr. Rennie.

"Conflict is inherent in government so you get divergent approaches and differing opinions. But the views of individual public servants are irrelevant because at the end of the day the government takes a decision and acts."

The two sides couldn't be farther apart.

The plaintiffs argue the pension accounts are "trust" funds. The contributions and interest paid into the accounts were for pensions and nothing else. In their eyes, the government has a fiduciary duty to manage the money in the best interests of workers.

They back those claims with documents they maintain prove the government told Parliament and their workers for years that the pension accounts were "fully funded" trust accounts. They point to former finance minister Michael Wilson, who, in his 1991 budget speech, called the pension plans "trust funds."

The government disagrees. Firstly, the plan was created by legislation and is not a separate account full of cash. Secondly, Mr. Rennie argues many of the documents can't be taken at face value. Complex issues are typically simplified as they move up the line to ministers and the terms bandied about in these documents, such as "funds" and "assets" are "forms of art" that mean different things to different people.

"If you asked Mr. Wilson if what he meant was that the '$30 billion in the accounts was not the property of the government; belonged to the unions and was alienated from the public purse,' his answer may have been a little different. In fact ... he would have fainted," said Mr. Rennie.

In most plans, employers and their staff contribute cash to a fund that is invested in stocks and bonds.

Here's how the federal plan worked:

The plan was an internal account. Employees' contributions were taken off their paycheques and credited to the account. The act governing the plan obliged the government to match the contributions of employees, plus pay interest and cover any shortfall so it could meet its pension obligations. It was silent, however, on what to do with a surplus.

The government argues the contributions, along with interest and other charges, were dumped or "co-mingled" in its consolidated revenue fund. On paper, the contributions were treated like they were invested in 20-year bonds and the interest from the bonds was credited to the accounts.

For years, the fund ran a deficit that the government dutifully topped. By the 1990s, the accounts started to grow a surplus that exploded as the decade wore on.

The surplus is the difference between the balance in the accounts and the pension benefits owed to current and future retirees. Actuaries estimate the cost of the plan based on assumptions about a slew of factors, including the economy, demographics, inflation, salary increases and rates of mortality or retirement.

Some of those assumptions, however, were out of whack. The surplus was mushrooming with high interest rates on government bonds dating back to the 1980s but burst when the Liberals froze public servants' salaries for six years.

Income tax and pension laws stop plans in the private sector from piling up large surpluses and regulate how a surplus can be used. The government is exempt from those rules.

By time the 1990s rolled around, the government was obsessed with reducing the federal deficit and eyed the "juicy" pension surplus as an easy and painless way to cut expenditures, said Dougald Brown, lawyer for 13 of unions and retiree groups.

The government reasoned it was responsible for covering any shortfall in the plan so was entitled to any surplus.

To do that, the government came up with an accounting manoeuvre to amortize or withdraw the surplus from the pension funds in a series of annual spending reductions -- between $1.8 billion and $2.6 billion -- that were booked over 13 to 15 years.

Mr. Brown said the government used a second "adjustment allowance" account to write down that amount against the debt. That amount also happened to be the same the government owed in contributions, which effectively meant the government took a contribution holiday from the plan.

Plan members claim they knew nothing of the move because the government kept two sets of books. The surplus was written off against the debt in the public accounts but the books for the pension plan showed the surplus was still there.

The government argues the surplus doesn't exist other than on paper. The accounts were "notional," mere bookkeeping entries first created in 1925 to keep Parliament informed of the cost of providing pensions to workers.

Officials argue there was nothing sneaky or nefarious about using the adjustment account, which the Auditor General had recommended to keep the mounting surplus in check.

Since the government recorded the pension accounts as liabilities in its books, the surplus wrongly inflated Canada's debt because it wasn't needed to pay pension benefits.

"The result was a gradual lowering of the government's recorded liabilities as reflected in its financial statements to an amount closer to the actuarial liability," the government said in its statement of defence.

The dispute goes back to the 1993 when Mr. Martin took over as finance minister. He inherited a massive $42-billion deficit and $487-billion debt that threatened Canada's credibility with international lenders.

Mr. Martin told Justice John Gomery during his testimony at the sponsorship inquiry nearly a year ago that Canada's looming financial crisis occupied 100 per cent of his time. It was the driving force behind the five-year downsizing of government that slashed budgets, scrapped programs and wiped out 50,000 federal jobs.

On the books, the three pension plans accounted for more than 20 per cent of the national debt.

For years, the plans didn't have as much money as actuaries figured necessary, forcing government to top up the difference. The government traditionally used an accounting manouevre to spread the deficit over a period of years.

By 1993, Treasury Board was aware of a budding $4.6-billion surplus in the public service pension plan. A surplus had already sprouted in the military plan.

But a few others noticed the plan, too.

In 1991, then-auditor general Kenneth Dye raised concerns about the impact of the pension plans on the country's debt and urged the government to review its fiduciary obligations and the way it financed the plan.

But it was a retired bureaucrat, Walter Kelm, who once headed Treasury Board's pension branch, who sewed the seeds for the dispute.

By 1993, Mr. Kelm noticed the plan was growing like topsy. The self-appointed watchdog, who became known as the Eliot Ness to the "government's Al Capone and Jimmy Hoffa school of pension management," spotted the adjustment account buried in the public accounts that the government used to amortize the surplus.

He alerted anyone who would listen that the surplus was the Finance Department's secret weapon against the deficit. He said government was using an "accounting sleight of hand" to use the surplus to offset the deficit. The amounts used, he insisted, were equivalent to what the government should have paid in pension contributions.

Mr. Kelm's concerns caught the attention of Mr.

Krause, then president of the Social Sciences Employees Association who wrote former Treasury Board president Art Eggleton in November 1995 to find out what was going on.

Mr. Eggleton explained the balance of the pension funds wouldn't be affected by the accounting practice. The letter explained the fund's balance was far more than what was needed to pay its pension obligations to workers. He explained the government was using an accounting device to spread out or amortize the surplus over 10 years to bring the pension accounts in line with the plan's actual liabilities.

Behind the scenes, however, a flurry of memos reveal Treasury Board was locked in a battle with the Finance Department over the use of the surplus.

By the spring of 1994, Treasury Board implored the Finance Department not to use the surplus against the deficit until ownership of the surplus had been resolved. In a memo, then Treasury Board secretary Robert Giroux warned that nothing in the existing laws suggested the surplus belonged to the government or allowed it to be removed.

Instead, Mr. Giroux offered to settle the surplus issue in negotiations with unions and pensioners on setting up a new pension fund that would be invested in the market. He said Treasury Board needed some of the surplus as a bargaining chip so unions would agree to the reforms.

But Mr. Giroux's pleas fell on deaf ears. By the summer of 1994, Mr. Giroux learned that the Finance Department decided to amortize the surplus anyway to the tune of $1.8 billion over a number of years to offset the deficit.

"Finance is already planning to spend the pension plan surpluses by using them to reduce expenditures, thereby in our opinion, constraining our ability to strike a pension deal," said an internal memo to Mr. Giroux.

"We cannot spend the surplus twice and therefore to the extent the government might want to share the surpluses with plan members, Finance's action makes it more difficult to manoeuvre."

In 1996, Finance Department officials briefed Mr. Dodge in a memo the surplus "could represent the largest single deficit reduction option" which would ensure the government could "meet future deficit targets without having to further reduce departmental spending."

Memos show some bureaucrats argued the accounting manoeuvre effectively gave the government a "contribution holiday through the back door." A memo sent to Mr. Dodge warned public servants and retirees would be up in arms if they found out because the legislation didn't allow for contribution holidays.

By 1997, documents say the surplus in the public service plan proved to be a huge "windfall" for the government that staved off further spending cuts. An internal Treasury Board memo said the government had already "scooped" half of the then $12-billion surplus, including the $800 million it "tapped to pay the freight" for early retirement packages handed out to lure thousands of bureaucrats to leave during the downsizing.

"The (plan) is generating large surpluses which the government has been scooping," the memo said. "Over the last four years, not only have the plans been entirely funded by employees' premiums and the plans investment income, but they have resulted in a windfall for the federal Treasury."

During this time, the government created an advisory committee of union and government officials with the mandate to negotiate a new pension deal. Unions had long wanted their pension funds invested in the capital markets to earn higher returns. A key issue in these talks, however, was managing any future surplus. The committee, however, was never told the government was using the existing surplus.

The government desperately wanted to get the pension plans off its books and shift more of the risk and rising premiums to employees. Treasury Board, however, argued it couldn't get a deal without offering some of the surplus.

In September 1996, the advisory committee submitted its final report. It recommended the public service plan be jointly managed by the employer and employees and contributions be invested in the financial market. It also concluded employees were entitled to the surplus.

But Finance's appetite for a new plan invested in the market appeared to diminish. It would mean the government had to come up with cash for its contributions, which memos suggest the department wasn't keen on until the surplus was fully amortized in 1999.

By February 1998, Mr. Masse kicked off another round of talks with unions on pension reform, promising to deal with the existing and future surpluses. Meanwhile, background papers circulating in government said the existing surplus was not on the table because it had largely been "spoken for in the fiscal framework." A Treasury Board memo reiterated its longstanding concern that ownership of the surplus is unclear but the prevailing opinion was that the government was entitled to it.

"In the event of a legal challenge, the view is that the federal position would prevail," said the memo.

"Notwithstanding the employer's position, the issue is sufficiently arguable that we would strongly suggest the issue of surplus disposition be avoided in the upcoming negotiations."

The government refused to budge on the surplus despite unions repeated efforts to put it on the table. In the end, talks collapsed and the government unilaterally passed the 1999 bill that phased out the old plan with a new one invested in the market.

The bill settled the ownership issue. It retroactively gave the government the right to the surplus the unions say it had already used.