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Evaluation of Public and Private Financial Incentives for Retirement

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Purpose

This brief highlights the main findings of an evaluation study initiated in 1997 to examine the nature and potential impact of financial incentives to retire that arise from the current public and private pension system for selected households or particular cases. In addition the study also examined a number of related issues such as the importance of various income sources for pre- and post-retirement groups, and others factors influencing retirement decisions.

Background and context

The decision to retire, either fully of partially from the labour market, can have a wide range of implications. It can open up jobs vacancies and promotion opportunities for younger workers, add to the costs of public pensions and income support, reduce the experience level of the work force, and possibly increase the prospects of future labour shortages.

The importance of retirement decisions will grow as the large baby boom generation (born 1947 to 1967) enters the age range when early retirement decisions are typically made.

Whether policy pressures favour early retirement or continued employment for older workers, it is important to understand the ways in which current pension programs influence retirement decisions, and the magnitude of these effects. This information is needed to determine how the current pension system and policy/program changes are likely to affect retirement behaviour.

Methodology and data

The development of evaluation methodologies was guided by detailed reviews of available data sources, alternative modelling approaches and current literature on retirement and pensions.

Data from the Survey of Consumer Finances (1989 and 1995) and the General Social Survey (GSS), Cycle 9 (1995) were used to profile retirees and to compare pre- and post-retirement groups.

Financial incentives and disincentives for retirement were examined using simulations of the present value of changes in the expected pension wealth accruals from public and private pensions under various pension plan scenarios. Simulations were used because of the lack of an available data set linking detailed information on pension plans to individual data for older worker. However, the generality of the findings is limited by the fact that the analysis is based on particular cases. In particular, the assumption is made of continuous work history at the median wage with no interruptions, of a recent male retiree, with a spouse who never worked. In respect of private pensions, the focus is on workers who have defined-benefit RPPs of varying types (less than half the workforce).

The determinants of some factors than can influence the planned and actual retirement decisions were examined empirically using the GSS, Cycle 9 data.

Key findings

Profiling of the pre- and post-retirement groups

About 14 percent of men age 55 to 59 were retired in 1994. This increased to 45 percent for men age 60 to 64, and to 78 percent for men age 65 to 69. The incidence of retirement was lower for women; although rising female labour force participation rates mean that more women will be making retirement decisions in the future.

Employment was the main source of income up to age 60 and declines thereafter. Employment income continued to be significant for many groups after age 60, indicating that some seniors were working past the age of early retirement. For the 65 to 69 age group, employment accounted for 4 percent of total income for single women and about 10 percent for single men and 9 percent for couples.

After age 65, public pensions (CPP/QPP, OAS/GIS/SPA) became the main source of income. For the 65 to 69 age group, these sources accounted for 62 percent of income for single men, 65 percent for single women and 60 percent for couples. In particular, single women over 70 rely heavily on the public retirement income system, which accounts for 69 percent of their income, compared to 61 percent for single males in the same age group. The second most important source was private pension income.

Comparing 1989 and 1995 showed an increase in the importance of CPP/QPP for all groups age 60 and over, particularly single people. Also, the importance of private pensions increased for most groups, particularly for age 65 and over. The share of income from employment increased for single men age 60 to 69, but fell slightly for most other groups age 60 and over.

Incentive effects of private and public pension plans

Private pension wealth accruals are potentially zero after maximum years of service which in the modelling is age 65 in private pension plans. They are potentially substantially negative in combined private/public plans at that age, without any special/early retirement benefits. The combined effect of the public and private pension plans (defined-benefit RPPs) with 'subsidized and special retirement' provisions are generally to encourage/provide incentives for early retirement around age 60 based on the particular and limited cases used in these simulations.

The combined retirement-inducing effect of both private and public pensions is especially prominent for low-wage workers. This occurs primarily because low-wage employees face clawbacks in income-tested public pensions (GIS/SPA) if they continue to earn income.

RRSPs and defined-contribution RPPs do not contain these incentive effects because they do not generate spikes in pension wealth accruals at certain ages. But it is important to note pension wealth accruals is only one measure of potential incentives to retire. For instance, even where pension wealth accruals are low or negative, the income replacement rate may be so low as to strongly encourage continued working. In addition, other factors affect an individual's decision to retire.

Determinants of planned and actual retirement decisions

This part of the evaluation examined the importance of a wide range of factors affecting the "planned" and "actual" retirement decisions of Canadians. The factors included gender, education, age, health status, spouse's status, occupation, other income, region and industry. Nevertheless, data do not permit comprehensive systematic assessments of the relative importance of all the factors in the actual retirement decision, which would include, among other things, pension wealth accrual effects.

GSS data indicated that the planned age of retirement for employed persons age 45 or older tended to bunch up, or spike, around the ages of 55, 60 or 65. Only about 25 percent of these workers said they planned to retire at age 65, however. Another 17 percent said they would never retire. Younger workers (age 16 to 44) planned to retire much earlier than older workers, with 48 percent saying they planned to retire by age 55 compare to 17 percent of workers age 45 and over.

The income-leisure choice framework and GSS data were used to examine a wide range of factors that could influence retirement decisions. The results confirmed that, other things being equal, the planned age of retirement increased continuously with age. For example, it was estimated that worker age 65 to 69 planned to work 9 years longer than those age 45 to 49.

The empirical results also showed that workers with fair or excellent health planned to work longer than those with poor health. Men planned to work only slightly longer than women; and workers without a spouse planned to work about one year longer. On the other hand, workers covered by an employer-sponsored pension planned to retire about 1.3 years earlier than those without a pension. Planned age of retirement also increases with education.

The findings regarding the factors influencing the "actual" retirement decision (or probability of retiring) generally were consistent with those for the planned age of retirement.

Conclusions

The public and private pension system should be regarded not only as a form of saving for retirement, but also as a system that has a potentially important set of incentives that can affect retirement decisions. This evaluation provides only preliminary indicative findings on this matter. It has not assessed the extent to which the retirement income system affects how widespread these incentives are, and the decision to retire.

There is substantial and growing diversity in retirement preferences. This diversity in retirement preferences and their policy implications, need in-depth analysis.