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POLICY BRIEF

Adequacy and individual agency in retirement planning: Do we need to revisit some assumptions?

Highlights

- While there are several studies on both actual and projected retirement incomes, Canada has no empirically-based metric of "adequacy" for income in retirement years.
- Even accepted standards – based on post-retirement replacement ratios of pre-retirement income – can lead to potentially misleading conclusions and can inhibit analysis using a more relevant set of factors.
- In addition to the need for better understanding of what the proper benchmarks of adequate retirement incomes might be (and how to set them), retirement income policies may benefit from importing the construct of "individual agency" (i.e. ability to direct one's life) from other social sciences.
- Through a lens of agency, Canadians exhibit an uneven capacity to make retirement planning choices, quite independently of their actual retirement resources, and may have unrealistic expectations of their ability to fully and effectively direct their own retirement futures.
- The lens of agency suggests that the impacts of retirement income policies may depend at least in part on how they anticipate or respond to differences in individuals' understanding and how individuals exercise choice.

Underlying the dialogue in Canada and around the world on retirement income are at least two foundational questions:

1. How much income is enough in retirement?
2. What is the capacity of citizens to secure that income?

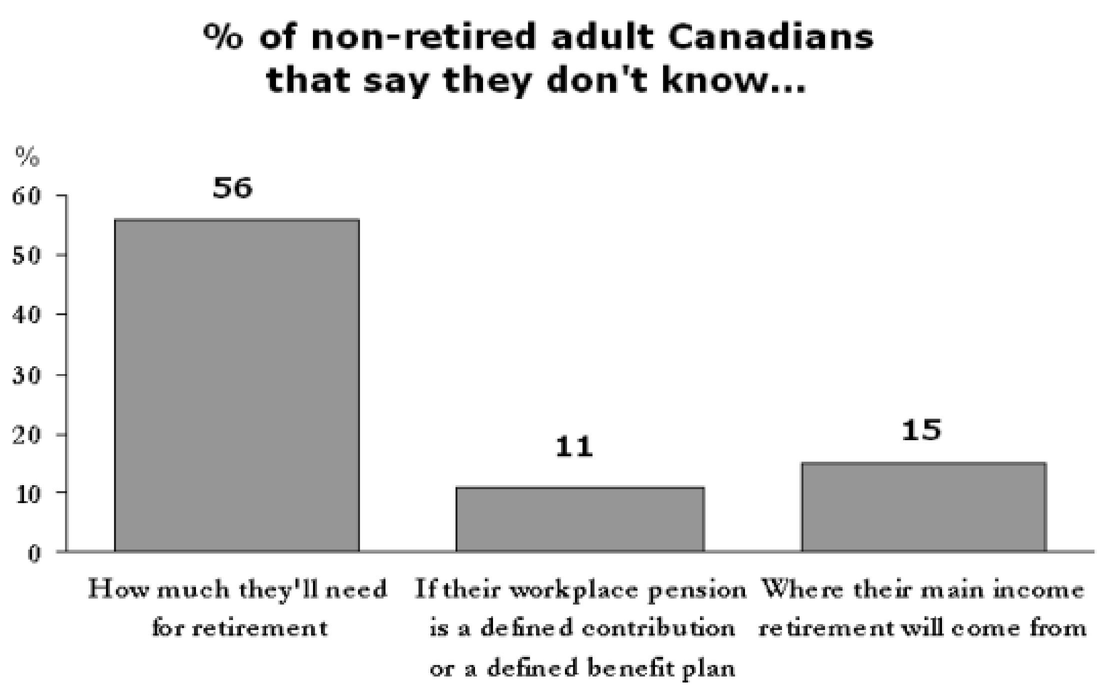
Canada

The first question points to the issue of adequacy while the second highlights differences in "individual agency" (i.e. people's ability to direct their own lives). Currently policy makers in Canada and around the world have no robust, agreed-upon answers to these questions. Worse, our current analytic tools may be limiting our ability to ask and address the right questions.

Questions about "adequacy"

Evidence from private sector surveys suggests that many Canadian consumers have trouble figuring out what an "adequate" retirement plan would look like for them. For example, a June 2010 poll for the Canadian Institute of Actuaries found that 62% of Canadians over the age of 45 are worried about running out of money in retirement but only half of respondents had taken any steps to find out how much money they might need in retirement.[i] The recent Canadian Survey of Financial Capability confirms findings from private polling that most Canadians do not know how much they need to save for retirement, that many are uncertain about the status of their workplace pension, and that a small but important number are not even sure where they plan to draw their retirement income from.

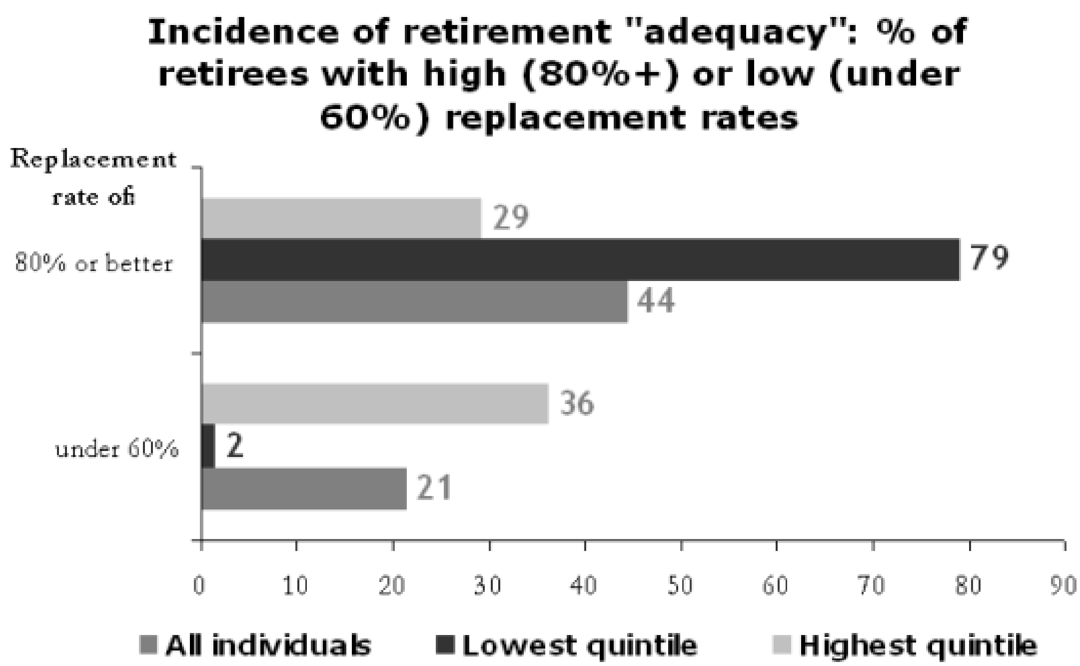
Figure 1[ii]



Though views vary even among experts, the level of income deemed adequate is generally defined as replacing between 60 and 80% of pre-retirement income (Mintz, 2009). Generally the analysis is based on combined income from the "three pillars" of Canada's retirement income system: Old Age Security and other public pension benefits; employment-related pensions; and private registered savings.

According to a 2008 study by LaRochelle-Côté, Myles and Picot, roughly half of Canadians of retirement age maintain an income at or above 80% of their income at age 55. Using only a blanket measure of adequacy – based on the replacement rate of retirement income relative to pre-retirement income – seems to suggest that substantial numbers of Canadians may experience difficulty in retirement. But will they?

Figure 2[iii]



In particular, consider the picture when we convert a replacement rate from a relative to an absolute figure: an upper-income earner (with a pre-retirement annual income of, say, $120,000) and facing a 60% replacement rate would have a still-substantial $72,000 in retirement income.

Looking as well at subjective measures of well-being and security among Canadian retirees suggests a very different pattern from that suggested by pre-retirement income replacement rates. Even though lower income households are likely to have the highest replacement rates, they are significantly more likely to report difficulty keeping up with monthly expenses and a feeling that their retirement is not as good as expected.

In a number of other cases, replacement-rate measurements alone may not be a sufficient index of "adequacy", especially if one or more of the following conditions apply:

- Post-retirement costs are uncertain and may unexpectedly rise (e.g. medial expenses or costs to care for aging parents) or fall (e.g. costs to support dependent children).
- Actual post-retirement costs were unforeseeable, as in cases of sudden catastrophic illness or disability.
- The pre-retirement income of retirees was itself low or insufficient to meet their needs.
- Retirees have either significant access to assets outside of the "three pillars" (e.g. housing assets and other unregistered assets) or, alternatively, significant post-retirement credit and debt obligations.
- There is some fuzziness about whether individuals have "retired" or not (e.g. cases of self-declared retirees who continue to work or those who had a limited attachment to the labour force during working life).

These examples raise a number of questions that policy analysis should probably consider:

- Do our measures of adequacy make reasonable assumptions and projections about changes in cost due to both life-course and market developments?
- How do we factor in the risk of unexpected and life-altering health changes?
- What is an adequate replacement rate for those with pre-retirement incomes below the Low Income Cut Off or alternative measures of deprivation?
- How should measures of adequacy take housing into account? In particular, what are reasonable assumptions about the housing costs, housing equity and mortgage and property tax liabilities of retirees?
- How should we think about the adequacy of income replacement rates for those performing unpaid work during much or all of their adult life?
- Is a plan based on continued labour market income (beyond the "usual" retirement age) a sustainable and adequate retirement strategy?

According to the Canadian Survey of Financial Capability, 44% of Canadians planning for retirement are expecting to have continued workforce earnings as part of their retirement strategy.

Questions about "agency"

> *"People who develop their competencies, self-regulatory skills and enabling beliefs in their efficacy can generate a wider array of options that expand their freedom of action"*
>
> - Albert Bandura

In psychology and related disciplines, the construct of "agency" described by a leading theorist, Albert Bandura, points out the degree to which self-interested action is always mediated by a complex range of intrapersonal, institutional and environmental factors. At its core, "agency" relies on an individual's belief in his or her own ability to direct their lives. It is a core that in turn shapes attitudes, motivation, cognition and ultimately decision-making.

In the psychotherapeutic context, addressing agency can be what motivates clients with substance abuse issues to take steps to quit or depressed clients to find hope that he or she will feel well again

While agency underlies some of the work of behavioral economists and has been used as a construct for re-examining policy abroad (see for example LeGrand, 2003[iv]), it has not yet made many inroads in policy analysis or policy-making in Canada. But there may be value to using "agency" as a lens through which to take a fresh look at messy issues such as retirement income policy.

Borrowing from Bandura's model, individual agency in retirement planning appears to involve at least four institutional, environmental and individual factors, each raising distinct policy (and policy research) questions:

Institutional and environmental factors

1. *Access to financial systems and infrastructure*: Canadians with stronger relationships to mainstream financial services providers are more likely to have access to information and personalized help with retirement planning choices.

    - *How much agency do Canadians sacrifice by using alternative financial services?*
    - *How much agency could Canadians gain through wider access to personalized financial services or advice?*

2. *Regulatory structure*: Rules can limit individual control in protective ways (mandatory pension deductions from payroll, for example) but can also limit control in potentially detrimental ways when they discourage individual savings or fail to insure against institutional failure (such as insolvency of a workplace pension)

    - *How would our legislative and regulatory structures on financial services and pensions look if they paid greater attention to the ability and willingness of different individuals to make choices, while at the same time protecting all Canadians against the worst risks?*
    - *Have we given adequate consideration to the perhaps unintended constraints on individual action or choice that result from interactions between different systems of rules?*

Individual factors

3. *Financial resources during working life*: Compared to those with unstable incomes and/or no access to stocks of wealth, Canadians with more stable and long-term working-life incomes, even if low or modest, have a constant stream out of which savings may be more easily generated, and those with access to lump sums (for example inheritances or large capital gains) have greater stocks of capital they can mobilize.

    - *What are the different choice constraints facing those early in their working-lives compared to those later in working-life even if the motivation to plan for retirement is the same?*
    - *What are the different choice constraints facing those with standard and stable employment compared to those in non-standard or irregular patterns of work?*
    - *How much agency does an individual gain out of expected or unexpected lump sums of capital on top of regular income?*

4. *Financial capability*: Some Canadians will have a greater ability to understand financial information and to use that information to take action on their own financial affairs. Similarly some will have a stronger sense of confidence or have adopted positive financial habits.

   - *Is it enough to provide consumers with information about retirement planning?*
   - *Do Canadians display different attitudes and behaviors about retirement decisions than other financial aspects of their lives?*
   - *Are Canadians lacking in confidence about their ability to effect change in their retirement prospects or are they instead over-confident relative to objective measures of their preparedness?*
   - *How do households and families make informal trades in roles and tasks to maximize financial resources and improve decision-making?*

For further research and discussion: When agency and adequacy intersect

Risk is never fully absent but a better understanding of "agency", alongside better measures of "adequacy", uncovers variations in the ability of Canadians to understand, manage and respond to risks related to their own retirement income security. The risks of greatest concern to policy-makers are likely to be those created out of an intersection between low levels of adequacy and low agency.

For example working age immigrants to Canada who experience difficulties with labour market integration are more susceptible to the combined effects of low adequacy and low agency: lower earned income and a typically shorter working time in Canada may constrain several sources of retirement security, while at the same time their ability to make effective choices may be constrained until Canadian financial and pension systems, regulations and norms become familiar.

By contrast, full-time employees in a mandatory defined benefit pension plan are relatively more sheltered from threats to their retirement security but they do give up at least some individual choice and decision-making (e.g. about how to plan, how much to save, etc.) in the bargain. Finally, consider the position of self-employed Canadians with moderate incomes: on the one hand, they have great flexibility to exercise control over their individual retirement savings but on the other they are excluded from certain opportunities to pool risk and maximize returns to scale through participation in pension funds.

The table below presents one way to consider the potential interactions between agency and adequacy. It is intended here as a rudimentary start that could lead to future directions for research and discussion. In the three cases described above, risk is not absent but the resources and capacities that can be mobilized are uneven.

Table 1

	High Agency	**Low Agency**
High Adequacy	*Low exposure to risk*	*Mixed exposure to risk (mostly endogenous)*
Low Adequacy	*Mixed exposure to risk (mostly exogenous)*	*Higher exposure to risk*

Overall most Canadians fare well in retirement. What we do not understand well is whether their outcomes are as a result of their own agency – or in spite of it. To the degree that public policies continue to have, as their goal, making choices available to consumers, it is critical that policymakers begin to ask questions about the real capacity of consumers to understand and avail themselves of those choices at different times and in different circumstances over their life courses. The lens of agency suggests that the impacts of retirement income policies may depend at least in part on how those policies anticipate or respond to differences in individuals' understanding and how they exercise choice.

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[i] CBC (2010) "Canadians worried about retirement: poll", CBC News, June 15, 2010. Available on-line.

[ii] Author's calculations using data from the *Canadian Survey of Financial Capability,2009* (2010), Statistics Canada, Ottawa.

[iii] LaRochelle-Côté, S., J. Myles and G. Picot (2008) "Income Security and Stability During Retirement in Canada", research paper, Analytical Studies Branch, Statistics Canada, Catalogue no. 11F0019M — No. 306, Ottawa. Available on-line.

[iv] LeGrand, J. (2003) *Motivation, agency & public policy: of knights and knaves, pawns & queens,* Oxford University Press.