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Financial Well-Being in Retirement

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.	not available for any reference period
..	not available for a specific reference period
...	not applicable
0	true zero or a value rounded to zero
0^s	value rounded to 0 (zero) where there is a meaningful distinction between true zero and the value that was rounded
^{p}	preliminary
^{r}	revised
x	suppressed to meet the confidentiality requirements of the *Statistics Act*
^{E}	use with caution
F	too unreliable to be published
*	significantly different from reference category ($p < 0.05$)

Financial Well-Being in Retirement

By Sébastien LaRochelle-Côté

This article in the *Economic Insights* series reports on the most recent statistical developments relating to the financial well-being of retirees. This summary is based on selected research done at Statistics Canada on the contribution of income, consumption, and financial wealth to the well-being of older Canadians.

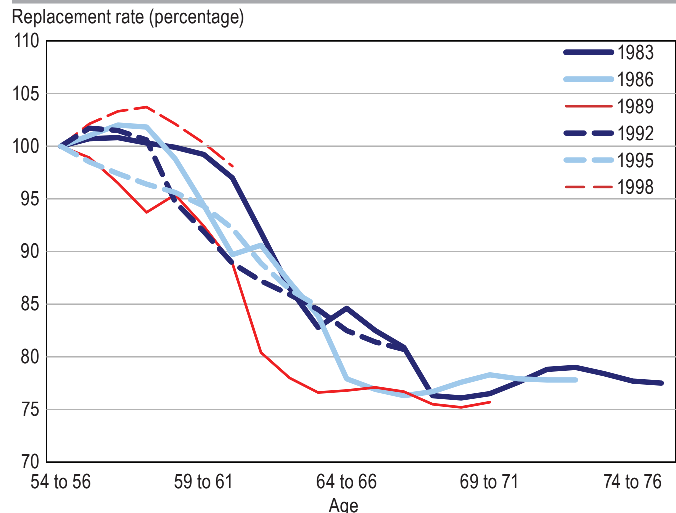
In Canada, as in most other industrialized countries, the financial well-being of retired persons remains a major public policy issue. There are a number of aspects to financial well-being, especially in the case of seniors. This article provides some insights into the financial well-being of individuals who have been retired for a number of years; and for whom the data are sufficiently developed to provide an overview of their financial situation.

Income

With respect to retirement income security, one of the most widely used indicators is the income replacement rate. This rate is obtained by dividing a person's family income (adjusted for family size) received at a given age (e.g., age 75) by the income received at the point when the person was most likely earning his or her highest employment wages (typically around age 55). Here, family income includes not only employment income but also income from private pension plans, retirement pension income, and personal income (such as investment income). In a 2008 study,[1] a cohort of Canadian workers aged 54 to 56 in 1983 was followed over two decades, and a replacement rate was calculated for these workers when they reached ages 75 to 77, 21 years later. For this cohort of workers born before the baby boom, the median replacement rate was 0.78 in 2004. In other words, the median person received 78% of the family income obtained 21 years earlier (Chart 1). In general, the situation of individuals in more recent cohorts was similar to that of the 1983 cohort.

The level of family income received at ages 54 to 56 is instrumental in determining future replacement rates. For individuals who had a family income in the lowest income quintile for those ages, that is, a family income of approximately $30,000 per couple, the replacement rates were generally higher (in excess of 100%), since public plans (Old Age Security, Guaranteed Income Supplement, and Canada Pension Plan/ Quebec Pension Plan) generally accounted for the lion's share of the replacement income. Conversely, replacement rates were generally lower (around 60%) for individuals who had a higher family income, that is, approximately $110,000 per couple, since these individuals were more dependent on private income

Chart 1
Replacement rates of adjusted family income after taxes, cohorts aged 54 to 56 in 1983, 1986, 1989, 1992, 1995, and 1998



Source: S. LaRochelle-Côté, J. Myles, and G. Picot, 2008, Income Security and Stability During Retirement in Canada, Statistics Canada, Ottawa.

sources. As for Canadians whose income was near the median income, they had a median replacement rate of around 80%.

However, not all those who were at the same income level at ages 54 to 56 necessarily had the same replacement rate two decades later. For a significant minority (20% to 25%) of individuals whose income was near the median income at ages 54 to 56, replacement rates were below 60% at ages 75 to 77. A replacement rate of 60% means that a couple who could count

1. See LaRochelle-Côté et al. 2008.

on an income of approximately $55,000 in 1983 had a family income of at most $33,000 twenty years later.

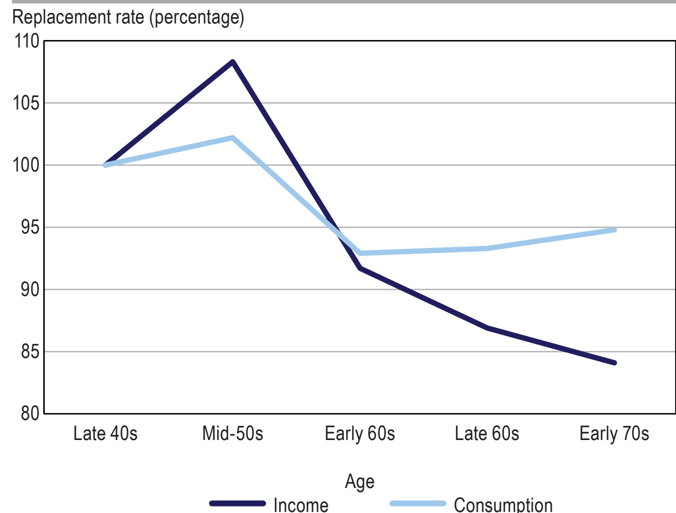
The use of replacement rates is not without limitations and should not be seen as optimal income targets for everyone, as discussed in a recent 2011 study.[2] Accumulated wealth, for instance, does not appear in traditional income data sources and may alter significantly the target replacement rates that must be achieved to maintain living standards, even among individuals who are otherwise similar in terms of family income and other characteristics. As well, as noted above, replacement rates are typically presented as a median or as an average, and there is a distribution around average rates. The remainder of this article will discuss the role of consumption and wealth in the financial well-being of retirees.

Consumption

As indicated above, income declines for many during the retirement years. How, then, does it compare with personal consumption? While Statistics Canada has no longitudinal data on consumption, it is possible to get an idea of expenditures over the life cycle by creating a synthetic cohort of respondents based on several sources of cross-sectional data. A recent 2011 study[3] examined the income and consumption (both adjusted for family size) of a synthetic cohort consisting of a generation of Canadians nearly 50 years of age in the early 1980s, which is the same generation that was followed to produce the income replacement statistics presented above.[4]

Twenty years after reaching age 50, households in this cohort had an average income replacement rate of 84%, but were still consuming more than 95% of what they consumed at the start of the period on average (Chart 2). It would seem that, despite a decrease in income, consumption tended to remain relatively stable among aging Canadians, at least in their seventies. However, this does not mean that senior households consume in the same way as they did when they were in their fifties: in general, they spent proportionately more on housing and health care, and usually spent less on food, clothing and recreation.

Chart 2
Replacement rate of family income after taxes and replacement rate of consumption (adjusted values), cohort nearly 50 years of age in 1982



Source: A. Lafrance and S. LaRochelle-Côté, 2011, Consumption Patterns Among Aging Canadians: A Synthetic Cohort Approach, Statistics Canada, Ottawa.

Lifetime income

How do retired persons whose consumption exceeds their income manage to maintain their standard of living as they age? A number of them do so by drawing on the assets that they have accumulated over their lifetime. For many seniors, a declining employment income stream does not necessarily signal financial pressures, because they have built up a stock of wealth. For this reason, it is important to consider the contribution of household wealth to retirees' financial well-being. Traditional income measures that do not include this contribution do not always capture all the financial resources available to seniors.

Household wealth may be defined as the total value of real estate holdings and other non-housing sources of financial wealth (such as savings accumulated in investment funds and retirement savings plans), minus outstanding debts. It may be expressed in the form of lifetime income (or, more simply, in the form of an annuity), which can then be added to income from other sources; this yields an income estimate that differs from estimates most often used to calculate replacement rates. Under this approach, assets contained in investment funds and registered retirement funds are considered as a stock of savings that can be expressed in the form of lifetime income along with other components of financial wealth. These assets are then added to other sources of income (mainly income from public pension funds and post-retirement employment). Thus, two estimates of income can be calculated: a first encompassing financial wealth, excluding the net worth associated with the principal residence; and a second encompassing all forms of financial wealth, including the principal residence. This methodology was applied in another 2011 study.[5]

After taking account of all assets not related to the principal residence in the calculation of income, the average value of the annual income of individuals aged 65 to 74 was 8% higher than income values obtained from the more conventional definitions

2. See MacDonald and Moore 2011.
3. See Lafrance and LaRochelle-Côté 2011.
4. Income includes not only income from the sources mentioned above, but also the implicit income from housing services, since the housing consumption expenses of owner-occupants are both an expense and an investment that can be expressed in the form of "implicit" annual income. The value of this income, which represents the amount that owners would have spent paying an equivalent rent if they had not been owners, ranges between 10% and 15% of the base income of individuals in the sample.
5. See Baldwin et al. 2011.

used in the replacement rates studies discussed above.[6] For individuals aged 75 to 84, the value of income including assets not related to the principal residence exceeded—by 20% on average—the value yielded by the more conventional income definition.

When lifetime income from the principal residence was incorporated into financial wealth, the measurement obtained was 15% higher than that based on the more conventional definition of income for individuals aged 65 to 74 and 35% higher for those aged 75 to 84. Thus, when financial wealth is taken into account, the "adjusted" income becomes similar to the average income of individuals aged 45 to 64, whose financial well-being is based largely on employment income. It is therefore possible that asset accumulation can play a significant role in maintaining seniors' level of consumption, at least for those in the generation born immediately before the baby boom.

However, these results must be interpreted with caution, since the contribution of financial wealth to overall income for higher-income individuals likely differs from that for lower-income individuals. Furthermore, it should be noted that the data on the younger members of the baby-boom generation are not yet included in the statistics described above. Since a large number of them will soon be retiring, the particular circumstances of this generation, including the changes observed in work and saving habits, could possibly affect the financial results of retirees in the future. An update of this study is planned following the next release of the Survey of Financial Security in 2013.

6. Assets not related to the principal residence include registered savings plans and employer pension plans, unregistered financial assets, and the net worth of a business, as well as other real estate holdings, such as secondary residences. The "standard" income definition used as a comparison point is adjusted family income from all sources, including implicit income from housing services.

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This article in the *Economic Insights* series is based on Statistics Canada studies on the financial wealth of retired persons. For more information, please see the following:

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