national union

pensions backgrounder #5

How Much Pension Will an Individual Need?

Part 5 in a Series

The full series of pension backgrounders are contained in the National Union's Pensions Manual, Fourth Edition—available from the National Office

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BACKGROUNDER #5

How Much Pension Will an Individual Need?

THERE IS really no generic answer to the question of how much income an individual or couple will need in order to live their retirement years in comfort and dignity. Each individual retiree will spend differently and have different needs. Accordingly, there is no scientific way of determining how much a particular person will require.

• • • Retirement Income Above the Poverty Line

One indicator that all individuals who are planning for retirement can consider is whether their retirement income will meet Statistics Canada's 'Low Income Cut-offs' (LICOs) which are also commonly known as poverty lines.

The LICO is based on Statistics Canada's detailed survey of the expenditure patterns of Canadian families known as the Family Expenditure Survey (FAMEX).

From FAMEX data, the Canadian average family expenditure on food, shelter and clothing is calculated. This is expressed as a percentage of pre-tax income.

Low income cut-offs are based each year on those individuals and families who spend 20% more than the average individual / family expenditure on food, shelter and clothing.

Persons and families living below these income levels are considered to be living in '*straitened circumstances*'. There are 35 different LICOs, varying according to family size and size of community.

So at a minimum, an individual or couple will want to try to ensure their annual retirement income will at least meet the LICO which corresponds to their family size and size of community.

If not, it's safe to say a large portion of their retirement years will be spent living in poverty.

••• OAS and GIS Will Not Provide Above Poverty Income

For those persons whose only retirement income consists of the maximum available benefits under Canada's old Age Security (OAS) and Guaranteed Income Supplement (GIS), most will live below the poverty line.

For the single elderly, the floor currently amounts to $13,635.96 per year (as of January 2008). This is $3,583 below the 2006 low income line for a single person in a large urban centre as established by Canada's national statistical agency, Statistics Canada.

For an elderly couple, the minimum income guarantee is $23,167 (as of January 2008), which is $1,723 above the 2006 low income line for a large city. As is commonly the case elsewhere, too, the single elderly in Canada are overwhelmingly women.

••• Less Income is Needed for Retirement

Another point to consider is that experience shows workers generally need less of an income during retirement, for a number of reasons:

- there are no more CPP / QPP or Employment Insurance contributions;
- there are no more pension plan contributions;
- there is an increased personal income tax exemption starting at age 65 (clawed back, subject to a means test for those with higher incomes);
- many personal items, such as mortgage payments, life insurance premiums, clothing for work, transportation to work and child related expenses may not only be reduced, but may disappear entirely; and
- there are benefits that may be available to people over 65, such as low-cost public transport.

On the other hand, many workers may find themselves 'retiring' at an earlier age than they anticipated, as a result of corporate or government downsizing. In these circumstances, their savings might be a lot less than they expected. They will have to rely on their retirement savings a lot longer.

Even if they do retire when they intended to, workers' lifestyles may change at retirement, so that other expenses replace those of working expenses. Retirees may travel more or have more time to pursue hobbies, for example.

A related factor is the decreased level of service relating to many government programs and the growing use of user fees that will affect many seniors in their retirement years, just as they are affecting the rest of us.

• • • Where Will This Money Come From?

The usual rule is that your pension income from all sources should be about 70% of your pre-retirement earnings if you want to maintain your standard of living once you're retired. Let's look at someone earning the current year's (2008) maximum pensionable earnings (YMPE), $44,900. The YMPE is set each year by the federal government, based on the average wage in Canada. According to this formula, that person requires 70% of $44,900 or $31,430 per year, when he or she retires.

Assume that this person retired in January 2008 and obtains the maximum basic Old Age Security (OAS) benefit, of $502.31 per month (or $6,027.72 a year) and the maximum Canada / Quebec Pension Plan (CPP / QPP) retirement benefit, of $884.58 per month (or $10,614.96 a year.) [See Backgrounder entitled *An Overview of Canada's Public Pension System*.]

As can be seen from the following table, to achieve a 70% replacement rate, the worker would therefore have to find $14,790.06 of pre-retirement earnings – $1,235.50 each and every month – from some other source.

Seventy Percent Replacement of a
Pre-retirement Annual Income of $44,900

Source of Income*	Dollar Amount	Percentage of pre-retirement income (of $44,900)
Old Age Security	$ 6,027.72	13.42%
Canada Pension Plan	$10,614.96	23.64%
The portion to make up, through workplace pension plan *and/or* private savings	**$14,787.32**	32.94%
Totals	$31,430.00	70.0%

* Based on January 1, 2008 rates

There are really only two other sources of income that a retired worker is able to tap from and that is a workplace pension plan or private savings. And remember from the previous chapter of this *Pensions Manual* that less than 40% of workers belong to a workplace pension plan.

For those workers who do not belong to a workplace pension plan, they will need to accumulate pre-retirement savings, usually through a Registered Retirement Savings Plan (RRSP).

Let's consider a worker who is 30 years of age who plans on retiring at age 65. How much retirement savings will be needed to ensure that individual can have an annual income $14,787.32 (representing the 32.94% of the $44,900 noted above)?

First we have to make the following three assumptions:

- *Life expectancy after the age of* 65 – for a Canadian male age 65, the average Canadian life expectancy is 81 years of age, for a Canadian female age 65, the average life expectancy is 85 years of age;
- *Annual rate of return* that the private retirement savings will generate during years of retirement – the assumption used for the calculation below is 6% annual yield on the balance of the savings; and
- *Annual inflation rate* to ensure that the value of the $14,787.32 income is protected during each year of retirement – the assumption used for the calculation below is an annual inflation rate of 2.5%.

So based on these three assumptions:

- The 30-year-old male who retires at age 65 will need a savings of $441,882 to have an annual income of $14,787.32 for each year of retirement; and
- The 30-year-old female who retires at age 65 will need a savings of $519,892 to have an annual income of $14,787.32 for each year of retirement.

The federal government of Canada has developed an online Canadian Retirement Income Calculator to help Canadians plan for their retirement. The calculator takes users step by step through an estimate of the ongoing income they may receive throughout their retirement from:

- Old Age Security (OAS);
- Canada Pension Plan (CPP) or Quebec Pension Plan (QPP);

- employer pension(s);
- Registered Retirement Savings Plans (RRSPs); and
- other sources of ongoing income.

It will therefore help individuals calculate how much private retirement savings from their defined contribution pension plan or their RRSP they will need to provide a certain income for a set number of years.

The calculator can be found at the following website:

https://srv111.services.gc.ca

When using the calculator, it is important that individuals keep in mind that the calculations can only provide a rough estimate of future retirement income and that those estimates are expressed in today's dollars and do not consider the amount of taxes an individual will have to pay on his/her retirement income.

• • • The Impact of Inflation

It's important to recognize that inflation over the years will impact seniors' income by reducing the income's purchasing power. The table below shows how different rates of inflation impact on purchasing power over the years.

The Impact of Inflation on Future Purchasing Power
The Future Value of One Dollar ($1.00)

Inflation Rate / Number of Years	2%	3%	4%	5%	6%	8%	10%
5 years	91¢	86¢	82¢	78¢	75¢	68¢	62¢
10 years	82¢	74¢	68¢	61¢	56¢	46¢	39¢
15 years	74¢	64¢	56¢	48¢	42¢	32¢	24¢
20 years	67¢	55¢	46¢	38¢	31¢	21¢	15¢
25 years	61¢	48¢	38¢	30¢	23¢	15¢	9¢

Inflation obviously will impose a major burden on pensioners with fixed income; it is often described as "*a monster that dines on your future*". On a somewhat positive note, however, is the fact that today's inflation experience is more moderate (in the 2 – 3% range). However, in the past it has been severe, peaking in 1980 at about 12.5%.

• • • No Easy Solutions

There are two general observations and conclusions that can often be made about retirement planning.

Individuals generally underestimate how much is required to fund a flow of income at retirement (or for purchasing pensionable service) and its mirror image. And conversely, individuals generally overestimate how much a stream of income can be generated from a given amount of dollars.

Recognizing these factors early in an individual's working life is preferable to later in terms of retirement planning. It is also important that we recognize that Canada's public pension system plays a critical role and we can expect it to play a critical role in the future given the low pension coverage rates amongst Canadian workers.

Add to this the additional challenges faced by increasing life expectancy, early retirement aspirations of workers and volatile investment markets.