Research Project #15: Pension Plans and the Labour Force

Research Paper: Incentive Effects of Occupational Pension Plans

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EXECUTIVE AND WORKER SUMMARY

- About 35% of the workforce is covered by employer pension plans and coverage is declining over time. Coverage is much higher in the public sector compared to the private sector and in large firms and when there is a collective agreement. Coverage rates have grown more rapidly for females than males so that female coverage is now almost as high as male coverage.

- About 81% of plan members are in defined-benefit (DB) plans divided between 66% being in final-earnings plans and 15% in flat-benefit plans. About 16% are in defined-contribution (DC) plans although there has been an increase in DC plans relative to DB plans over time.

- The ageing workforce and impending retirements means that larger numbers are facing "pension issues." Impending labour and skill shortages means that employers may want to consider pensions as a strategic human resource policy to facilitate retention – the opposite to the strategy followed in the 1970s and 1980s to facilitate early retirements and downsizing.

- This will give rise to other related issues such as: age-related fringe benefits including disability benefits; reasonable accommodation requirements; age discrimination issues; and the continuation of seniority-based pay.

- For employees, the main challenge will be to insure a degree of financial security in retirement that may otherwise be jeopardized by:
  - A longer period of retirement because of increased life expectancy;
  - The decline in pension coverage and the shift from DB to DC plans;
  - Concerns over the financial viability of even DB plans;
  - Potential retrenchments in public pensions;
  - Risks to pensions associated with increases in non-standard employment and the *possible* decline of long-tenured jobs, at least for some.

- The long-term trend towards early retirement appears to be reversing perhaps reflecting:
  - Concerns over income adequacy in retirement perhaps from uncertainties over pensions;
  - A need to continue working to accumulate the service credits that affect pension benefits;

- The growth of non-standard work that may provide less income security although it may also accommodate continued employment;
- A desire or need to amortize the cost of a longer education period over a longer worklife;
- More job opportunities associated with the growing labour and skill shortages;
- Shift in the nature of work away from blue-collar work that is physically arduous, and towards white-collar work that is less physically demanding and intrinsically more interesting;
- Improved health and longer life expectancy;
- Fewer early retirement buyouts in pension plans;
- Increased participation of women, also coordinating their retirement with their husbands.

➢ With respect to retirement preferences:
- Most people tend to retire for voluntary reasons.
- Few retired due to mandatory retirement and few cited mandatory retirement as a substantial barrier to continued employment.
- Working time inflexibility was a prominent barrier.
- Slightly less than one-quarter of retirees return to work after initially retiring.
- Returning for financial reasons was the most prominent reason for returning.
- The expected age of retirement is increasing.
- The probability of returning to work after retiring is greatest for those with the following characteristics: healthy; younger when they initially retire; have a pension and other income that provides financial security during retirement; have an available job; were in a previous job that was not physically demanding; and had a "distaste" for retirement.

➢ Regulations on DB plans have also fostered the shift to DC plans. While DC plans may expose workers to more investment risk, DB plans also expose them to other risk:
- inflation risk since the benefits are not fully adjusted for post-retirement inflation;
- risk of benefit loss associated with job loss or job changing or wage concessions which affect earnings and service credits upon which such benefits are usually based;
- the risk of firm bankruptcy and its implications for pension solvency;
- risk associated with inadequate funding arising from various factors;
- risk associated with disputes over surplus assets;
- risk associated with having so much of your wealth tied to your employer;
- risk associated with not understanding the complexities of DB plans.

➢ Both theory and evidence suggest that employees "pay" for their pension plan in the form of compensating wages. This also implies that employees will "pay" in the form of lower cash wages for at least some of the benefits they may receive from improvements in occupational pension plans if those benefits impose a cost on employers. As well, it may be perfectly rational for workers in low-wage jobs to not want costly pension coverage since they may prefer the cash wages especially if they are liquidity constrained, or have spousal coverage or if private pension benefits when they are retired would reduce their eligibility for income-tested public benefits.

- The wage-benefit tradeoff could also imply that female wages are lower than male wages in part because of greater pension benefits that females receive because of their greater life expectancy. However, this is more than offset by other factors that reduce their pension benefits so that females tend to receive fewer pension benefits than do males and this exacerbates the male-female wage gap.

- Employer pensions are the most prominent source of income for seniors age 65 and over and the increase in both private and public pensions have contributed substantially to Canada's success in dramatically reducing poverty amongst the aged. Some concerns remain:
  - There are still some elderly groups "at risk", especially divorced and separated women.
  - Much of the improvement for seniors *relative* to that of non-seniors reflects the stagnation of employment income for the non-elderly.
  - For many elderly, the *security* of their income and well-being can still be "at risk" given the difficulties of combating elder abuse and financial exploitation.

- With respect to job tenure and hence the ability to accumulate pension benefits:
  - The evidence is inconclusive, but recent evidence suggests it has been decreasing because the decline for males has more than offset the increase for females.
  - There is more polarization about the average with short-duration jobs getting shorter and long-duration ones getting longer.
  - There is a slight decline in job duration for youths, and especially for less educated and younger males.
  - There is also considerable variability over time for youths.

- With respect to incentive effects, both theory and evidence suggests that employer pensions facilitate deferred compensation and a range of inter-related positive behaviours including: employee loyalty, commitment and bonding to the firm; employee interest in the financial solvency of the firm; and periodic and retrospective evaluations. Employees also exhibit a strong preference for such deferred compensation for reasons outlined.

- Pensions can be used strategically to induce early retirement and discourage postponed retirement (as was prominent during the downsizing of the 1970s and 1980s) or vice versa to alleviate shortages (as are prominent today).

- Pensions can foster desirable effects with respect to employee selection, recruitment and retention by discouraging poor performers from applying, and encouraging employees who are "savers" and future oriented.

- Pensions (and even under-funding) can foster employee interest in the financial solvency of the firm, which in turn can induce positive behaviour and foster a willingness to engage in concession bargaining.

- Pensions can save on current wages and thereby provide private sector firms with an internal source of funds. In the public sector the concern is that this will be used to reduce tax costs for current generations by shifting pension obligations to future taxpayers.

- Pensions can reduce unwanted turnover and quits (and thereby foster training) but this can also mean reduced mobility.

- Mandatory retirement, which existed for about half of the workforce in the 1990s before Ontario banned it in 2006, is intricately twinned with pensions in that the security of a pension income is the quid pro quo for having to retire from the particular job. Mandatory retirement provisions tend to prevail in "good jobs" and for workers who would generally not be considered as vulnerable. If mandatory retirement is banned, as is increasingly the case, this suggests that pensions may also dissipate or they may be altered in ways to serve as a substitute for mandatory retirement by creating incentives to leave the job with the pension plan. As well, it may be more difficult to have other human resource practices: deferred compensation; job and promotion opportunities for youths; succession planning as well as the costing of age-related benefits for employers; retirement planning for employees; and periodic and retrospective monitoring and evaluation of older workers.

- The evidence on job stability is mixed, albeit some recent comprehensive evidence suggests it has declined in the U.S. especially for older males. Whether this suggests that DB plans are less capable of delivering pension benefits that depend upon such long-term employment relations is an open question. Earlier Canadian evidence suggested no substantial change in job durations.

- DC plans, however, have other advantages for employees:
  - they do not inhibit mobility (as do DB plans);
  - they are attached to workers and not jobs and increasing emphasis is being placed on "protecting" workers rather than jobs;
  - while DC plans expose workers to investment risk, DB plans also have risk

- Both economic theory and empirical evidence suggest that employees "pay" for their pension plan in the form of compensating wages. This also implies that employees will "pay" in the form of lower cash wages for at least some of the benefits they may receive from improvements in occupational pension plans if those benefits impose a cost on employers.

- DB plans can have a wide range of incentive effects including:
  - facilitate deferred compensation with its positive associated effects for both employers and employees
  - induce early retirement and discourage postponed retirement (as was prominent during the downsizing of the 1970s and 1980s) or vice versa to alleviate shortages (as are prominent today)
  - foster desirable selection, recruitment and retention effects, discouraging poor performers from applying, and encouraging employees who are "savers" and future oriented
  - foster employee interest in the financial solvency of the firm, which in turn can induce positive behaviour
  - save on current wages and thereby provide private sector firms with an internal source of funds (albeit in the public sector this can be used to reduce tax costs for current generations by shifting pension obligations to future taxpayers)
  - reduce unwanted turnover and quits (and thereby foster training) but this can also mean reduced mobility.