How Much Do Retirees Spend?

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Financial planners are well aware that most retirement income projections are very sensitive to the assumptions made about how much retirees will spend over the entire duration of their retirement years. Due to the difficulty of estimating future spending, the standard approach is to either assume spending does not decline in retirement or that spending declines immediately to some rule of thumb amount (e.g. the 70%-80% Rule). Fortunately, there's been some relatively recent research on this topic, and the results indicate that retirement spending rarely moves in a straight (inflation-adjusted) line.

In this brief, we attempt to utilize the research to provide a framework for those trying to come up with their own estimates of how much they might spend during these critical years. The results might reveal some unexpectedly good news.

Research Findings

The most quoted research is a 2005 study in which a wealth manager Ty Bernicke, CFP®, drew on data from the Consumer Expenditure Survey conducted by the Bureau of Labor Statistics (BLS).[1] The survey results indicate that those age 75 or older spend an average of about 33% less than younger retirees, and 53% less than those at age 55. Moreover, Bernicke found that the gap held steady across different time frames.

Critics have responded that the spending differentials found in the study may not be as large or as voluntary as suggested. They cite studies showing that among the elderly, poverty does increase with age, and that those who are poor rely more heavily on Social Security. The issue is that since Social Security is adjusted for wage growth prior to retirement but only for inflation after retirement, older retirees will most often receive smaller benefits than younger retirees, one explanation for less spending.

Moreover, Bernicke didn't incorporate the fact that inflation is higher in some spending categories than others, as he only looked at a cross-section of the different age groups in a single year. With healthcare inflation over double overall consumer inflation in the last decade or two, one would expect higher healthcare spending by the current 65-74-year-old cohort when they reach the 75+ age group 10 years later.

Nevertheless, neither of these critiques accounts for all of the decline in spending. There is widespread agreement (and lots of anecdotal evidence) that the data is picking up the key trend that older retirees spend less on discretionary items such as travel, entertainment and restaurants, and that increased healthcare spending does not fully take its place. Moreover, many older retirees are quite ready to downsize and reduce their housing costs.

[1] Bernicke, Ty. "Reality Retirement Planning: A New Paradigm For An Old Science." Journal of Financial Planning, June 2005.

Thus, the first place to start is to figure how much of your projected spending is on discretionary items and maintaining a large home, and how much is required for the basics. In general terms, the more that is spent on discretionary items in early retirement, the more that spending can and is likely to decline in later years.

This pattern of declining discretionary spend is backed by anecdotal evidence from financial advisors. Michael Kitces, CFP®, ChFC, a financial advisor and industry consultant, actually examined his firm's affluent financial planning clients at age 64 and 84 and found an average decline in overall spending of 20%.[2]

What About Healthcare Costs?

Retirees' healthcare expenditures include two categories of costs:

(1) premium costs for insurance coverage (Medicare and supplemental insurance policies); and

(2) expenditures on services or items paid for directly by the insured (deductibles, co-payments and expenses typically not covered by Medicare, such as dental and eyecare).

There is no question that these expenses rise with age. Such results have been found not only in the BLS study cited above, but in others, including the Health and Retirement Study conducted by the National Institute on Aging.[3] Yet both studies found that, on average, increased healthcare spending is not enough to offset decreases in other categories, primarily because Medicare puts a brake on healthcare spending (exclusive of long-term care) with out-of-pocket maximums. Moreover, these surveys examined the average American, who spend far less on discretionary items than the affluent.

One key concern is the trajectory of healthcare spending in the last five years of life. Much has been written about how healthcare spending can spiral out of control at the end of life, and this is the main justification for long-term care insurance.

Researchers utilizing the above-mentioned Health and Retirement Study found that spending does increase for all income groups at the end of life.[4] Specifically, they found that those in the top 10% of total healthcare spending spent on average $163,000 (at constant 2008 dollars) during their last five years, with nursing home expenditures accounting for 58% of total spending. While this amount is manageable for the wealthiest households (and is why many wealthy people choose to self-insure), the study found that, on average, total spending during those years exceeded the financial wealth (exclusive of the home) of 43% of the subjects in the study.

The Bottom Line

All the research to date supports the notion that the larger the percentage of discretionary spending relative to total spending, the greater will be the projected spending decline in later years. The planner who examined his firm's largely affluent clients over a 20-year period argued that most retirement spending plans can be given a 10% haircut when the individual

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[2]Kitces, Michael. "Do Your Clients Spend More, Or Less, in Their Later Retirement Years." Blog on Kitces.com, February 28, 2012

[3]National Institute on Aging. Health and Retirement Study. University of Michigan.

[4]Kelley, Amy et.al. "Out-of-Pocket Spending in the Last Five Years of Life." Journal of General Internal Medicine. Volume 28(2). September, 2012

(or couple) is in their mid-70s, and another 15% when they are in their mid-80s.

An alternative approach, suggested by Wade Pfau, Ph.D., a professor at the American College of Financial Planning, is to break down estimated retirement spend into four buckets: basic living, taxes, healthcare, and leisure. For each category of spending, a person starts with how much money is available to spend at the time of retirement. Then, the person applies adjustment factors, based on his or her age. These will produce a more detailed view of the trajectory of retirement spending over time. This type of analysis can be further refined by applying different inflation rates to each category of spending.

Table 1 shows a simplified illustration of such age banding. The approach, and the adjustment factors, can be customized.

The bottom line is that financial planners whose clients are affluent may be underestimating how much spending tails offs later in life and, therefore, overestimating how much savings is required to have a comfortable retirement. We will be investigating this issue with our clients in the coming year.

Table 1. An Age-Banding Illustration

	Inflation Rate	Lifestyle Adjustment Factor-Age 65	Lifestyle Adjustment Factor-Age 75	Lifestyle Adjustment Factor-Age 85
Taxes	3%	0.5	1.0	1.0
Basic Living	3%	0.7	0.8	0.9
Healthcare	7%	1.15	1.2	1.25
Leisure	7%	1.5	0.5	0.25

Source: Pau, Wade. "How Do Spending Levels Evolve During Retirement?" *Advisor Perspectives*, March 13, 2012. Framework adapted from Somnath Basu's "Age Banding: A Model for Planning Retirement Needs." *Financial Counseling and Planning*. January 2005.

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