Retirement Spending and Changing Needs During the Retirement Period
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One of the most important factors affecting well being in old age is the resource allocation decision. Since work and borrowing decisions can be limited in old age, resource availability in retirement is primarily determined while young, through savings. For a secure retirement, younger workers must decide how much they will need in retirement, and how to protect themselves in case their estimate is too low. This guesswork, along with actual investment returns, are the two most important factors in determining a secure retirement.

This collection of papers, presented in a Society of Actuaries (SOA) symposium on retirement spending, all focus on how to come up with better estimates. The Society of Actuaries Committee on Post-Retirement Needs and Risks, the symposium's sponsor, focuses on what risks are important in old age and how to manage them. Two of the questions that have come up repeatedly is why spending is lower in retirement than before retirement and how spending changes. To help us understand these issues better, a call for papers was issued on the topic of "Retirement Spending and Changing Needs during the Retirement Period" and papers were presented at a symposium in late 2007. This article provides an overview of the issues raised and provides observations on the key issues raised from the perspective of the author.

Previous research has attempted, through deductive reasoning, to ascertain the optimal "replacement rate," the proportion of pre-retirement income that is needed post-retirement that keeps the standard of living constant. Perhaps the most well-known study on this topic is that of Palmer (1989), who infers replacement rates from the different tax treatment of labor, pension, and Social Security income, as well as the assertion that retired households need no longer save. Palmer's 1986 replacement ratios, which range from approximately two-thirds (at higher levels of income) to eight-tenths (at lower levels), have been advocated by many retirement planners and textbooks ever since (see, for example, Schulz (1995); Dickman et al, 1998; Gitman and Joehnk, 2005). The appropriateness of these replacement ratios hinges upon two factors. One, that individuals want the same amount of consumption in retirement as before, and two, that household saving pre-retirement will build asset amounts sufficient to insure smooth consumption over the remaining lifetime (Palmer's savings amounts were gleaned from consumer expenditure data). There is an abundance of evidence that consumption tends to decrease in retirement (Bernheim, Skinner and Weinberg, 2001; Laitner and Silverman, 2005). But does this reflect ex-ante preferences, or poor financial planning? This conundrum has been previously referred to as the "Retirement Savings Puzzle" (Banks, Blundell and Tanner, 1998).

The main theme of this symposium was to shed light on the nature of this puzzle by understanding more clearly what determines consumption in retirement. The symposium uncovers substantial evidence that not only confirms the propensity for households' expenditures to decrease in the retirement years, but also that one's financial situation/circumstances, and not preferences, impacts how much of one's income is replaced. Yung-Ping Chen, Jon Scott and Jie Chen use longitudinal data on consumption collected from the Health and Retirement Survey from 2001, 2003 and 2005. They analyze eight different categories of expenditures, and show not only that retired households spend less, but that retirement seems to exacerbate the effects of age, race and disability status on expenditures. Charles Hatcher uses data from the 2004 Consumer Expenditure Survey and finds that wealthier households see a smaller drop in consumption at retirement, suggesting that liquidity, or even perhaps poor financial planning, might play a role in retirement spending. Barbara Butrica and Gordon Mermin use the 2001 Health and Retirement Survey and find that older households that have more of their wealth in payout annuities tend to spend less in retirement, which may indicate myopia on the part of the older consumer. Sumit Agarwal, John Driscoll, Xavier Gabaix and David Laibson use data collected on individuals from an institutional lender in 2002, and find that while financial acumen increases during pre-retirement years, it tends to decline in retirement. There is an abundance of evidence coming out of this symposium that financial circumstances—not merely preferences—play a significant role in retirement consumption.

There is also evidence that the replacement ratio concept is too simplistic, and that heterogeneity among individuals (including even heterogeneity in preferences) is impacting how much people spend. Anna Rappaport shows that while income can change dramatically in the retirement years, there can be many different patterns and/or approaches to the retirement transition, as well as different “money personalities,” which can lead to vastly different recommendations and results. Rappaport stresses that retirement is not merely a point in time whereby things change, but a period of change in itself. Though not in the paper, Rappaport suggested at the symposium different "phases" of retirement, whereby one might apply different replacement ratios. The practical efficacy of different replacement ratios for different stages of retirement notwithstanding, one clear conclusion of the symposium was that replacement ratios are too simplistic for today's complex retiree (note that the Society of Actuaries 2007 Risks and Process of Retirement Survey provides more information on the stages of retirement. The full report of the study can be found at *http://www.soa.org/research/pension/research-post-retirement-needs-and-risks.aspx*)

The housing budget seems to be an important portion of retirement spending, and also acutely attributes to its variability. Retired homeowners can expect to spend much less on housing than renters, homeowners that own free and clear even less so. And housing options also tend to be more expensive as health care declines. Surprisingly, evidence on the effect of health status on retirement expenditures seems more mixed. Chen, Scott and Chen find little evidence of effects of health status on expenditure in their panel (they conclude that public programs may serve as a cushioning effect). However, Vickie Bajtelsmit and Scott Harrington use data from the household component of the Medical Expenditure Panel Survey and find that as many as 10 percent of retired households have unexpected health status changes. Furthermore, they find that health care expenses make up almost 20 percent of out-of-pocket costs for the bottom quintile of elderly American households, an astonishing statistic, given the amount of public dollars devoted to health care for older Americans (not to mention the poor). These findings highlight the variability in health care expenditures across households—

the sickest 10 percent of the retired population account for a majority of the expenditures on health care.

Going forward, one major challenge will be to glean how much of these changes in retirement spending can be predicted. For items that are likely to be potential shocks, insurance seems the more effective solution. For items that are more predictable, better retirement planning and decision-making (particularly the timing of retirement, annuitization of assets, asset allocation in retirement, etc.) seems more important. Furthermore, many lower income retirees are essentially dependent on public programs. While costs tend to hit lower income groups harder, it is unclear whether or not the for-profit financial services community will be ready to help.

It is clear that retirement planning needs to include components that take into account different phases of retirement (early, middle, late) and need to be contingency based (e.g. account for periods of widowhood). In the end, the question isn't which rule of thumb is most appropriate, but rather—how can individuals and families, with the assistance of the financial service profession, figure out the most appropriate strategy for themselves?

References

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