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Will the Financial Fragility of Retirees Increase?

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Retirees have long been considered financially fragile. The notion that they are ill-equipped to absorb financial shocks is captured in the traditional trope that they live on fixed incomes. Going forward, retirees will get much less income from fixed Social Security and employer pensions, and much more from savings in 401(k) plans and individual retirement accounts (IRAs). These savings give retirees greater flexibility to respond to shocks. But tapping into their nest eggs comes at the cost of having fewer resources to cover ongoing expenses. The increased dependence on financial assets also introduces new sources of risk—that households accumulate too little over their working years or draw down their savings too quickly in retirement, and their finances increasingly are exposed to financial market downturns. To the extent these changes increase the financial fragility of retirees, they create new challenges that must be addressed.

WEATHERING SHOCKS TODAY

What makes retirees financially fragile is not just that their incomes are fixed, but that their expenses also are largely fixed. Butrica et al. (2005) find that nearly 80 percent of the expenditures of retirees are used to secure five basic needs: housing, health care, food, clothing, and transportation (see figure 1; note that these "basic" needs do not include cable TV or a cell phone).[1] The study also finds that these five basic needs account for an even greater share of the expenditures of lower-income households, single individuals, and households that rent or have a mortgage (Butrica et al. 2005). Retirees could cut back on entertainment, gifts, and other "non-basic" items if hit by a sudden spike in expenses or a drop in income. They also could trim spending on basic needs, primarily on food or transportation. Nevertheless, these figures suggest that most retirees cannot cut their current expenditures more than 20 percent without experiencing hardship. Lower-income households, single individuals, and households that rent or have a mortgage are even less able to cut back.

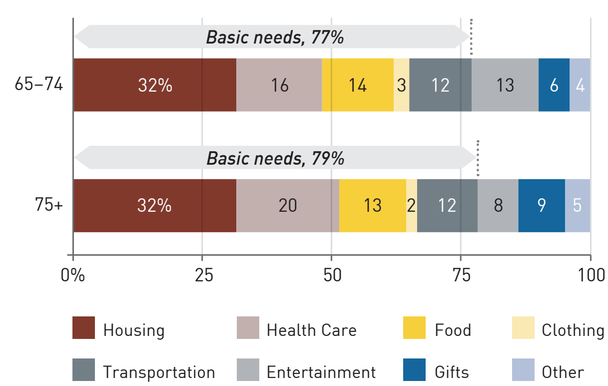
Retirees face two major shocks today: a spike in medical expenses and a sharp drop in income when widowed.

- Medical expenditures can jump much higher suddenly, and this is especially so for retirees who are more susceptible to health shocks and more likely to develop conditions that require expensive care (see figure 2). Given the importance of care to those who need it, medical expenditure shocks could crowd out spending on other basic items.
- The other common shock is a sharp drop in income upon becoming a widow. Most Americans enter retirement as married couples, and the wife typically outlives her husband. Federal poverty thresholds say widows need 79 percent of the couple's income to maintain their standard of living.[2] But Social Security and employer pension plans provide significantly less. Gillen and Kim (2009) find that women

Figure 1

ALLOCATION OF SPENDING FOR TYPICAL HOUSEHOLDS, AGES 65–74 AND 75+

Figure 1 shows the average allocation of spending for the 45th–55th percentile of per-capita household spending.

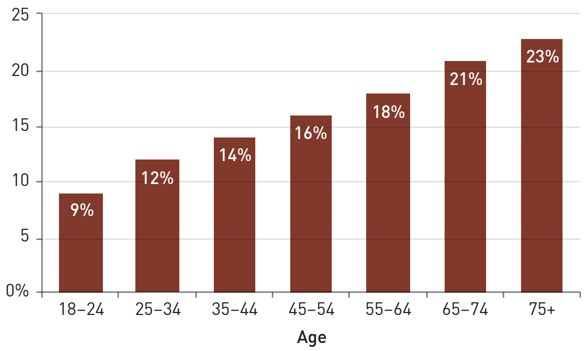


Source: Butrica et al. (2005)

Figure 2

PERCENTAGE OF FAMILIES MAKING AN "EXTRAORDINARY" MEDICAL PAYMENT RISES WITH AGE

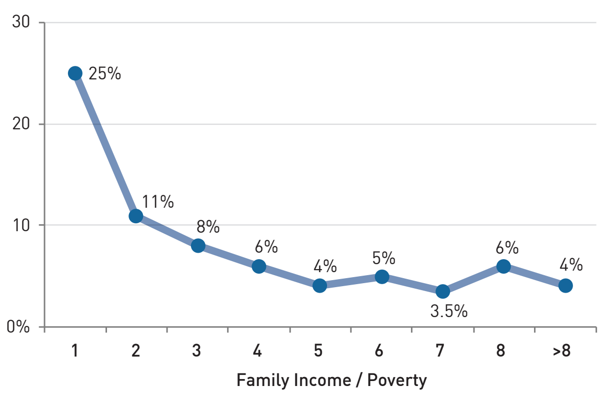
An "extraordinary" medical payment is at least $400, more than 1 percent of annual income, and more than two standard deviations above the family's normal monthly mean expense on health care in 2013–2015.



Source: JP Morgan Chase & Co. Institute (2017)

Figure 3

PERCENTAGE OF HOUSEHOLDS AGES 65 AND OLDER EXPERIENCING HARDSHIP, BY FAMILY INCOME RELATIVE TO THE POVERTY LINE



Source: Adapted from Levy (2009)

widowed between 2002 and 2004 typically received 62 percent of the couple's Social Security benefit and only half of its employer pension benefit. Weaver (2010), using the Modeling Income in the Near Term (MINT) simulation model, projects similar reductions for married women entering retirement over the next quarter century: Half will have 62 percent of the couple's income or less when widowed; one in four will have 55 percent or less (Weaver 2010; Butrica et al. 2012).[3]

Studies find that while some of today's elderly are unable to absorb these shocks without incurring hardship, this is generally not the case. Levy (2009) identifies hardship as cutting back on needed food or medication due to a lack of funds.[4]

Levy (2009) finds that only 10 percent of retirees report such cutbacks over a given two-year period. Because the incidence is greatest among the poor, Levy (2009) suggests that this financial hardship is due to a chronic lack of income as much as a sudden shock. Nevertheless, about 5 percent of households with incomes well above the poverty line report cutbacks in needed food or medication due to a lack of funds (see figure 3).[5]

Levy (2009) finds health declines to be a clear predictor of such cutbacks. Each one-point decline in self-reported health, on a one-point scale from "excellent" to "poor," is associated with a one-percentage-point increase in the incidence of hardship. Levy (2009) also finds evidence that widowhood increases hardship. The incidence of cutbacks in needed food or medication due to a lack of funds was 3.5 percentage points higher among single women, most of whom were widows, than among married women. Sevak et al. (2003) likewise find that a significant number of women with incomes above the poverty line when their husbands are alive have incomes below the poverty line when widowed.[6]

Shapiro (2009), however, finds that health shocks and widowhood do not generally create hardship—at least not immediately. The study examines how household expenditures change up to four years following a health shock or the loss of a spouse. It finds that health shocks that increase medical spending typically are associated with an increase, not a decrease, in non-medical expenditures. Rather than crowding out other types of consumption, spending typically rises on items such as home maintenance, food preparation, and transportation—expenditures occasioned by a decline in health.[7]

Shapiro (2009) also finds that the consumption expenditures of widows are generally about 75 percent of what the couple had spent, about the amount needed to maintain their standard of living. The study finds that widows generally experience a decline in household income consistent with Gillen and Kim (2009), but that the decline in income is much greater than the decline in consumption. These findings suggest that most widows have sufficient reserves they can tap into to maintain their standard of living. That they tap into these resources, despite the decline in income, supports the notion that retirees' expenditures, even for non-basic items, are relatively fixed.

The results of these studies indicate that a majority of today's retired households are able to absorb financial shocks without incurring serious hardship. Public and private health insurance, family contributions, and retirees' savings seem sufficient to allow most to avoid a significant reduction in living standards—at least in the years immediately following the shock.

WEATHERING SHOCKS TOMORROW

Changes in the retirement landscape suggest that the finances of future retirees could be more fragile. Social Security will replace a smaller share of household earnings at any given claiming age.[8] Drawing income from 401(k)/IRA savings is far more challenging and, for most retirees, likely will replace a smaller share of pre-retirement earnings than employer pensions had in the past.[9]

Butrica et al. (2012) quantify the growing importance of financial assets using the MINT simulation model. The study estimates the change over time in household incomes at age sixty-seven, when most individuals have retired, assuming that households annuitize 80 percent of their financial assets. Figure 4 shows the rising contribution of financial assets to retirement income (excluding earnings from work and imputed rent). The increased dependence on financial assets is especially striking for low- and middle-income households, which currently rely primarily on Social Security and (for the middle income) employer pension benefits.

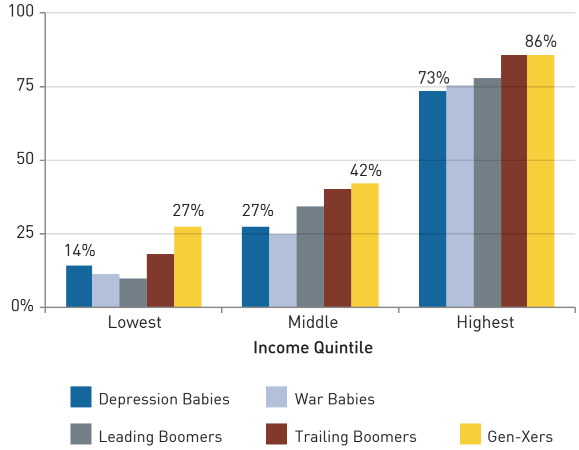
The fragility of retirees would rise if they failed to accumulate enough savings to provide the same cushion of income above the fixed expenses that they carry into retirement. And this seems to be the case. According to the MINT projections, retirement incomes over the next quarter century will replace a smaller share of pre-retirement incomes than they do today. Figure 5 shows the projected decline in replacement rates for baby boomers and gen-xers at age sixty-seven, compared to the replacement rates of recent retirees, who are now in their seventies and older. The projected declines are significant; for gen-xers, they range from 6 percent to 21 percent.

These projections actually understate the likely decline in replacement rates. They assume households annuitize most of their savings at an actuarially fair rate, which provides more income per dollar than commercially available annuities or "safe" drawdown strategies.[10] Because few retirees purchase annuities, the income that most will get from their savings will depend on how they invest, their investment returns, and how they draw down their savings. The 4 percent drawdown rule, traditionally considered a best practice, says that retirees have little chance of running out of money if they invest about half their savings in stocks and, at age sixty-five, draw out 4 percent of their savings, with the amount thereafter rising in line with inflation. Many experts now think that a 4 percent drawdown rate is too high, given rising longevity and potential declines in investment returns. Whatever the safe withdrawal rate and asset allocation, the risk of running out of money rises if retirees draw out more or invest a different amount in equities (Finke et al. 2013; Finke and Blanchett 2016). Having a substantial portion of their wealth in the form of financial assets, as opposed to employer pensions, improves the ability of retirees to respond to shocks. Income from savings does not

Figure 4

POTENTIAL SHARE OF RETIREMENT INCOME FROM FINANCIAL ASSETS AT AGE 67, BY COHORT AND INCOME QUINTILE

Retirement income excludes income from work and imputed rent. Per-capita family income, used to sort households into quintiles, includes such income. Depression babies turned age sixty-seven between 1993 and 2002; war babies between 2003 and 2012; leading boomers between 2013 and 2022; trailing boomers between 2023 and 2032; and gen-xers between 2033 and 2042.

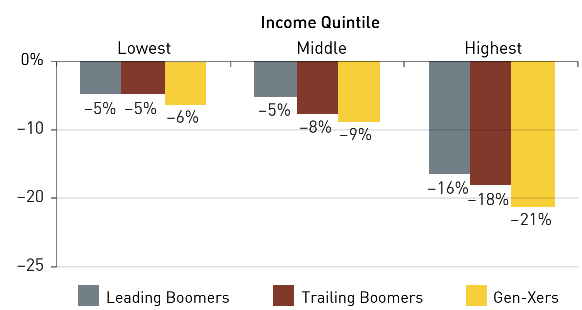


Source: Author's calculations based on Butrica et al. (2012)

Figure 5

PROJECTED PERCENTAGE DECLINE IN REPLACEMENT RATES AT AGE 67 FOR BOOMERS AND GEN-XERS RELATIVE TO RECENT RETIREES, BY INCOME QUINTILE

In this case, retirement income includes income from work and imputed rent because complete data on individual income components were unavailable. Households are sorted into quintiles based on per-capita family income. Leading boomers turn age sixty-seven between 2013 and 2022; trailing boomers between 2023 and 2032; and gen-xers between 2033 and 2042. Recent retirees are households that turned sixty-seven between 1993 and 2012.



Source: Author's calculations based on Butrica et al. (2012)

decline when widowed, unlike employer pension benefits. But using savings to cushion a spike in medical or other unexpected expenditures leaves less to provide for the household's ongoing consumption needs. Increasing the withdrawal rate to offset a decline in Social Security benefits also raises the widow's risk of outliving her savings.

Using savings to offset a shock generally will be less of a problem toward the end of life. A safe withdrawal rate usually, but not always, results in the household retaining a relatively large amount of its savings to advanced ages, and medical expenditure shocks and the loss of a spouse often come at those ages. But given the projected decline in replacement rates and narrowing income cushion above household fixed expenses, retirees hit by a shock early in retirement could face a serious problem (Milevsky and Abaimova 2006). They face hardship if they fail to tap into their savings to cover basic expenses, but they increase the risk of hardship later on if they do. Given the volatility of financial markets, it is all but certain that some cohorts will be hit by a sharp financial downturn early in retirement, making this difficult choice even harder, and increasing the incidence of hardship, either then or later.

IMPLICATIONS

The incomes of retirees will be much less fixed going forward, and much more dependent on what they draw out of 401(k)/IRA savings. But this does not mean that their finances will be less fragile. Even if they purchase annuities or use best practice drawdown strategies, current projections suggest that cushions between retirement incomes and household fixed expenses will decline. Best practice drawdown strategies also involve investments in equities, and thus exposure to financial risk.

Households entering retirement thus need to focus on expanding the cushion between their income and fixed expenses. Working longer, annuitizing, and taking out a reverse mortgage are the best options for increasing retirement incomes. Downsizing is the most effective way to reduce fixed expenses and also could increase the household's financial assets. While many individuals already are working somewhat longer, retirees rarely annuitize, downsize, or take out a reverse mortgage.[11]

Households also need to address the risk of a financial downturn early in retirement. Reducing allocations to equities reduces households' exposure to financial shocks, but at the cost of reducing the expected income savings will provide. For households unable to absorb the shock of a significant downturn, this is a welfare-improving strategy.

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ENDNOTES

1. Foster (2016) reports a similar pattern of average (not median) expenditures using the 2014 Consumer Expenditure Survey.
2. This figure would be lower using the alternative supplemental poverty measure developed by the U.S. Census Bureau. For example, see the influential study edited by Citro and Michael (1995), which contended that a widow would need a lower percentage of the couple's income because the official federal poverty thresholds build in too much economy of scale.
3. Widows' income from "all sources" excludes the annuitized value of financial assets.
4. Hardship is identified based on responses to: "(Since your last interview/in the last two years), have you always had enough money to buy the food you need?" and "At any time (since your last interview/in the last two years) have you ended up taking less medication than was prescribed for you because of the cost?"
5. Many households of working age also are financially fragile, with one in four unable to come up with $2,000 to cover an unexpected expense (Lusardi et al. 2011). In contrast to workers, retirees have little ability to improve their finances through borrowing or working and are especially vulnerable to the two major shocks identified in this section.
6. The greater incidence of hardship among single women in Levy (2009) is to a large extent due to their lower incomes adjusted for household size. Controlling for income, the incidence of hardship among single women is just 1.4 percentage points higher than for married women. This finding is consistent with the notion that the reduction in income that widows experience increases the incidence of hardship. But as widows were disproportionately in lower-income households when married (Sevak et al. 2003), the finding that does not control for income could overstate the relationship between widowhood and hardship.
   Losing one's husband since the previous interview is associated with a similar increase in hardship, but the relationship is not statistically significant. Levy (2009) suggests that this lack of statistical significance could be due to the limited number of women becoming widowed and experiencing hardship over the survey's two-year window.
7. Butrica et al. (2009) also find little or no reduction in non-health spending.
8. The factors affecting Social Security replacement rates are a rise in the program's full retirement age, increasing Medicare premiums, more beneficiaries subject to income tax on a portion of their benefits, and the increased employment of married women. For details, see Ellis et al. (2014) and Wu et al. (2013).
9. 401(k) plans tend to have modest balances; the typical working household ages fifty-five to sixty-four with a 401(k) had combined 401(k)/IRA wealth in 2016 of $134,000 (Munnell and Chen 2017). In addition, Munnell et al. (2016) find that each dollar of 401(k) wealth yields less retirement income than a dollar of wealth from a defined benefit plan.
10. For a discussion of the impediments to annuitization, see Sass (2016). "Actuarially fair" annuity rates ignore insurance company costs and adverse selection and produce about 20 percent more income than commercially available annuities (Mitchell et al. 1999).
11. See Kitces and Pfau (2015) and Delorme (2015).

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