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Understanding how people spend their money in retirement

Aaron Minney | Challenger | 12 April 2018

In putting a plan together with a client to generate income in retirement, time horizon should, of course, affect the substance of the plan. And, with new retirees realistically able to expect to live up to 30 years or more, it's reasonable that their spending needs will change over time. However, the question of spending profile over time is often avoided or glossed over. It needs to be addressed. Assuming a constant level of real spending is like ignoring the topography of a map - when walking through mountains, the shortest and most direct path is often not a straight line on the map.

A PROBLEM WITH THE TRADITIONAL ASSUMPTIONS

The traditional economic assumption is that people maintain (or, at least, try to maintain) a constant real level of spending throughout their lives. This includes the assumption that spending is constant in real terms throughout retirement. Bengen's 4% rule explicitly assumes that this is the spending profile.

But there is a big problem with this assumption. It is not what people do.

In retirement, measures of spending point to older retirees spending less than younger retirees. This is sometimes described as the difference between an active stage of retirement and a passive stage of retirement - an additional frail stage when health-related costs increase but most of the other expenses fall away. The pattern is far from an assumed constant, real spending level.

The observed pattern might just reflect that older retirees can see their capital running down and so they reduce their spending. However, it also aligns with the health of older retirees. They might have once been able to enjoy an active lifestyle but eventually slow down as they find themselves unable to enjoy an active lifestyle even if they could still afford it.

So retirees face an economic problem over time. They have limited resources but they still want to get the most out of life. Planning to spend the same level throughout retirement won't maximise the utility of a retiree whose health deteriorates. They may have the money for golf fees in their 90s but alas, they can't swing the club like they used to so they won't enjoy the benefit of their retained money. The preferable option is probably to play more golf as a younger retiree.

HOUSEHOLD SPENDING OVER TIME

Knowing that an 80-year-old spends less than a 65-year-old today doesn't necessarily tell us what the 65-year-old will spend in 15 years. There are many other variables that the cross-section misses.

Looking at a longitudinal study such as the HILDA surveys can provide a better picture on the path of household spending over time.[1]

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Interestingly, spending tracked by the HILDA surveys does not change much over time. Average spending, adjusted for inflation, is broadly constant when households are matched over time. It is also the case that older retirees are spending less than younger retirees.

To clarify, at any time, older retirees are spending less than younger retirees but, over time, retirees maintain their level of spending (in real terms, on the items measured in the HILDA survey).

This is clear evidence of a cohort effect for retirees. In effect, people lock in their lifestyle at the point of retirement. (Anecdotally, you can tell how long someone had been retired by the model of their car they drive in retirement. Upgrading to a new car at the point of retirement and continuing to drive that car, until someone can no longer drive, is a common observation reflecting this lifestyle lock-in.)

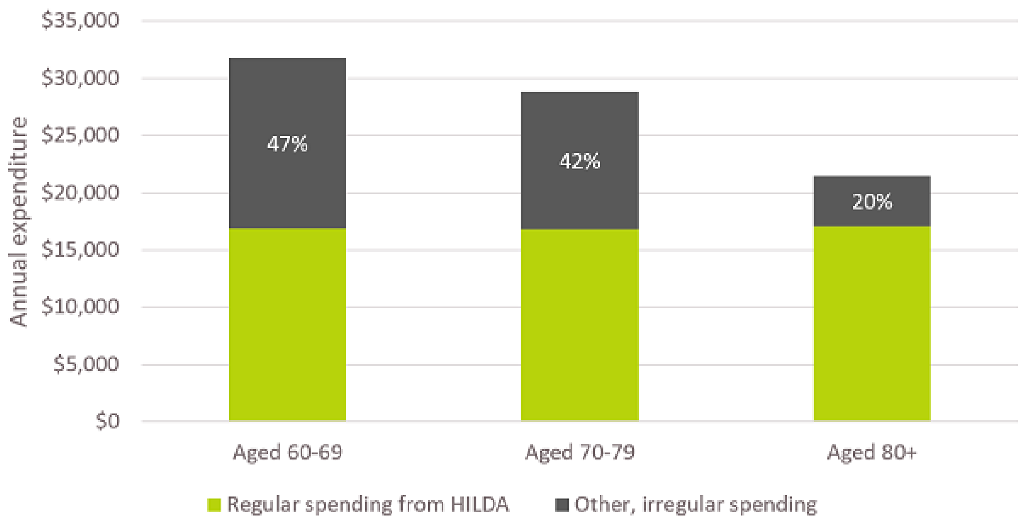
DON'T FORGET ABOUT THE OTHER SPENDING

Importantly, HILDA doesn't measure all spending. In fact, if you look only at HILDA, you might conclude that Australian retirees spend less than the age pension. However, there is limited other supporting evidence for this conclusion.

Instead, the data points to age pensioners spending down their savings and not accumulating more. Of course, some wealthy retirees do save more as they can't spend the income from their lofty savings base. There is not much commentary that the age pension is too generous, with arguments for the government to cut the level of support.

Spending that isn't measured in HILDA is measured by the Australian Bureau of Statistics (ABS), but it doesn't track households over time. By linking the two data sources, it becomes clear that not only are older retirees spending less, but they are spending a lower proportion on the expenditure items that are not included in HILDA. This pattern is consistent across years with the pattern for single households in 2015-16 shown in Figure 1. The percentages highlight the proportion of spending outside the HILDA survey.

Figure 1: Retired single households expenditure, by age
2015-16



Source: Constructed by author from HILDA and data supplied by the Australian Bureau of Statistics

NEED AND WANTS

The split between HILDA and the other spending might not be an exact match to retiree desires, but it does highlight two different types of spending.

The first is a level of spending that is maintained across ages and is generally captured by HILDA (the green in Figure 1). Let's call these 'needs'. The other spending appears more flexible so let's call them 'wants'. Wants tend to fall with age (as seen in Figure 1) and it seems that retirees choose to forego this expenditure while they continue meeting their needs.

This concept of needs and wants seems sensible in the real world. If retirees have two different types on consumption, it makes sense to generate the income to spend on needs and wants in different ways. A good retirement plan should include the flexibility to meet the retiree's needs and the wants separately. This is what an income layering approach delivers to retirees.

ENDNOTES

1. HILDA stands for the *Household, Income and Labour Dynamics in Australia* survey which is funded by the Department of Social Services and managed by the Melbourne Institute. It tracks a panel of Australians over time, capturing - among other variables - spending of key items at the household level.

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