Challenger

Retirement Income Research

Spending patterns in retirement

Retiree's spending is not constant over time – it changes as they age

Introduction

Most people can expect to enjoy a long time in retirement and planning for retirement income should reflect that, over this period, people's lifestyle and spending are likely to change. Academics and planning software often assume that spending will be fixed, but in the real world it changes. Understanding the typical pattern of retiree spending can help advisers develop a retirement income plan that will be more likely to suit their clients' needs.

The typical assumption: constant real spending

A common approach for spending is to assume that it is constant in real terms throughout retirement. Nobel-Prize winning economists such as Paul Samuelson and Franco Modigliani posited that people should smooth their consumption. Bill Bengen used the approach in developing his 4% rule- namely if retirees spend 4% of their starting capital and increase that with inflation every year, then there is a very high chance that their spending will last 30 years (their assumed lifespan).[1]

However, looking at what people do, provides a different picture. Blanchett (2014) looked at actual US spending and found that spending tends to fall at different rates in real terms through retirement.[2] Using Australian data from the HILDA survey highlights that total spending falls, but there is a distinct difference in behaviour between spending types.[3]

1 Bengen, W. (1994) 'Determining Withdrawal Rates Using Historical Data'. Journal of Financial Planning 7, 4 (October): 171–180.

2 Blanchett, D. (2014). 'Exploring the Retirement Consumption Puzzle.' Journal of Financial Planning, May 2014. https://www.onefpa.org/journal/Pages/MAY14-Exploring-the-Retirement-Consumption-Puzzle-.aspx.

3 Full paper to be published in 2018.

There is clear evidence that retirees spend differently on 'needs' and 'wants'

Needs and wants

The evidence suggests that retirees spend differently on two types of consumption, which we can call ‘needs’ and ‘wants’:

> **Needs** are the regular everyday expenses that define someone’s minimum standard of living. They will want to meet their needs under all situations.
>
> **Wants** are those goods and services that are not made consumed every day and/or can be more easily foregone. They will define a higher lifestyle, which is desirable, but the impact from not having the want satisfying is not as large.

The Australian Bureau of Statistics (ABS) publishes data on how much Australian households are spending. This enables us to track average spending over time (as the ASFA retirement standards do[4]) but it doesn’t tell us what happens within households. For that we need a data set that tracks the spending of the same household over time. This is exactly what the HILDA database does.

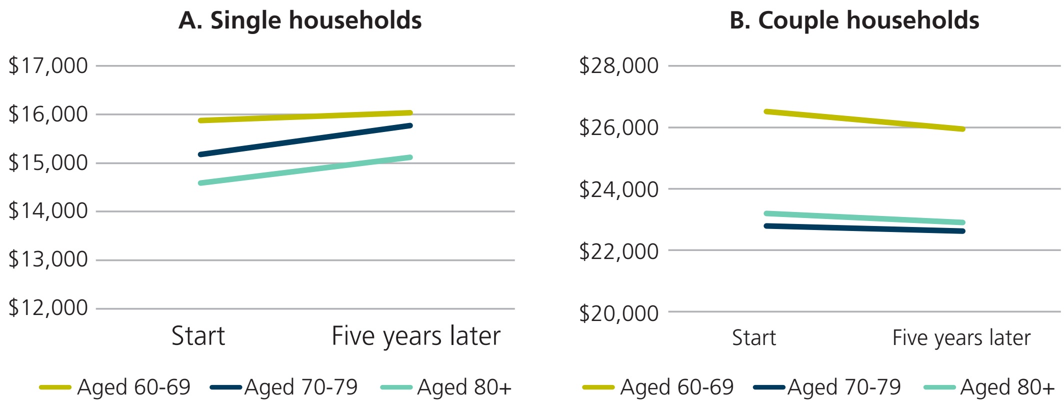
The HILDA database

Data on spending is available from the HILDA survey but is not complete. It only includes regular spending items. The expenditure data from HILDA can be used to approximate spending on ‘needs’ by retiree households and how that changes over time. We can use the ABS numbers on total spending to determine how spending on ‘wants’ varies with age.

Household spending on regular items adjusts in line with inflation, on average.

On average, household spending on the regular items in HILDA changed broadly in line with the CPI movements. For single households, it is clear the 80-year-old households spent less than the 70-year-olds who spent less than 60-year-old retirees. Younger couple households spent the most.

Figure 1 Real household spending changes by age and household type



Source: Calculated from the HILDA database. Spending is across all items collected in HILDA survey by retired households of a stable 1 or 2 persons for 5 years. Values adjusted to 2016 prices using CPI.

4 https://www.superannuation.asn.au/resources/retirement-standard provides details on the ASFA retirement standard.

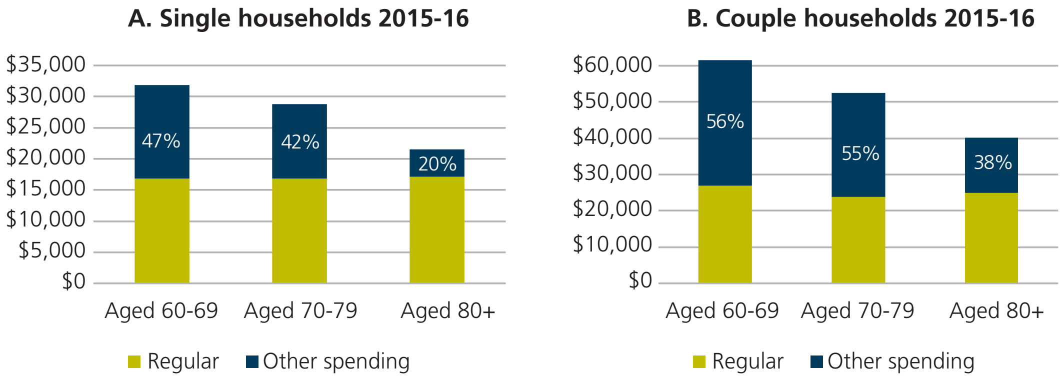
Constant needs, but declining wants

The HILDA data show that retirees spending on regular essentials (their 'needs') remains broadly constant in real terms. There is a cohort effect with more recent retirees spending more, so at any point in time, the older retirees are spending less than younger retirees.

The same is not true for total spending. Household expenditure data from the ABS shows that total spending falls with age. The reconciliation for this can be seen in Figure 2. Older retirees spend a smaller proportion of their total spending on wants, with a higher proportion being spent on needs. While the needs are broadly constant, the reduction in wants leads to a decline in overall spending. This is consistent with assumptions about lower spending in a passive retirement phase after an active retirement phase.

Spending on needs is constant over time, but spending on wants decline

Figure 2 Regular and other household spending, by age and household and 2015-16



Source: Calculated from the HILDA database and data from the ABS Survey of Income and Housing

Implications for retirement income plans

Retirees spend money on two different forms of consumption. They spend a consistent amount (adjusted for inflation) on their regular, everyday needs. This will be sustained through retirement. They also have irregular spending on items that they could potentially do without. As they get older, retirees will spend a smaller proportion on the wants in their consumption, preserving their spending on everyday needs.

A retirement income plan should align with these different spending needs. Retirees require a secure layer of income that will meet their spending needs through retirement, as well as a flexible approach to other income to pay for their various wants in life.

The information in the report has been compiled by the Challenger Retirement Income Research team.

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