THE GROWING BURDEN OF RETIREMENT

RISING COSTS AND MORE RISK INCREASE UNCERTAINTY

NATIONAL INSTITUTE ON
Retirement Security
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By Tyler Bond and Dan Doonan

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EXECUTIVE SUMMARY

Retirement has long been a daunting challenge for working people. Saving enough during working years to retire securely has never been easy, but the burden of preparing for retirement has increased in recent years. Social Security now replaces less income than it did in the past. Fewer Americans are offered a defined benefit pension through their employer. Defined contribution plans, such as 401(k) s, shift various risks from employers to workers - risks that these individuals often are poorly equipped to manage on their own.

While individual workers face more risks, they also face rising costs in retirement. Housing, healthcare, and long-term care costs have all increased and present greater obstacles now than in past decades. As the population in the United States continues to age - all of the Baby Boomers will be retirement age by 2030 - these costs are projected to rise even more.

Addressing the twin challenges of more risk and rising costs, along with the decline in overall retirement savings, will require a concerted societal effort. The demographic realities make this unavoidable. Furthermore, systemic gaps in wealth, on the one hand, and costs, on the other hand, which are related to race, gender, and income, make retirement much less secure for certain groups. These gaps arise because of systemic inequities in labor, housing, and credit markets, to name the most important ones. Efforts designed to strengthen retirement security will be more successful if they are designed with these inequalities in mind.

This report offers a roadmap to the various hurdles that make retirement security difficult to achieve. Stepping back and viewing the entire picture of the different retirement challenges can help to understand just how much the burden has grown.

Key findings from this report include the following:

- Saving early and continuously during working years is difficult for many workers. While organizations offer suggested retirement savings targets for each age, many workers may struggle to meet them, even if they have a desire to save.
- Workers face market timing, interest rate, and longevity risks when they approach retirement age. Any of these risks can derail carefully laid retirement plans and together they can make the prospect of retirement daunting.
- While older Americans are the most likely to own a home, the number of Americans age 65 and older who are cost-burdened by housing costs has increased as more seniors are carrying mortgage debt into retirement.
- Healthcare costs continue to rise for all Americans, but these costs are higher for older Americans, who are more likely to have multiple chronic health conditions. Furthermore, lower-income seniors spend a greater proportion of their income on healthcare costs than their more affluent peers.
- Long-term care costs represent an increasing challenge for many older Americans as more senior citizens need long-term care every year. While it can be prohibitively expensive for those who require nursing home care for multiple years, the majority of seniors receiving long-term care will receive it at home or in a non-nursing facility. This need is projected to increase even more as the Baby Boomers continue retiring.
- Creative solutions exist to begin addressing these challenges. Washington State is pioneering a program to cover long-term care costs using a social insurance model. The private sector, aided by the passage of recent federal legislation, is working to create lifetime income options for retirees and expand access to workplace plans. Meanwhile, some experts have proposed allowing retirees to purchase annuities through Social Security. Finally, expanding Social Security benefits would have a broad impact as most seniors receive the majority of their income through the program.

INTRODUCTION

One of the most consequential endeavors most Americans will tackle is preparing for retirement. When to retire and how much to save before leaving the workforce are two key questions that workers must try to answer. Unfortunately, these are complex questions. No one knows how long they will live -- it could be five years or 25 years after retirement. Preparing for retirement across those two timespans is vastly different. How much to save also depends on the lifestyle an individual wants or expects in retirement.

A number of organizations offer retirement savings targets as guideposts to help working people think through how much they need to save. Fidelity recommends saving ten times a person's annual salary by age 67.[1] For example, someone earning $50,000 per year should have $500,000 saved by age 67. Aon, in the *Real Deal* report, recommends saving 11.1 times final pay by age 67, slightly more than Fidelity.[2] Aon's report also provides customized targets that range from 6.3 to 13.1 times final pay based upon current age and income level. These retirement savings targets are developed by experts and may accurately reflect the true savings needs of working people. However, much of the challenge of retirement planning is its unpredictability at the individual level.

This report considers the unpredictability of key retirement factors. Drawing upon a variety of sources, this paper examines how retirement costs, income, and lifespan intersect with demographic characteristics, health status, and preretirement income and wealth to yield a wide range of retirement outcomes. Navigating this unpredictable and complex set of potential outcomes is perhaps the toughest financial challenge most Americans will face.

Much of the focus of retirement planning is on the savings needed to generate sufficient income in retirement. Under the traditional retirement model of the "three-legged stool," guaranteed monthly income from Social Security is one leg of the stool; guaranteed monthly income from a defined benefit pension is another; and savings, either through an employer-provided defined contribution plan or private savings, forms the third. This is the ideal scenario that was more commonly available to previous generations, but even then, many workers were left out of this system. While retirement planning would certainly be easier with two guaranteed income streams from Social Security and defined benefit pensions, the three-legged stool now is elusive for most Americans. NIRS research released earlier this year found that only 6.8 percent of current retirees receives retirement income from all three of these sources.[3] This focus on savings and income is further complicated by the unpredictability of costs that can arise in retirement.

Seniors generally face higher healthcare costs than younger people. These costs are often the largest single expense older Americans face. Unfortunately, healthcare costs have been rising for seniors, consuming an increasing amount of what are often fixed incomes. Related to this are rising costs for long-term care (LTC), sometimes referred to as long-term services and supports (LTSS). Not every older American will need long-term care, but it is almost impossible to predict who will need it. For those who do, it can be prohibitively expensive.

Housing costs also remain a concern for many seniors. While Americans ages 65 and older are the most likely to own their home, housing affordability poses a challenge for an increasing number of seniors. More seniors are now cost-burdened by housing in retirement due to increasing mortgage debt and homelessness among older Americans is on the rise.[4]

Taken together, the costs relating to healthcare, long-term care, and housing, as well as the challenge of accumulating sufficient retirement savings and investing it well to last a lifetime, make retirement a difficult puzzle to solve. And requiring individuals to solve it on their own, as the nation has increasingly required individual Americans to do, leads to predictable shortfalls and failures. This report reveals the complexities of retirement and highlights how common pitfalls undermine the best laid retirement plans. Four policy recommendations relating to long-term care, more effective tax incentives, better annuity options, and expanded Social Security benefits would help mitigate the risks in retirement planning.

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I. THE CHALLENGE OF SAVINGS

Working people need to start preparing for retirement as soon as they enter the workforce. That might sound paradoxical for a younger worker who may work for another 42 years, but there are good reasons to start saving early. Fidelity's model assumes workers begin saving 15 percent of their salary at age 25 and have one times their salary saved by age 30.[5] For a worker who perfectly follows this path and achieves each of the recommended savings targets along the way, they likely will be well-prepared for a secure retirement. Unfortunately, the available evidence suggests this doesn't happen.[6]

Less than half of all workers in the U.S. have access to a retirement savings plan through their employer at any given time.[7] Workers are 15 times more likely to save for retirement if they are offered a plan through their employer, so this lack of access creates an immediate hurdle to saving.[8] Even if an employer offers a plan, workers may not be eligible to participate in the plan if they don't work enough hours or have not worked long enough for the employer. These eligibility obstacles particularly impact part-time workers (who are more likely to be women) and younger workers, hindering the recommended early start to saving. Previous NIRS research found that only 40 percent of workers in 2014 were participating in an employer-provided plan, after overcoming the access and eligibility hurdles.[9]

If workers are eligible for an employer plan and choose to participate, it is unlikely they are contributing 15 percent to the plan. Aon found that contributing employees on average contribute eight percent of pay.[10] The Plan Sponsor Council of America found an average participant savings rate of 7.1 percent in 2017.[11] Even for defined contribution plans that incorporate auto-escalation (72% of Fidelity clients do take advantage of this), most stop well short of 15 percent.[12] Investment consulting firm Callan found that the median cap on auto-escalation was ten percent.[13] Passage of the Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019 allows safe harbor 401(k) plans to raise the cap on auto-escalation from ten percent to 15 percent; non-safe harbor plans were already uncapped.[14]

Most workers start out in a position where they are already falling short of their retirement savings targets. They either don't work for an employer that offers a plan, aren't eligible to participate if one is offered, or if they do participate, they likely contribute far less than 15 percent of pay. But, for the sake of the example, let's say a worker is committed to retirement preparedness and actually is contributing 15 percent of pay, probably their own contribution with a partial employer match, to an employer-provided plan. The retirement savings targets also assume continuous contributions over the course of a career. Again, there are numerous reasons why this is unlikely to happen.

Because retirement plans for most workers are tied to employment, losing a job, or even just changing jobs, can disrupt savings. If a worker moves from one job where they were contributing to a 401(k) account to another with a 401(k) plan, they could rollover their accumulated savings from one 401(k) account to another, or roll over their accumulated savings into an IRA. In fact, research indicates that most IRAs simply contain rollovers from 401(k) accounts because few workers save independently in IRAs.[15] However, many workers simply cash out 401(k) savings when changing jobs, especially if they suffer a job loss, and therefore lose out on future retirement savings. The Center for Retirement Research, citing data from Vanguard, estimates job change cash-outs to be the largest source of 401(k)/IRA leakages.[16]

Another issue is that employers may suspend retirement plan matches during economic downturns and workers may reduce or stop their retirement plan contributions if their financial situation worsens. The Plan Sponsor Council of America found in a 2009 survey that 18.5 percent of companies suspended or reduced company matching contributions to employees' retirement plans in response to the financial crisis.[17] Separately, 26.8 percent of companies suspended or reduced non-matching contributions during the same time period.[18] More recently, the Center for Retirement Research has been tracking the companies that have paused 401(k) matching contributions during the COVID-19 crisis.[19] For all of the reasons mentioned above, forty-two years of continuously saving at 15 percent of salary is almost unheard of.[20]

In addition, many people end up not working for as long as they had planned. According to the Center for Retirement Research, more than a third of retirees (37%) retired earlier than planned.[21] Involuntary retirement is an increasing problem in the COVID-19 recession.[22] CRR cites four main reasons for early retirement: 1) health; 2) employment; 3) familial; and 4) financial. Retiring earlier than planned has clear implications for retirement security because it means fewer years to save and more years to draw down on existing savings. Both of these factors can mean a decreased standard of living. The ongoing COVID-19 pandemic and resulting recession could force more older Americans to retire early if they lose their job and are unable to find a new one. They also could stay unemployed longer than in the past for the same reasons. This employment shock could derail the careful retirement plans of many older workers. Having to leave the workforce earlier than one planned, which also involves an earlier than planned draw down of assets and Social Security collection, is a significant reason retirement income is inadequate.[23]

Let's continue with the example of the "perfect" retirement saver. Suppose the saver began saving early at age 25 and contributed 15 percent of pay steadily throughout a 40-year career until retiring at age 65. This dedicated saver also faces a market timing risk. The state of the financial markets immediately before a planned retirement can have a significant impact on a person's retirement savings. If the market crashes, as it did in 2007 and 2008, it could wipe out a major portion of accumulated savings, and our perfect saver would unlikely have time to recover the losses. An important element of retirement savings then becomes retiring at the right time and guaranteeing that retirement assets are protected from a market downturn.

Below is a chart that shows the level of savings accrued at retirement under a number of scenarios. The first assumes seven percent returns for all years, which serves as the baseline scenario. The next two scenarios illustrate just how important the final five years are in determining the outcome for an individual. In the baseline scenario, about three-quarters of asset accruals occur after reaching the age of 50, and much of that is interest earned in the final years. This means these projections heavily depend on two factors, both of which may not come to fruition for individuals. First, by simply earning zero percent returns during the final five years of working, an individual will only reach 72 percent of the baseline projection. In contrast, if a worker retires after a bull market with 12 percent returns per year, they would overshoot the projection by 25 percent. The volatility of returns during the early years impacts results far less because the asset base is still small. But, the final years have a very large impact in these projections -- and in real life.

Another problem with the baseline scenario is that it is common to begin saving much later. The fourth scenario looks at the impact of contributing for 25 years, instead of 40 years.[24] Here, one should expect to reach half of the target. Most of this is due to lost returns. In the late start scenario, the worker ends up making 78 percent of the contributions that are made in the baseline scenario; however, they miss out on 60 percent of the returns that are accrued in the baseline scenario. If a worker gets a late start, and faces zero percent returns in their final five years of work, they now are down to 37 percent of the baseline target.

Saving enough for retirement is a challenge that most American workers will face. The many hurdles involved in saving enough have been detailed in the first part of this report. Unfortunately, the difficulty of retirement planning doesn't stop there. Converting savings to income and rising costs in retirement also present obstacles for many senior citizens, even when individuals followed a reasonable savings plan. These issues and their impact on retirement security are discussed throughout the rest of this report.

Figure 1: DC Savings as a Multiple of Final Pay at Retirement

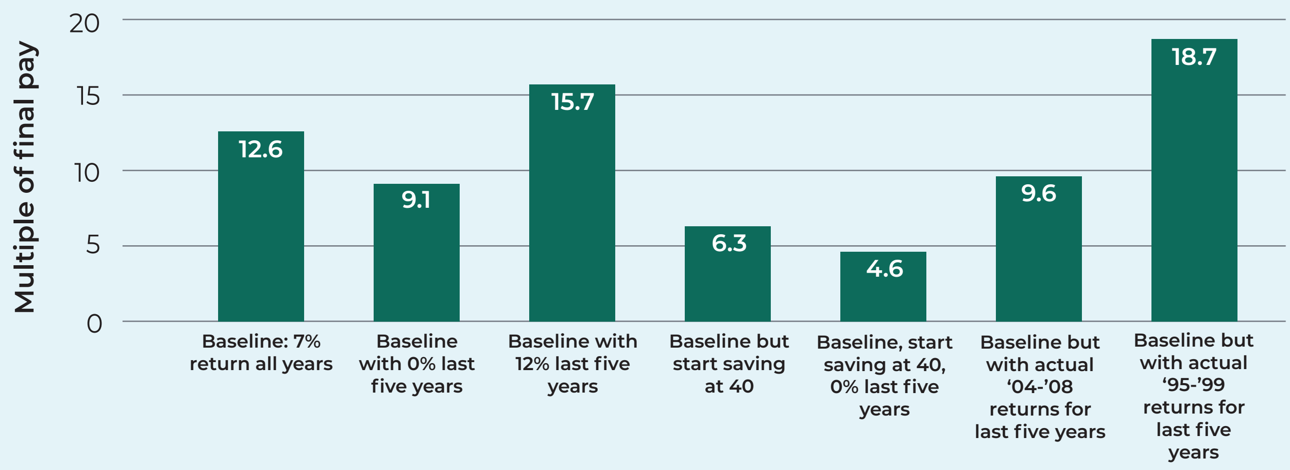

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Figure 2: Base Scenario, Savings as a Multiple of Pay

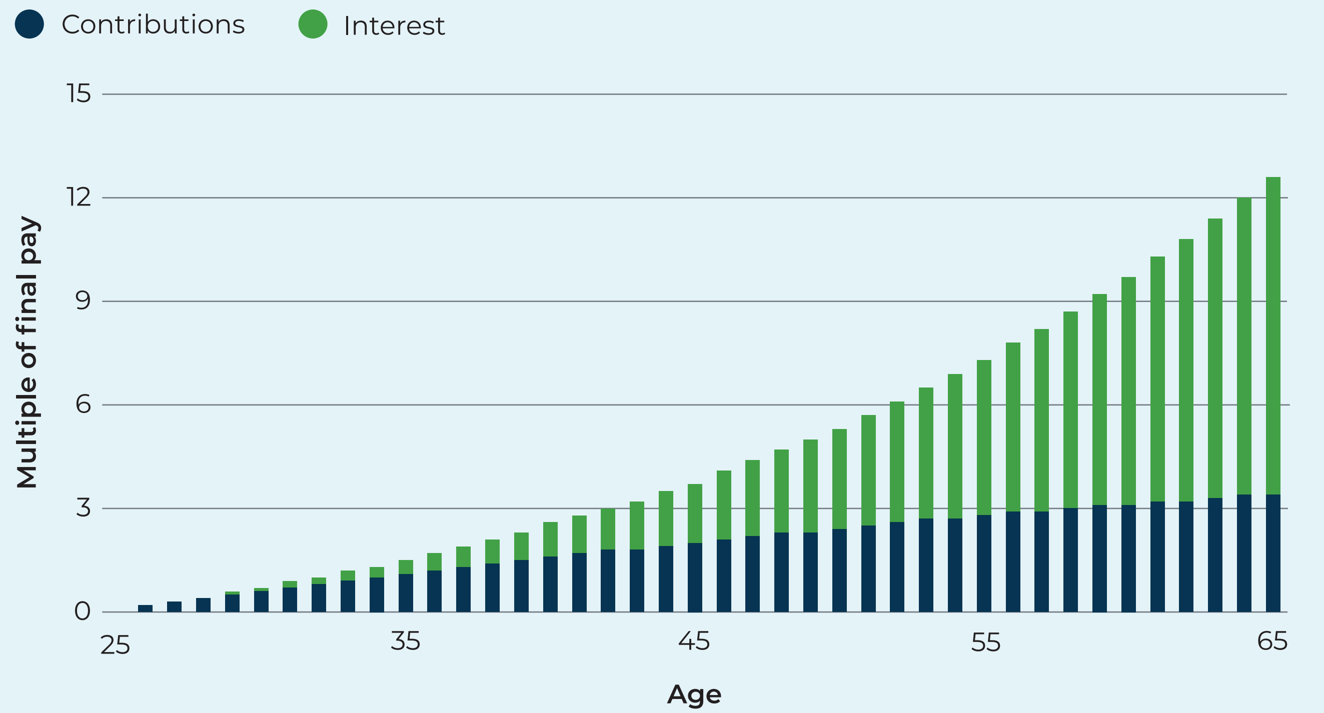


Figure 3: 0% Returns for Last 5 Years, Savings as a Multiple of Pay

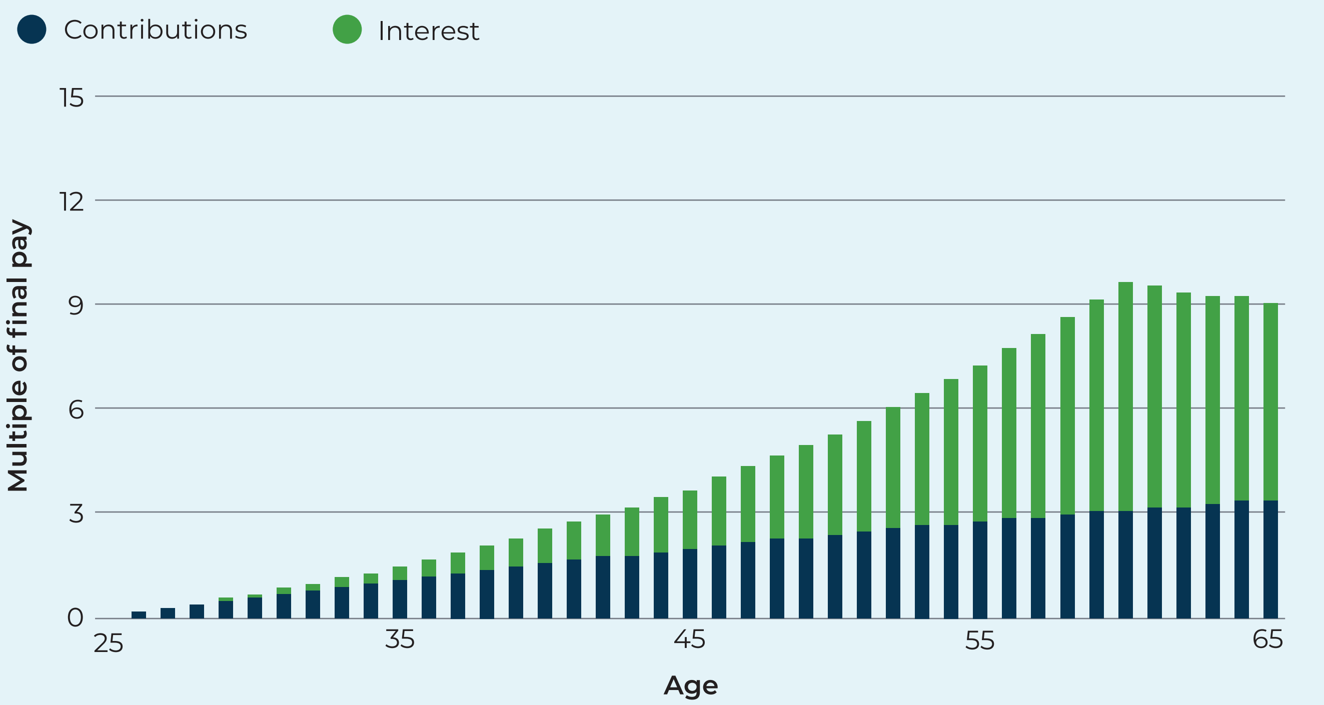


Figure 4: Starting at Age 40, Savings as a Multiple of Pay

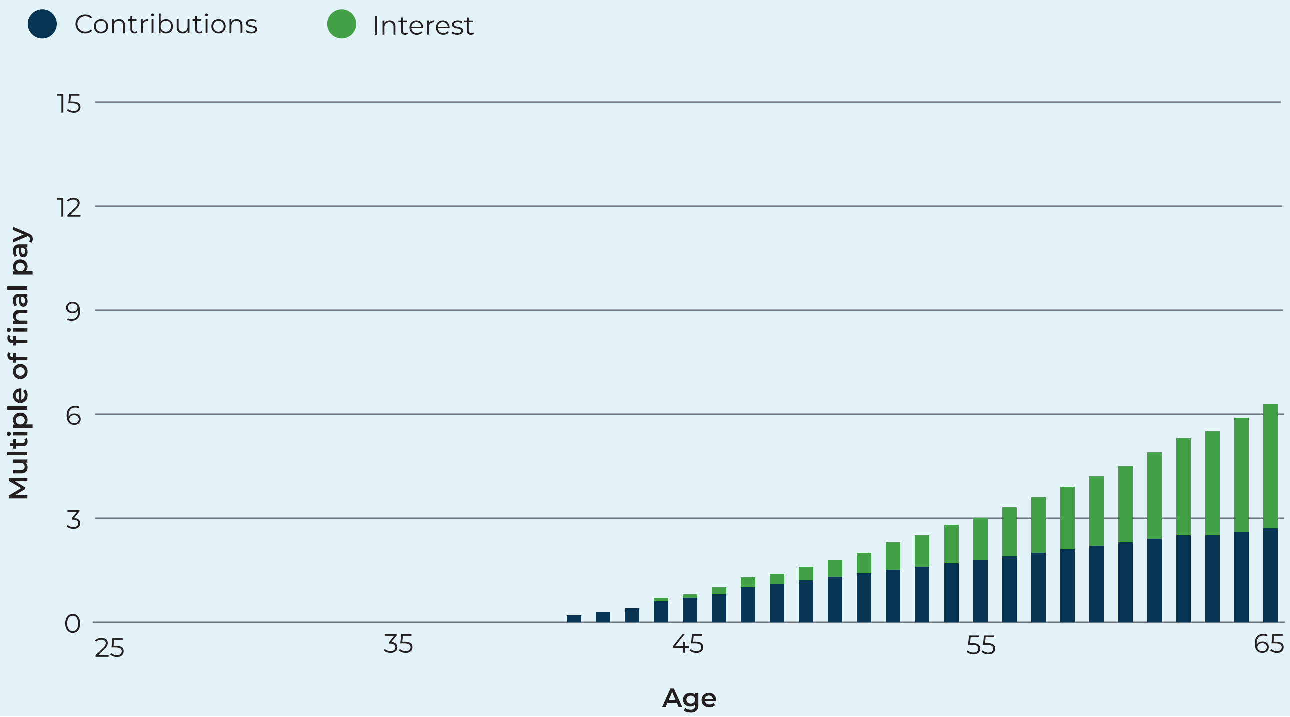
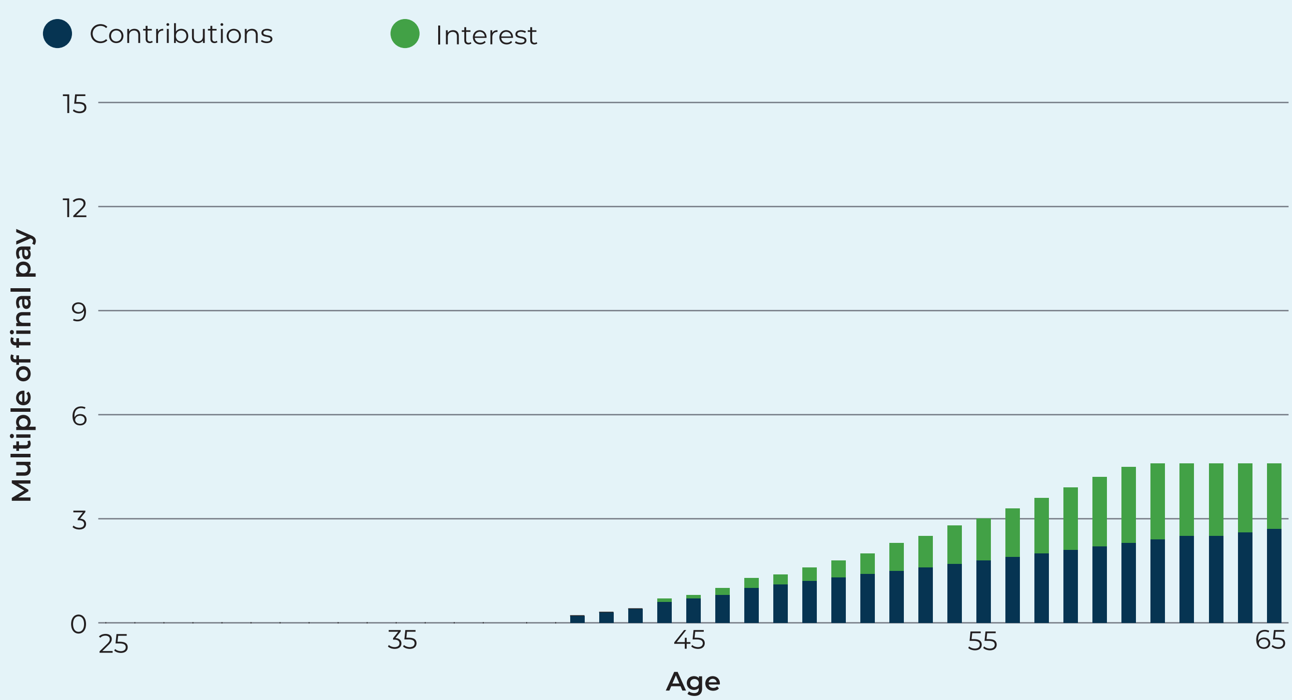


Figure 5: Starting at Age 40 plus 0% Returns for Last 5 Years, Savings as a Multiple of Pay



II. CONVERTING SAVINGS TO INCOME WITH FLUCTUATING INTEREST RATES AND WITHOUT LONGEVITY POOLING

Fluctuating Interest Rates Impact Income from a Lump Sum: Interest rates impact the level of income retirees might receive from their savings in a few ways. First, if a retiree plans to purchase an annuity, the interest rate is a key driver of pricing because insurance companies typically invest the vast majority of annuity sales in fixed income products that are interest rate sensitive. This practice makes it more likely that these product lines will not fail due to adverse investment experience, but it also means retirees largely will not benefit from much equity premium in their investments. In addition, even if an individual hits their savings target, they may not achieve the anticipated level of income from those assets. In short, it is another layer of volatility that arises through timing and interest rate risk. Individuals, unlike long-term investors, cannot smooth interest rate risk over time other than by trying to find an opportune time to purchase an annuity.

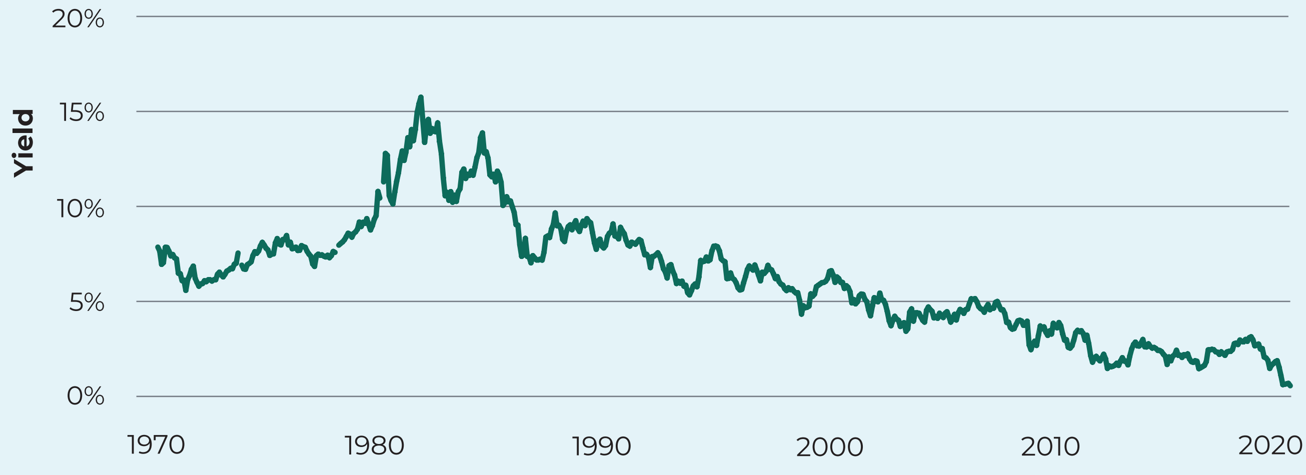
Thus, if one would have purchased an annuity in the 1980's or 1990's when interest rates were generally much higher (typically from 6 to 14 percent), the assets invested would have produced significant income for the insurance company selling the annuity. This leads to more income for retirees, per dollar invested.

In contrast, if one were to retire today, interest rates are below three percent as federal policy again is trying to boost the economy to deal with another economic crisis. It is doubtful that workers saving during the past three to four decades could have anticipated this. The result is that a retiree today would only get a portion of the income with the same lump sum due to poor timing.

If one does not purchase an annuity, interest rate risk is still present. This dynamic often is discussed when talking about how pension funds invest, but individuals face the challenge too. In fact, retirees often are counseled to buy safer investments, which includes fixed income products, relative to investors with longer-term investment horizons. Low interest rates will either mean retirees earn less income from investments or will be pushed into riskier investments to reach a higher return target. And, recovery from a lengthy market crash is harder when drawing-down a significant portion of assets each year.

Given the trend of Treasury bond yields during recent decades, the price for the same levels of income, using fixed income products, has been steadily increasing. And, that is before accounting for any increase in longevity of lifespans.

Figure 6: 10-year Treasury Bond Yields



Citation: Board of Governors of the Federal Reserve System (US), 10-Year Treasury Constant Maturity Rate [DGS10], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/DGS10, August 20, 2020.

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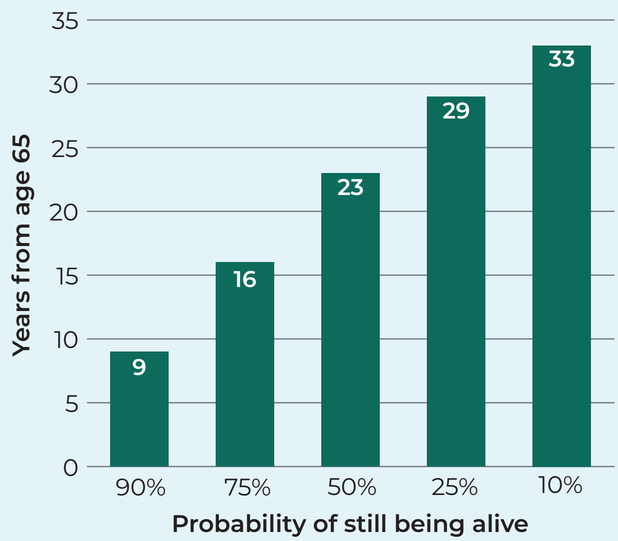
Generating Income Without Longevity Pooling: When employers consider switching employees from a defined benefit pension to a defined contribution plan, it is common to discuss the shifting of investment risk from the employer to workers. It also is common to focus on the costs being shifted from the employer to workers. But, one important aspect that often receives less attention is the loss of risk-pooling for longevity risk (or the number of years of income needed in retirement).

Below are two charts that utilize data from the Actuaries Longevity Illustrator, which show the large variance in life spans at age 65 that individuals and couples face.[25]

Figure 7 illustrates the probability that a non-smoking woman age 65 with average health will be alive in x years. For instance, there is a 90 percent chance of being alive nine years after age 65. If non-smoking women with average health retired at age 65, ten percent would live less than nine years, and would need savings to only last nine years, while an additional ten percent of these women would still be alive in 33 years. There is a lot of individual variability in predicted mortality so the average longevity doesn't help a person plan -- 20 percent of healthy women aged 65 will either live less than nine years or more than 33 years.

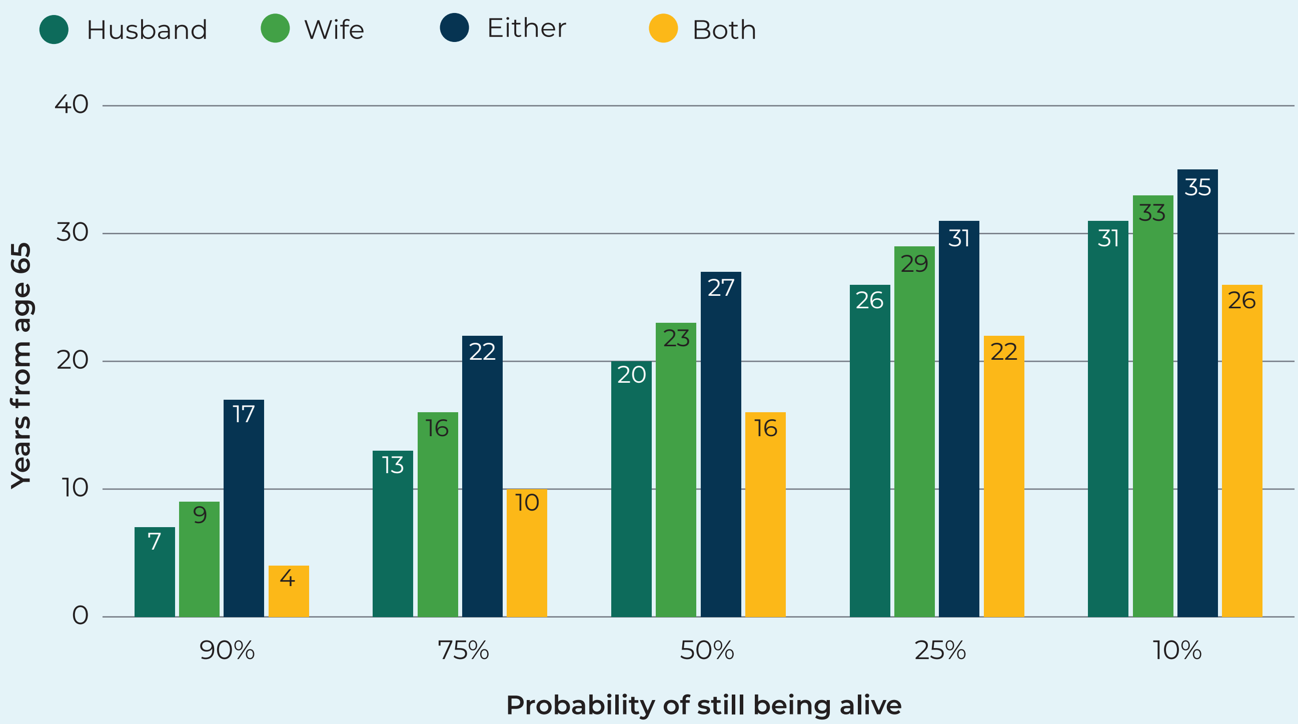
The probabilities grow more complex when considering couples. Now, instead of two scenarios in the years after both turn age 65, there are four possibilities for each year after age 65: both partners are still alive, neither partner is still alive, and two iterations of only one partner being alive and one not.

Figure 7: Planning Horizon, Women Aged 65+



The Actuaries Longevity Illustrator was developed by the American Academy of Actuaries and the Society of Actuaries to help provide perspectives on longevity.

Figure 8: Planning Horizon, Married Couple



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With couples, there is a 90 percent chance that both partners age 65 are still alive at age 69, in four years. And there is a ten percent chance both partners will still be alive in 26 years. There is also a ten percent chance that neither person would be alive in 17 years. And, there is a ten percent chance that at least one person would be alive in 35 years. The range of possible outcomes for a couple retiring together are wide.

Understandably, accounting for variations in expected longevity is challenging to comprehend. It is far more challenging to devise a successful draw-down strategy for accumulated retirement savings that will last throughout a lifetime, than it is to simply not use those retirement savings for retirement income given the wide range of possible outcomes. This is particularly true as only 17 percent of Americans use the services of a financial planner, which are heavily reliant on assumptions that may or may not apply to the individual.[26]

Longevity risk is simpler to deal with in risk-pooled plans such as defined benefit pensions because actuaries have a pretty good idea how longevity will play out once there are a large number of people in a risk pool. The people who live longer than average tend to be offset by those who do not. And, today, actuarial tables even account for future mortality improvements by utilizing generational mortality tables.

But on their own, individuals will face a wide range of possible outcomes, which creates a serious challenge for determining a savings target and figuring out a reasonable and safe draw-down strategy. It also makes the likelihood of either running out of resources, or not using tax-advantaged retirement resources for generating retirement income, much more likely.

Both interest rate risk and longevity risk, when unpooled, act as volatility multipliers for what a reasonable target would be for an individual or couple who are trying to achieve a certain level of retirement income.

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III. THE RISING COST OF HOUSING

Americans age 65 and older are the most likely to own their own home, but homeownership and mortgage costs and rents are still a major issue for older Americans. According to the Harvard Joint Center for Housing Studies, the number of older Americans who own their home is projected to decline, while seniors who rent face growing challenges in finding affordable housing.[27] Especially as the Baby Boomers continue to age, housing affordability will be an increasing challenge for many older households.

Homeownership among older Americans reached a peak of 81 percent in 2012. Recently, that number has declined slightly to 78.5 percent.[28] It is likely that number will continue to decline as fewer near-retirement adults own homes than those already in retirement age. More older Americans have mortgages or second mortgages than before. Fewer retirees owning their homes will present challenges not just for future retirees, but for their families and for service providers.

A home is the largest source of wealth for most older American families.[29] The equity built up in homes generally surpasses retirement savings and other forms of savings. Therefore, home ownership is a critical element of wealth accumulation. This means there are large wealth differences between homeowners and renters. According to Harvard JCHS, homeowners age 65 and older in 2016 had a median wealth of $319,200, whereas renters age 65 and older only had a median wealth of $6,700; the numbers are similar for those in the age 50-64 group.[30] The observed decline in homeownership will mean a decline in wealth for American households.

Even for households with similar incomes there is a stark difference in wealth between homeowners and renters just when comparing non-housing wealth. According to the Harvard study, an older homeowner in 2016 in the upper middle-income quartile had $185,800 in non-housing wealth, compared to $69,000 in non-housing wealth for an upper middle-income renter.[31] The numbers are similar for people in the other income quartiles. Clearly, the connection between homeownership and wealth accumulation is strong.

Owning a home has implications for retirement beyond wealth accumulation. Fully owning a home with no housing debt also is a major cost saver in retirement. In addition to accumulating sufficient savings, reducing and managing costs in retirement is another aspect of maintaining a preretirement standard of living. Financial planners typically recommend targeting a 70-85 percent income replacement rate in retirement because certain expenses go down or are eliminated in retirement, e.g., no one needs to save for retirement once in retirement. If a home is fully owned, then that eliminates mortgage payments (but not related housing costs) in retirement, which are a major cost for most American families. Figure 10 below approximates how the different shapes of housing costs change over time for renters compared to homeowners. Unfortunately, the trendlines are moving in the wrong direction.

The number of American households with mortgage debt during retirement is increasing. Older Americans who still face this cost must either save more before retirement or accept a lower standard of living during retirement, at least until they pay off their mortgage and eliminate that cost. The researchers at Harvard JCHS found that 46 percent of older Americans in 2016 had mortgage debt, compared to 24 percent of older homeowners three decades ago.[32]

Renters face other challenges that are similar, but different to those faced by homeowners with mortgage debt. As mentioned above, there is a stark wealth gap between owners and renters. Renters must deal with housing costs during retirement. However, their housing costs are less stable than those of homeowners with mortgage debt. Older renters may seek affordable housing to reduce costs during retirement, but affordable housing, especially for low-income seniors, is increasingly hard to find. The Harvard researchers project that the number of very low-income seniors without affordable housing could increase by 2.4 million from 2018 to 2038.[33]

Additionally, the number of cost-burdened seniors, those paying more than 30 percent of their income on housing, grew by 200,000 to ten million from 2016 to 2017.[34] Of these, nearly five million were severely burdened -- more than 50 percent. The share of the population in this age group that are cost-burdened remained flat at one-third since the total senior population increased. Furthermore, while a larger percentage of older renters are cost-burdened, the number of cost-burdened homeowners is greater because more seniors own their homes.

There is a serious racial divide when it comes to homeownership and housing costs in retirement. The

Black-white homeownership gap among older households reached a 30 year high of 19.4 percent in 2018.[35] Much of the racial wealth gap is rooted in this homeownership gap. Median net worth for white families in the United States was measured at about $171,000 in 2016, or nearly ten times that of Black families ($17,150).[36] Many Black families have most of their wealth in their homes. The Urban Institute found that the median older Black household had 73 percent of net worth in their home equity, compared to 38 percent of older white households.[37] However, the history of redlining and other discriminatory policies has led to the much lower levels of homeownership among Black families than among white families, which contributes to the overall racial wealth gap.

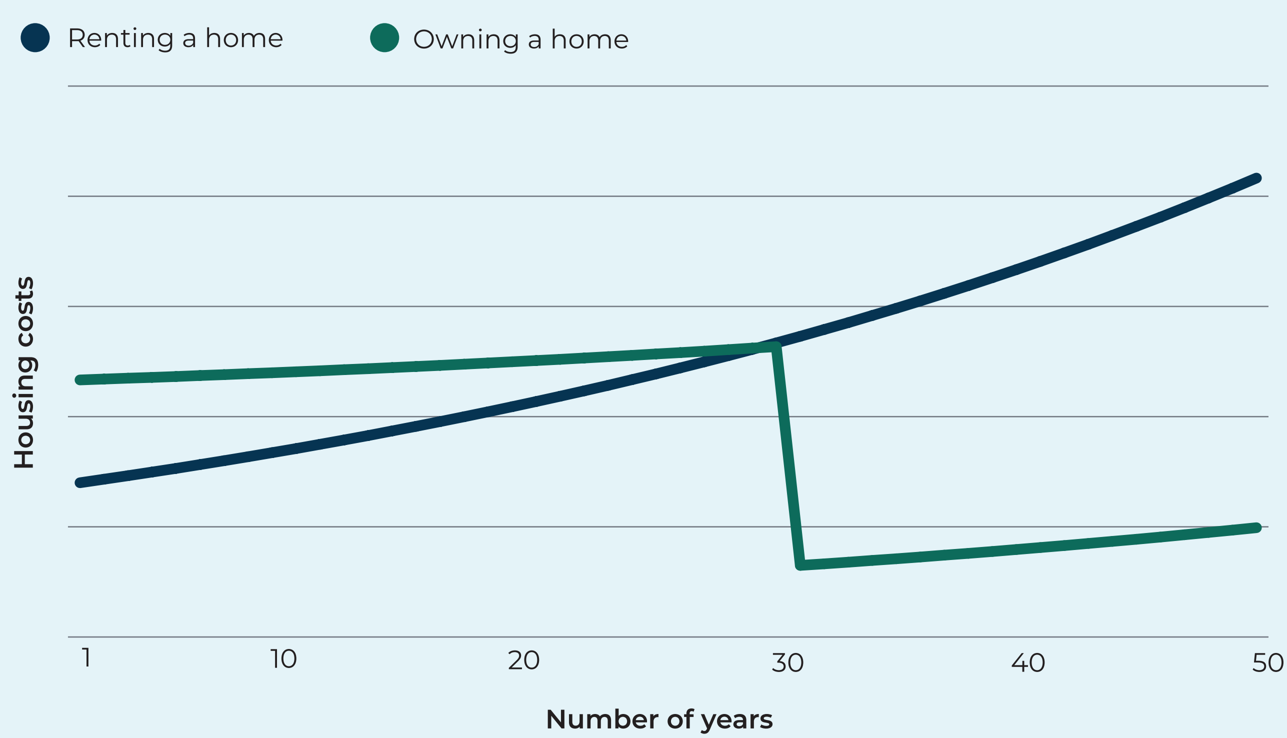
For Latino families, the numbers are similar to Black families, but differ in some important ways. Harvard JCHS found that the homeownership gap among older white and Latino families in 2018 was 18.4 percent, slightly narrower than the Black-white gap.[38] The Urban Institute found that older Latino homeowners in 2016 had median net worth and median home equity that were higher than older Black homeowners, but still significantly lower than for whites.[39] However, for these Latino households, home equity represented 90 percent of net worth, indicating a severe lack of other financial resources.[40] Black and Latino older households also are more likely to have mortgage debt than older white households.

There also is an important gender difference that relates to aging and living arrangements. Women tend to live longer than men, so there are simply more women living into their 80s and 90s. Also, men who reach advanced ages are more likely to be part of a couple, whereas women are more likely to become widows as they age. However, income declines with age, so women who live into their 80s and 90s do so with lower incomes.[41] Older adults are also more likely to live alone, meaning they bear any housing costs on their own, likely with reduced incomes.[42] This means there is a serious need for affordable housing for the oldest Americans, who are disproportionately women, and this need will grow in the coming decades as the number of much older Americans increases.

An increasing focus for many organizations working with older Americans is how to integrate housing with healthcare and long-term care. In *America's Growing Senior Population*, the Bipartisan Policy Center highlighted the potential cost savings that could be achieved by coordinating home and community-based services to prevent or manage chronic disease.[43] Approximately 80 percent of seniors have a chronic health condition, which means they access more healthcare. Furthermore, the number of near-seniors with two or more chronic conditions has increased, which means a likely increase in future healthcare spending for seniors.

The next two sections discuss the challenges of paying for healthcare and long-term care in retirement.

Figure 9: Housing Costs over Lifetime, Rent vs. Own



IV. THE CONTINUING CHALLENGE OF HEALTHCARE

One of the most significant challenges most older Americans will face is paying for healthcare, which tends to increase in cost as people age. Rising healthcare costs are nothing new. Despite efforts to bend the cost curve, the cost of healthcare has continued to rise. Americans in 2018 spent twice as much on healthcare as they did in 1984.[44] Americans ages 65 and older have access to Medicare, but Medicare is not free, and managing out-of-pocket costs associated with Medicare can be difficult for older Americans. While the highest healthcare costs for older Americans tend to be borne by those with chronic health conditions, healthcare costs also tend to increase as people reach advanced ages. Given that the average life expectancy is projected to continue to increase, more seniors will face greater healthcare costs in the future due to their longer lifespans.[45]

Fidelity Investments calculates that a healthy male-female couple retiring at age 65 in 2019 can expect to spend $285,000 on healthcare expenses in retirement.[46] However, this analysis only focuses on expenses associated with Medicare coverage: premiums and copays, as well as prescription drug costs. It does not include other expenses, such as dental, vision, or over-the-counter medicines. It also does not include long-term care costs, which will be discussed in the next section of this report.

Healthcare costs represent a major burden for most retirees, many of whom must deal with rising costs while living on fixed incomes. The Kaiser Family Foundation, looking deeper into the out-of-pocket spending of Medicare beneficiaries, found Americans in the 85 and older age group spent more than twice as much as Americans in the 65-74 age group. Much of the difference was due to significantly higher spending on long-term care facility services among beneficiaries in the oldest age group.[47]

KFF also found that half of all beneficiaries in traditional Medicare spent at least 12 percent of their income on out-of-pocket healthcare costs in 2016.[48] Again, however, different demographic groups spend different portions of their income on healthcare costs. As mentioned above, those age 85 and above spend more of their income on healthcare - half spend at least 16 percent - than those in younger age cohorts. Those with incomes of less than $10,000 per year spend a far larger share of their income -- 18 percent -- on healthcare than those making more than $40,000 per year, who spend 7 percent. Again, KFF is reporting median costs, so half of those earning less than $10,000 annually spend *more* than 18 percent of their income on healthcare. Healthcare costs are not a function of income, which is why low-income individuals often spend a greater portion of their income on healthcare costs.

Generally, more privileged groups spend more on healthcare in retirement in absolute terms, i.e., in total dollar amount, not as a proportion of income. Whites, men, those with a college education, and those with higher incomes all spend more on healthcare than their peer demographic groups.[49] These groups also tend to have higher retirement incomes, which makes it easier for them to afford higher healthcare costs.[50] For example, those with $40,000 or more in income spent more on total out-of-pocket healthcare costs in 2016 than any other income level of Medicare beneficiaries.[51] However, as noted above, they spent a much smaller portion of their income on healthcare, compared to very-low income Medicare beneficiaries. This higher level of total healthcare spending enables these more privileged groups to access more healthcare and different types of care.

When looking at different types of healthcare services, the distribution of which groups spend more on different types of services varies. For example, women spend far more than men on stays in long-term care facilities. However, for both men and women age 85 and older, the amount spent on long-term care facilities is significantly higher than for younger cohorts of both genders. By education level, those with lower levels of educational attainment tend to spend more on long-term care than those with a college education. When looking at marital status, married Medicare beneficiaries spend the least on long-term care facilities and widows spend by far the most (widows spend far more on medical services in total than Medicare beneficiaries with other marital statuses). In the next section, we are going to dig a little deeper into the complex and growing problem of long-term care costs for retirees.

“Healthcare costs represent a major burden for most retirees, many of whom must deal with rising costs while living on fixed incomes.”

V. THE GROWING BURDEN OF LONG-TERM CARE COSTS

Housing and healthcare costs, while significant, also are familiar. Most people have been paying for housing and healthcare for their entire adult lives. The exact nature of those costs may change in retirement, but they are still familiar costs. Long-term care may be the thorniest problem for retirees to solve. Long-term care is something few retirees may have had any previous personal experience with, unless they or someone close to them developed a serious health condition that required a stay in a long-term care facility. Long-term care also is challenging because most but not everyone needs it, and many of those who do only need it for a short time, but it can be very expensive, depending on the kind of service needed.

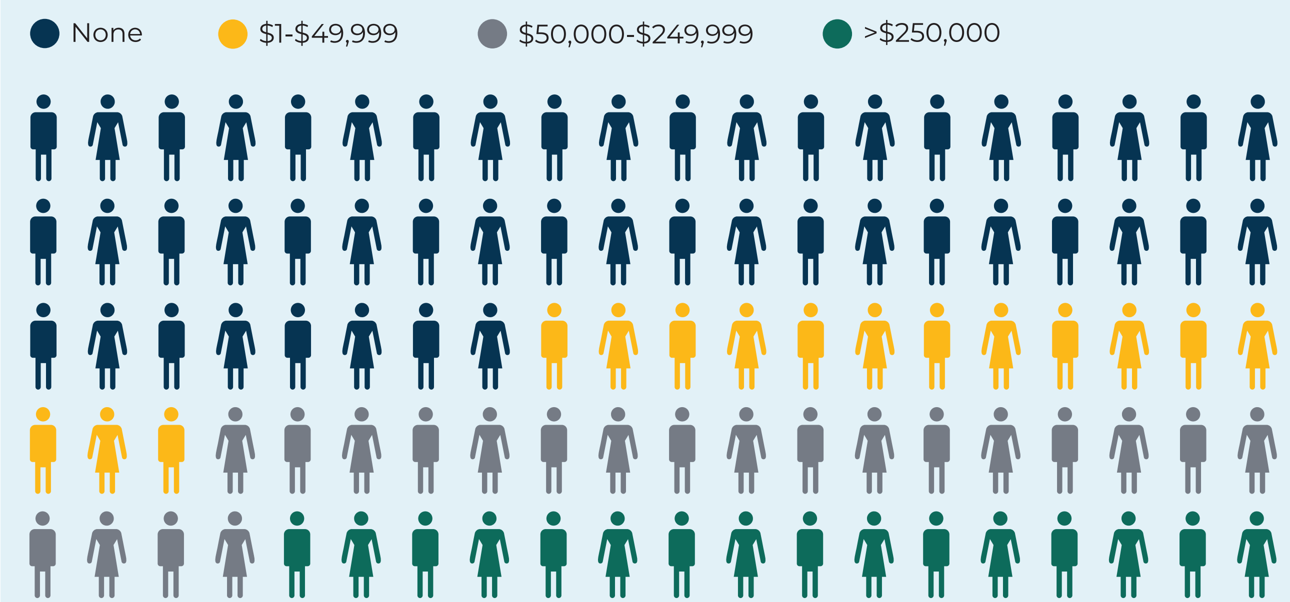
Long-term care encompasses a range of different services and supports. It does not just mean a stay at a nursing home, which typically is the most expensive type of long-term care. It also includes home-based care, such as that provided by a home health aide, and stays in an assisted living facility. There is a fairly broad dispersion of people who will need which types of care and for how long.

According to the U.S. Department of Health and Human Services (HHS), senior citizens today have an almost 70 percent chance of needing long-term care at some point.[52] While one-third of seniors will never need long-term care, one in five will need it for at least five years. Nearly twice as many seniors will receive long-term care at home rather than in a facility.[53] Separate research from HHS found that 48 percent of older Americans will have $0 in long-term services and supports (LTSS) expenditures, but 15.2 percent will have expenditures greater than $250,000. The dispersion of costs is fairly even in the middle, but it's high on both ends.[54]

Economists Michael Hurd, Pierre-Carl Michaud, and Susann Rohwedder found fifty-six percent of older adults had or will have at least one night in a nursing home over the course of their lifetime.[55] What is truly significant about their research, however, is the wide dispersion they found. The median number of nights spent in a nursing home is just ten, while the average is 272 nights; however, ten percent of older adults will spend 1,001 nights and five percent will spend 1,495 nights. In short, someone age 57-61 has a ten percent chance of spending three years or more in a nursing home and a five percent chance of spending more than four years.[56]

According to the Genworth Cost of Care survey, in 2019, the monthly median cost of a home health aide was $4,385 or nearly half the cost of a private room in a nursing home, $8,517.[57] Those who are able to remain in their homes and

Figure 10: Variance in LTSS Costs for Retirees



receive care as they age can realize a significant cost savings as a result. Unfortunately, for those who are among the one in ten who will spend three years or more in a nursing home, the cost can be forbidding. Three years in a private room in a nursing home exceeds $300,000, based on Genworth's estimates. Three hundred thousand dollars far exceeds the median account balance of individuals ages 55-64 with retirement accounts of $88,000.[58] Requiring serious, lengthy long-term care is like winning the lottery in reverse: it's unlikely to happen, but is financially devastating if it does.

The incidence rate of long-term care needs will rise. The United States has a rapidly aging population. The U.S. Census Bureau projects that by 2034 the number of adults ages 65 and over will outnumber the number of children under age 18. That gap will continue to widen and by 2060, older adults will represent 23.4 percent of the U.S. population, while children will represent 19.8 percent.[59] This phenomenon is referred to as the "graying of America" and with this graying, it is also widely accepted that the costs of long-term care will continue to increase as well.

For some, the cost of long-term care will be manageable. But for many, especially those who will spend more than a year in a nursing home, public systems will be forced to pick up these costs because savings levels generally are not large enough for most individuals to have hundreds of thousands of dollars in their 80s. So, it makes sense that states are starting to build systems to deal with these projected costs.

WASHINGTON STATE LONG-TERM CARE PROGRAM

Absent federal action to deal with rising long-term care costs, states are leading the way. In 2019, Washington became the first state to adopt a social insurance program to address long-term care needs. The Long Term Care Trust Act was passed by the Washington legislature in April 2019 and signed into law by the governor in early May.

Washington residents will pay 58 cents of every $100 in income into the long-term care trust fund beginning in 2022. After paying into the trust fund for ten years, residents can claim up to $100 a day in benefits, with a lifetime cap of $36,500. However, residents can access benefits after three years if they experience a catastrophic disabling event, and the lifetime cap on benefits rises with inflation. The earliest the program could begin paying benefits would be 2025.

While a lifetime cap of $36,500 may seem small, it could go a long way for the many older Americans with more manageable long-term care needs. Relatively few will spend years in a nursing home, the most expensive form of long-term care. Many seniors simply need lower-cost services, such as a home health aide or home modifications, and receiving these services can actually prevent the move to a nursing home. If successful, this program could serve as a model for other states and even a federal program.

As a result of the lack of options for managing long-term care costs, coupled with the lack of preparation for these costs by individuals, Medicaid is the single largest payer of long-term care costs in the United States. Medicaid is a joint federal-state program that primarily provides health insurance to low-income Americans. Medicare, which all Americans age 65 and older are entitled to receive, covers very few long-term care costs and does not cover nursing home care. Due to the aforementioned lack of savings, many older adults who face high long-term care costs will turn to Medicaid to receive coverage. Some may already be entitled to Medicaid coverage due to their low incomes, but others may be forced to spend down their retirement savings in order to access Medicaid to receive coverage for their long-term care. While it is helpful that Medicaid is able to provide a safety net for those who need long-term care coverage, this represents a systemic failure to provide better options for covering prohibitively expensive long-term care costs.

It is likely that the Washington State LTC program discussed above will ultimately lead to a reduction in Medicaid costs for the state because it should decrease the reliance on Medicaid to cover long-term care costs. In fact, the Washington program is projected to save $19 million in Medicaid spending in its first year and up to $440 million by 2050.[60] A social insurance model, like the Washington State program, offers other advantages to Medicaid. For example, it can take time for recipients to get reimbursed from Medicaid for home-and-community-based long-term care costs (it's generally quicker to get nursing home stays covered). But accessing benefits from a trust fund model could enable an older person to more quickly cover home-based costs, such as a home modification or weekly visits from a home health aide, which could potentially prevent, or at least delay, the move to an assisted living facility or nursing home.

VI. RETIREMENT IN JEOPARDY

Retirement security advocates often focus on saving enough for a secure retirement. Saving enough is critical to achieving a secure retirement, but the purpose of saving is to have the ability to pay for goods and services needed to maintain one's standard of living: housing, healthcare, food, etc. Oftentimes the other side of the equation, cost, is left out of the retirement security discussion. Costs have been rising for many retirees, and there is a growing divide regarding who is facing unmanageable costs in retirement. Retirement security is not just a savings question, but a cost question as well.

The typical conversation about the impact of volatile 401(k) returns is valid, but volatility is a challenge across the board in retirement after so many of these risks have been unpooled in recent decades. A discussion focused on average costs that retirees face for health and long-term care costs misses the large number of Americans who will face high costs for the big ticket items, such as spending months or years in a nursing home--which typically occurs during one's later years--or dealing with one or more chronic health conditions that require long-term treatments.

Unfortunately, as is often the case, those who are at greatest risk of falling behind in saving for retirement are also the most likely to face unaffordable costs in retirement. As has been the case throughout our society, most of the income gains of recent years have gone to older Americans in the top income quintile; incomes for lower-income older Americans have remained flat. Meanwhile, as incomes have remained flat, homeownership has decreased and costs have increased. More seniors are cost-burdened by housing now than ever before. Older Americans are projected to spend a greater share of their incomes on healthcare in 2030 than they do today. The lack of affordable housing for seniors is leading to an increase in homelessness.

The aging of the Baby Boomers will accelerate many of these trends. Approximately 10,000 Baby Boomers a day will turn age 65 until 2030, when all Boomers will have reached retirement age. This large generational cohort will drive up healthcare costs as they age and will increase the need for long-term care. And many Baby Boomers, especially late Boomers, may not be prepared financially for these costs. A report from the Center for Retirement Research found that late Boomers have less wealth than early Boomers.[61] This does not bode well for the retirement security of a significant portion of future retirees.

Risk pooling, on both the savings side and the cost side of the retirement equation, is crucial for many Americans to achieve a secure retirement, given the wide variance of many of these costs. For example, let's assume a retiree earned $50,000 in his last year of work and managed to achieve Fidelity's savings target of $500,000 (ten times his annual income). Let's further assume that he is married and both spouses have average health. Already, according to Fidelity's estimates, $285,000 of that $500,000 will go toward healthcare costs. Let's then suppose that this retiree suffers an unexpected medical crisis during retirement and spends three years in a nursing home. With average annual nursing home costs totaling roughly $80,000, then three years of nursing home care would consume nearly half of his retirement savings. Healthcare costs and long-term care costs alone could consume more than his total savings for retirement. Meanwhile, it has become much harder to generate low-risk investment returns to grow that nest egg during retirement to help meet those challenges.

RECOMMENDATIONS

Given the extremely wide range of possible outcomes that exist for the level of costs a retiree may face in retirement, building systems that take advantage of risk pooling for costs that are highly volatile would go a long way toward making a *you're-on-your-own* retirement system more feasible.

#1 Long-Term Care Recommendation: One major way to reduce the range of outcomes would be to have systems in place to help systemically deal with LTSS costs, as Washington State has begun to do. It is worth considering whether these systems would be more effective by targeting the tail risk, i.e. people who are likely to spend more than 6 months in care, rather than covering LTSS costs more broadly. Targeting tail risk would reduce significantly the upper limit that individuals face, but would not impact as many retirees. Today, these costs are largely absorbed by Medicaid.

Another possibility is to follow Washington State's lead, which grants a right to long-term care costs, but also includes a dollar limit set at a point that misses the tail risk. This program will be hugely beneficial to a larger number of people, but will likely still lead to those with longer term needs drifting back to Medicaid after hitting the dollar cap established under the State program.

Absent a comprehensive national solution, such as covering these legitimate health costs under Medicare, the Washington State model seems to work best. Care needs can impose themselves quickly on individuals and families. So, having a program ready to step in with modest administrative burdens will help families navigate these difficult issues with far less turmoil (often during already stressful times). When needs are expected to outlive the program allowances, the Washington program will buy time for families to learn more about the laboriously complicated rules surrounding Medicaid eligibility.

In the end, if the nation must deal with another piecemeal system for health costs, it does make sense for the early months of coverage to be picked up by systems that are more user-friendly for families facing health emergencies.

#2 Use Existing Tax Incentives to Create Stronger Private Programs: Today, tax incentives provided to employers who offer programs largely are blind to the quality of those programs, assuming the programs meet the minimum standards set by law. But, stronger programs do not yield better financial results for those offering these private employer-based systems.

Instead of tax incentives having one level, functioning like an on/off switch, it is worth thinking about two or more tiers of tax incentives that are based upon quality measures.

The goal would be to help drive private programs to be more user-friendly. Already, major industry groups are converging around an interest in improving 401(k) programs, which is illustrated by the recently passed bipartisan SECURE Act that helped remove barriers to offering life income via defined contribution plans. The overwhelming support for the SECURE Act may indicate a willingness to not only say it is acceptable to provide life income options, but to take the next step and incentivize plan design to risk-pool the existing longevity risks.

However, as discussed below, if the products ultimately included in 401(k)s do not provide decent value to retirees, then the benefits of the SECURE Act will mostly accrue to those offering new products. And, the laudable goal of life income could be nullified by high fees, unnecessary complexities, and product inefficiencies. So, the benefits of moving in this direction largely depend on the inclusion of reasonable life income products that provide decent value, even when interest rates are very low.

For instance: Should employers who have programs that offer life income options that provide reasonable value, which manage longevity risk for individuals, benefit more from tax incentives than those who do not? It is likely that such programs --if utilized-- would lead to lower public costs through other public programs. Life income options also would help retirees feel comfortable spending their retirement resources, virtually eliminating the fear of running out of money too soon. This dynamic whereby some retirees spend-down too quickly, while others fear using their retirement savings at all, leads to inefficient use of tax expenditures.

Since retirement coverage in the workplace is generally weaker at smaller firms, it may make sense to only apply such limiting provisions to larger firms, at least at the outset.

#3 Developing More Attractive Annuities: NIRS believes the healthy discussion about improving upon existing annuity options, utilizing either private or public systems, is vitally important. Whether providing annuity options through Social Security or looking at regulations that might allow for better value among private sector products, improving these options offers enormous potential for the large number of Americans who are expected to navigate all of these complexities on their own. This is particularly true as we have been living through an extended period with extraordinarily low interest rates, which are being held artificially at these very low levels for other economic purposes.

The existing regulations surrounding private annuities have served a legitimate purpose: protecting against insurers pricing themselves into failure during market turmoil. However, they also serve as handcuffs, which largely prevent insurers from benefiting from more equity exposure and collecting risk-premiums that help to support costs and offer more value.

If policymakers are unable to develop regulatory structures for annuity sales that both provide decent value to retirees and protect insurers from defaults, some have proposed using the Social Security system as a means to sell annuities. More specifically, these proposals would allow retirees to take their accumulated savings (up to a dollar cap) and purchase an actuarially fair annuity to supplement their monthly Social Security benefit.[62] This would take advantage of the administratively efficient structure that already exists for distributing monthly Social Security benefits to tens of millions of retirees. Additionally, the Social Security system does not face the same market forces that make selling annuities challenging for private sector entities, and--due to its scale--may be able to avoid most adverse selection challenges. However, it raises the question of how Social Security would price those annuities and invest the funds it collects.

If we are unable to solve this puzzle, too few retirees will have lifetime income in the future. They will be subjected to the extreme level of volatility that longevity risk presents at the individual level. These facts make it imperative that we focus our attention on improving the options to convert savings to income that are available to retirees. The healthy dialogue around this issue in recent years has been encouraging, but more work remains to be done.

#4 Expand Social Security Benefits: Social Security remains the primary income source for the majority of retired Americans. Approximately 90 percent of retirees receive Social Security benefits, and 40 percent of retirees receive Social Security but have no income from either a pension or retirement savings accounts.[63] Given the overwhelming role Social Security plays in providing retirement income, expanding benefits represents one of the most direct paths toward relieving the burden of retirement for working families.

Expanding Social Security benefits could take several forms. Expansion could just mean a straightforward increase in benefits either by a certain dollar amount, e.g., $200 per month, or by targeting a slightly higher replacement rate of preretirement earnings. Expansion could also mean plugging holes in the existing system. This could mean establishing a minimum benefit level set above the federal poverty line. It could also involve establishing caregiver credits for people who take time out of the workforce to care for children, a spouse, or parents. The spousal benefit could also be updated to reflect the realities of 21st century life and the contemporary workforce.

Any legislation to strengthen and expand Social Security would likely include a number of these proposals. Ensuring retirees have more guaranteed income would go a long way toward reducing unpredictability by dampening risk and making costs more manageable. All of these proposals for expanding Social Security benefits deserve serious consideration.

CONCLUSION

Most working adults will confront the challenge of saving for a secure retirement throughout their working years. The American Dream of retirement starting at age 65 is increasingly elusive for many families. Saving early and continuously throughout a career are two big hurdles, but rising costs and the volatility in so many areas also are major burdens that retirees may not be factoring into their savings. Solving the puzzle of retirement in an environment where families are increasingly navigating these challenges on their own likely will become an even more difficult task in the years ahead. This is particularly true when these various risks are stacked on top of one another. One person may own a home, retire at a good moment in time, live for only four years in retirement, and never face any long-term care costs, while their neighbor may be forced to retire earlier than planned due to an employment shock (like COVID-19), live for another 40 years, and face hundreds of thousands of dollars in care costs in their 80s after managing rent increases for 25 years. The variance in outcomes is simply too much to manage individually.

Absent a serious rebuilding of America's retirement infrastructure, it is likely that these challenges will be dealt with piece-by-piece after the problems become impossible to ignore, rather than addressed holistically. Instead, policymakers would be prudent to build forward-looking programs that prepare for the demographic changes that are coming. Otherwise, the golden years of America's senior citizens will continue to be threatened by rising costs and unpredictability, while their children and grandchildren shoulder the burden of society's failure to plan ahead.

"One person may own a home, retire at a good moment in time, live for only four years in retirement, and never face any long-term care costs, while their neighbor may be forced to retire earlier than planned due to an employment shock (like COVID-19), live for another 40 years, and face hundreds of thousands of dollars in care costs in their 80s after managing rent increases for 25 years. The variance in outcomes is simply too much to manage individually."

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The National Institute on Retirement Security is a non-profit research and education organization established to contribute to informed policymaking by fostering a deep understanding of the value of retirement security to employees, employers, and the economy as a whole.

Our Vision

Through our activities, NIRS seeks to encourage the development of public policies that enhance retirement security in America. Our vision is one of a retirement system that simultaneously meets the needs of employers, employees, and the public interest. That is, one where:

- employers can offer affordable, high quality retirement benefits that help them achieve their human resources goals;
- employees can count on a secure source of retirement income that enables them to maintain a decent living standard after a lifetime of work; and
- the public interest is well-served by retirement systems that are managed in ways that promote fiscal responsibility, economic growth, and responsible stewardship of retirement assets.

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- High-quality research that informs the public debate on retirement policy. The research program focuses on the role ad value of defineed benefit pension plans for employers, employees, and the public at large. We also conduct research on policy approaches and other innovative strategies to expand broad based retirement security.
- Education programs that disseminate our research findings broadly. NIRS disseminates its research findings to the public, policy makers, and the media by distributing reports, conducting briefings, and participating in conferences and other public forums.
- Outreach to partners and key stakeholders. By building partnerships with other experts in the field of retirement research and with stakeholders that support retirement security, we leverage the impact of our research and education efforts. Our outreach activities also improve the capacity of government agencies, non-profits, the private sector, and others working to promote and expand retirement security.

The National Institute on Retirement Security is a non-profit research institute established to contribute to informed policy making by fostering a deep understanding of the value of retirement security to employees, employers, and the economy as a whole. NIRS works to fulfill this mission through research, education, and outreach programs that are national in scope.

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