

Factors to Consider When Determining Adequate Retirement Income

**Retirement Security: Better Information on
Income Replacement Rates Needed to Help
Workers Plan for Retirement**

Issued on March 1, 2016

Overview

- As part of a broader body of work on retirement security, GAO released a report in 2016 (GAO-16-242) that analyzed key factors used for determining target replacement rates and how spending patterns vary by age. This report will be the focus of our presentation today.
- Other relevant GAO reports in the retirement security portfolio include: low savings of households approaching retirement (GAO-15-419); improving retirement income options for 401(K) plan participants (GAO-16-433); and phased retirement programs for older workers (GAO-17-536)
- These reports can be downloaded from our website free of charge. <http://www.gao.gov/>

What Are Replacement Rates and Why Do They Matter?

- An income replacement rate estimates the percentage of pre-retirement income needed to maintain a certain standard of living in retirement.
- Replacement rates are one common tool for analyzing the retirement readiness of individuals and providing information to help individual workers plan for retirement.
- They can be used by
 - Researchers
 - Policy makers
 - Financial industry professionals
 - Individuals

What's the Policy Issue?

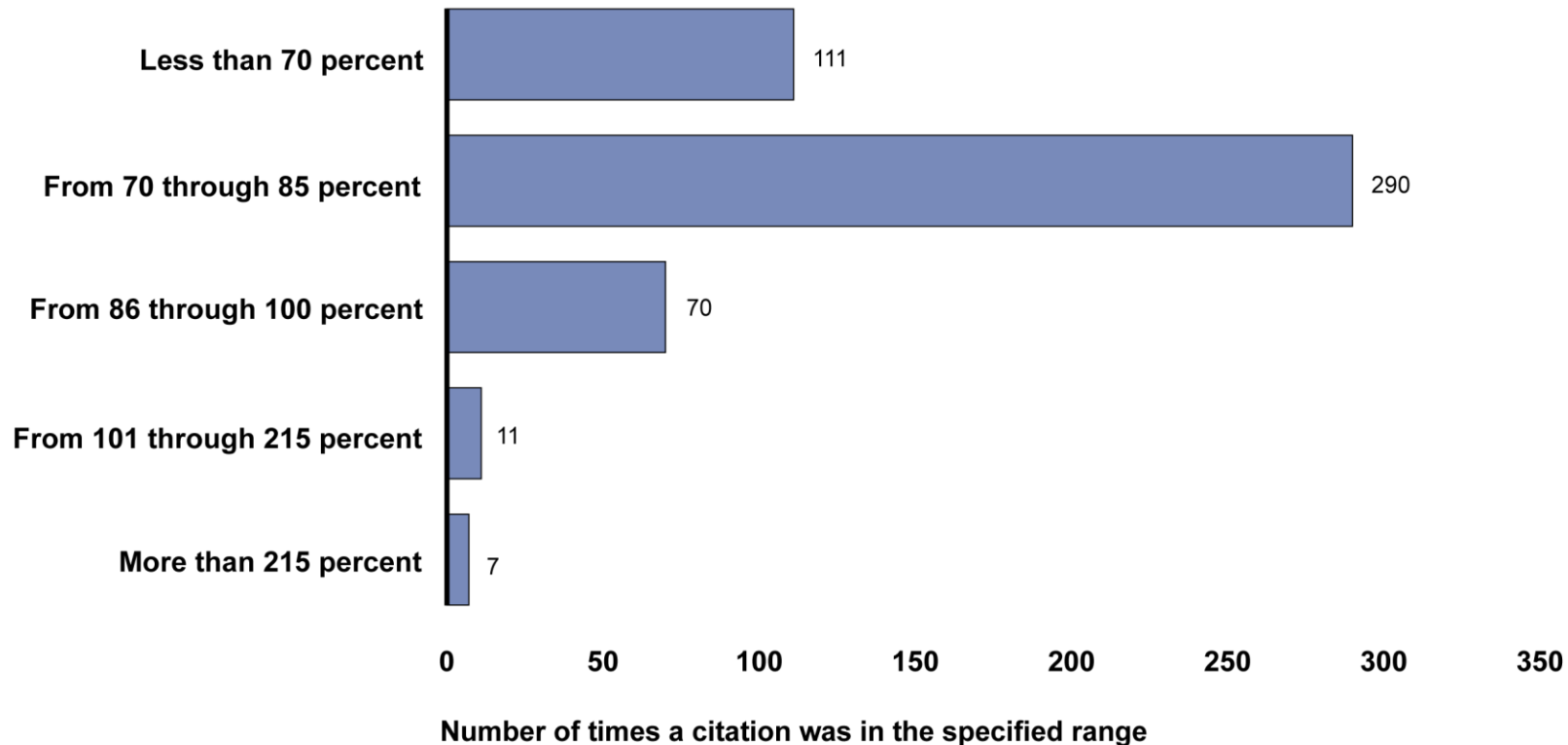
- While there have been many studies on replacement rates, there is no consensus recommendation on what income replacement rate households should target for their retirement years.
- This is due, in part, to the fact that replacement rate targets are heavily dependent on the underlying assumptions used to develop them.
- However, to accurately interpret their implications for retirement adequacy, it is important for policy makers and individuals to better understand how these targets are developed.

GAO's Research Questions

- What are the key factors used to develop target replacement rates?
- Have spending patterns varied by age and, if so, how?

We Found About 500 References to Target Replacement Rate Recommendations in 52 Articles Included in Our Literature Review

Range of target replacement rate citations



Source: GAO analysis of articles and reports discussing retirement replacement rates. | GAO-16-242

Key Considerations for Deciding How Much Income Should be Replaced in Retirement: Household Characteristics

- Researchers and financial industry professionals consider a variety of key factors when determining target replacement rates, including household characteristics, spending, and pre-retirement earnings
- Housing characteristics play an important role in determining a household's expenses and income needs in retirement.
 - Household size may not be static.
 - Researchers disagree on how having had children should factor into estimating a target replacement rate.
 - Age at retirement also matters.

Key Considerations for Deciding How Much Income Should be Replaced in Retirement: Spending

- Assumptions need to be made about a number of expenses, including housing, health care, education, entertainment, consumer goods, and paying down debt.
 - Example: Housing expenses may decrease if a retired household downsizes or pays off a mortgage at retirement, so a person may not need as much income in retirement. On the other hand, expenses may increase if a retiree moves into specialized senior housing, requiring more income than anticipated in retirement.

Key Considerations for Deciding How Much Income Should be Replaced in Retirement: Pre-Retirement Earnings

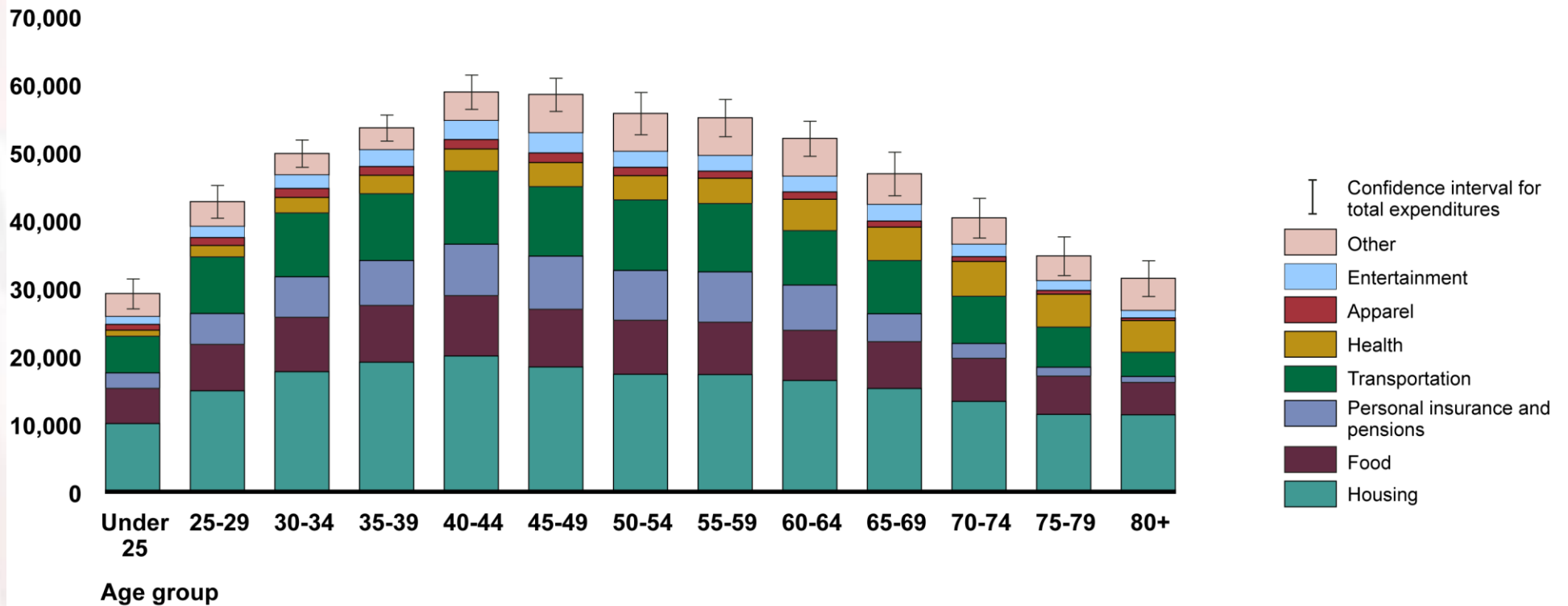
- Lower earners may need higher target replacement rates than higher earners.
- Developers of target replacement rates must make important decisions about how to calculate pre-retirement earnings.
 - What time period should be used to calculate pre-retirement earnings?
 - Are earnings adjusted to account for inflation or wage growth?
 - Should the target rate account for phased retirement?

Some Financial Professionals Recommend Target Replacement Rates While Others Question Their Usefulness

- Six of the 14 financial professionals we collected information from recommend target replacement rates to their clients, and four develop customized rates using information about an individual's finances and household composition.
- The remaining eight financial professionals questioned the usefulness of target replacement rates for retirement plan participants or their clients.
 - Using a rule of thumb is not appropriate for everyone, according to one retirement services consultant.
 - Income needs in retirement may be expense- or goals-based, according to two financial planners.

Spending Patterns: Older Households Spent about 20 Percent Less than Mid-Career Households in 2013

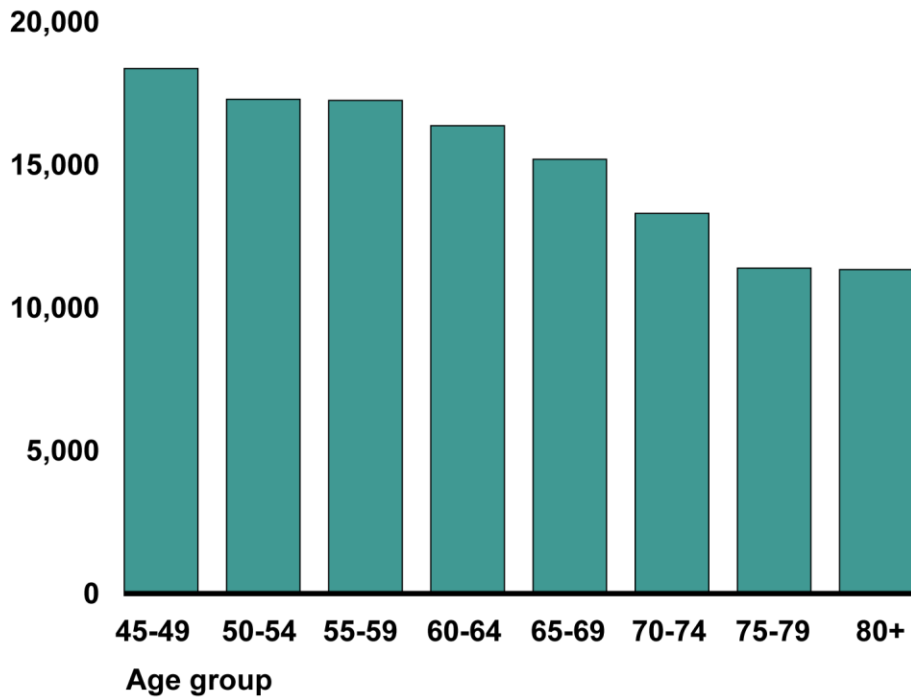
Average household expenditures



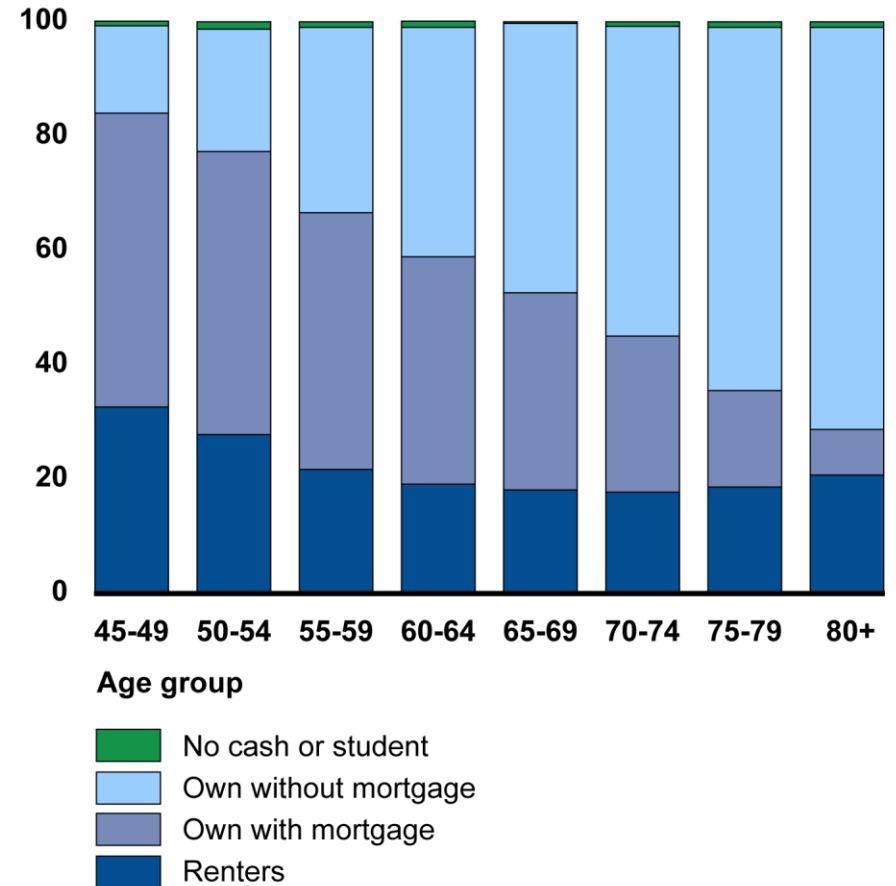
Source: GAO analysis of 2013 Bureau of Labor Statistics Consumer Expenditure Survey, Interview Survey data. | GAO-16-242

Spending Patterns: Housing Was the Top Expense Regardless of Age

Average housing expenditures



Percentage of households



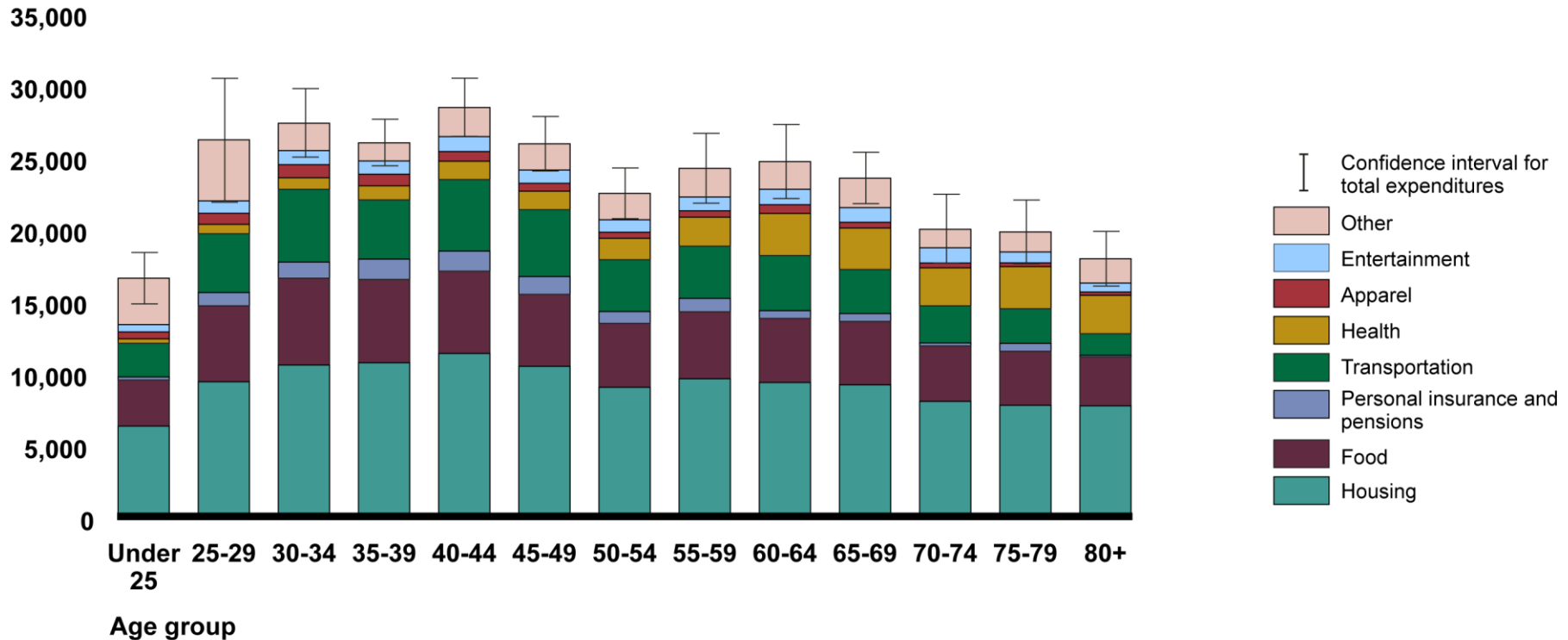
Source: GAO analysis of 2013 Bureau of Labor Statistics Consumer Expenditure Survey, Interview Survey data. | GAO-16-242

Spending Patterns: Older Households Spent More Out-of-Pocket on Health Care

- Unlike other spending categories, health care was a larger expense for older households.
 - For example, the share of total spending on health care for older retirees was more than double the share that mid-career households spent.
- Long-term care (LTC) costs can be an important consideration for retirement, but these costs are difficult to plan for.
 - Average LTC spending may not be indicative of potential costs

Spending Patterns: Unlike for Other Households, Spending Was Relatively Flat Across Low-Income Households Regardless of Age

Average household expenditures - lowest income quartile



Source: GAO analysis of 2013 Bureau of Labor Statistics Consumer Expenditure Survey, Interview Survey data. | GAO-16-242

Our Conclusions

- Income replacement rates may be a helpful gauge for younger workers and low- and middle-income households.
- However, there is no rule of thumb that will work for everyone.
- Developing a customized replacement rate requires careful consideration to appropriately balance all of the underlying assumptions.

Notes on Figure “We Found About 500 References to Target Replacement Rate Recommendations in 52 Articles Included in Our Literature Review”

- Figure presents GAO analysis of 52 reports discussing retirement replacement rates. A bibliography of these reports can be found at <http://www.gao.gov/products/GAO-16-242>.
- The citations in the figure came from 52 studies and reports included in our literature review.
 - While our literature review included articles and reports published by international organizations for other analyses in our report, they were not included in this particular analysis. Countries have different pension and social safety net systems, making it hard to compare the rates calculated and used in these studies with those found in studies that focus solely on the United States.
- The citations were grouped into the ranges in the figure. They did not encompass the entire range. For example, if the study cited a target replacement rate of 75 percent, it is included in the “from 70 percent through 85 percent” bar.

Notes on Spending Figures Used in This Presentation

- Figures present GAO analysis of 2013 Bureau of Labor Statistics Consumer Expenditure Survey, Interview Survey data.
- Age groupings are based on the age of the reference person, or the person who rents or owns the home, for the consumer unit. There may be adults in the consumer unit who are older or younger than the reference person. A consumer unit can comprise (1) all members of a household related by blood, marriage, or other legal arrangement, (2) a person living alone or sharing a household but who is financially independent, or (3) two or more persons living together who make joint expenditures. For the purposes of this report, we refer to consumer units as households. We did not adjust spending levels for household size.
- Income categories were defined by age-specific income brackets. As a result, each income bracket at each age group has approximately the same number of households.
- Income includes some non-wage sources from public programs, such as Supplemental Security Income and unemployment compensation.

Notes on Spending Figures Used in This Presentation (continued)

- The “other” category of spending includes expenditures for reading, tobacco, alcoholic beverages, education, cash contributions, personal care, and miscellaneous expenses.
- The “personal insurance and pensions category” includes deductions for government and railroad retirement, private pensions, and Social Security. According to Bureau of Labor Statistics officials, the private pensions category includes defined benefit, defined contribution, and individual retirement accounts.
- Housing expenditures include expenses such as rent, utilities, and mortgage interest payments, but do not include payments on mortgage principal.