



Breaking Down Health Care Expenses in Retirement

Separating estimates for annual premiums and out-of-pocket costs makes planning easier.

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KEY INSIGHTS

- Given that health care costs are incurred over time, it makes more sense to view them as an ongoing regular budget item instead of a lump sum needed at the start of retirement.
- Health insurance premiums account for between 75% and 82% of retirees' annual health care expenses and, for the most part, are predictable and can be paid from monthly income. However, out-of-pocket expenses can vary and should be paid from savings.
- Traditional financial planning principles and basic budgeting can help address many of the financial unknowns about health care costs in retirement.



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A recent survey from T. Rowe Price finds that health care costs are the top spending concern of retirees. This comes as no surprise as some studies predict that a 65-year-old couple may need up to \$400,000¹ to cover health care costs in retirement. But these estimates don't provide an accurate picture of what most retirees will encounter.

Such daunting numbers give an impression that it will be difficult for most retirees to afford health care in retirement. We believe that planning for health care costs in retirement can be made simpler by using the available assets and income retirees have. But we need to approach calculating health care costs differently.

When trying to plan for future health care expenses in retirement, consider these three things.

- 1. Health care is not a one-time, bulk expense.** In our view, approaching health care costs as an annual expense makes it easier to plan for. Any type of expense incurred over a 20- to 30-year period can look daunting when summed up. We might balk at the thought of prepaying an \$86,000 cable bill in retirement,² but that's not how we pay for cable. Similarly, estimating cumulative future health care costs is not useful because we don't prepay for health care.

¹ Fronstin, Paul and Jack VanDerhei. "Savings Medicare Beneficiaries Need for Health Expenses: Some Couples Could Need as Much as \$400,000, Up From \$370,000 in 2017." EBRI Issue Brief, no. 460 (Employee Benefit Research Institute, October 8, 2018).

² Assuming a \$150 monthly cable expense with 3% annual inflation over 30 years.

75%–82%

Medicare premiums with prescription drug coverage account for between 75% and 82% of annual health care costs for the majority of retirees, regardless of the type of Medicare coverage they have.

2. Think about premiums and out-of-pocket expenses differently.

Premiums are relatively stable, but out-of-pocket expenses are not. Usually, retirees pay a fixed monthly premium, but out-of-pocket expenses can vary from month to month.

As Figure 1 shows, Medicare premiums with prescription drug coverage account for between 75% and 82% of annual health care costs for the majority of retirees, regardless of the type of Medicare coverage they have.

Given that month-to-month premiums are fixed and premiums make up the bulk of annual health care expenses means that most of the annual health care expenses are predictable. So they can be budgeted for and paid from monthly income.

On the other hand, out-of-pocket expenses can vary greatly from individual to individual and from month to month. Figure 2 illustrates how out-of-pocket expenses can vary.

It is clear from Figure 2 that out-of-pocket expenses are highly variable, and they are the primary source of uncertainty in health care expenses.

We believe maintaining a fund (like a savings account) with enough liquid savings to meet the annual out-of-pocket expenses and replenishing it annually might be a good way to address the uncertainty of out-of-pocket expenses.

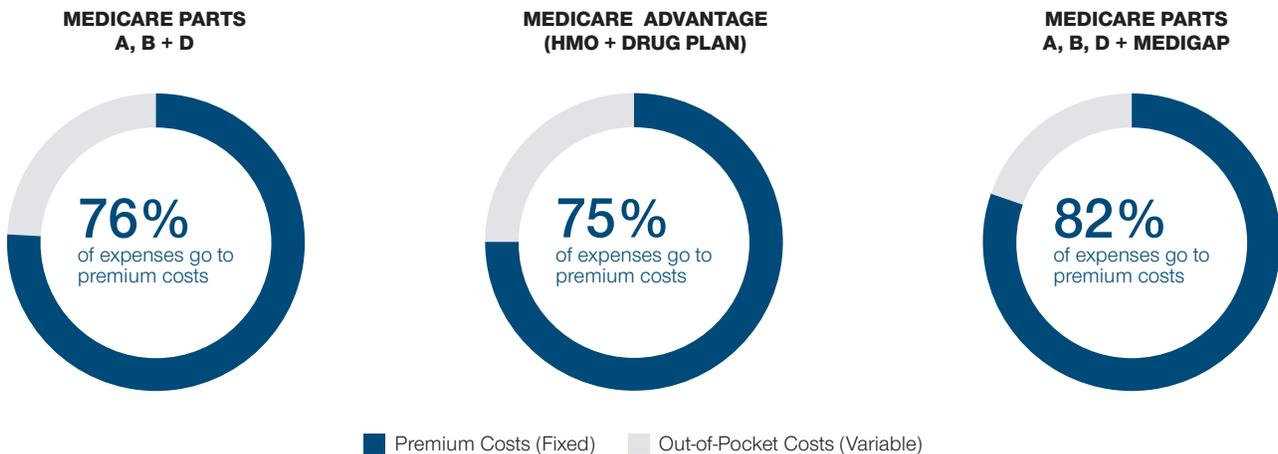
3. Don't get caught up on one large number.

Most of the estimates regarding retiree health care expenses assume a single type of coverage, which may differ from yours. Also, the astronomical health care cost numbers often correspond to a few unfortunate people who experience very high expenses for a prolonged period. Most retirees won't be in that situation.

According to our estimates, half of retirees with traditional Medicare (Parts A and B), a prescription drug plan (Part D), and Medigap will spend less than \$1,100 per year on out-of-pocket expenses. Only one in 10 will likely spend more than \$4,600 per year on out-of-pocket expenses. Also, it's not necessarily true that someone spending \$4,600 in out-of-pocket expenses this year will keep doing so for the rest of his or her life.

(Fig. 1) A Look at the Share of Premiums in Total Annual Health Care Costs

Median percentage share of individual health insurance premiums (ages 65 and above)



Source: T. Rowe Price estimates based on projected 2020 Medicare premiums and data from the Health and Retirement Study (HRS).

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— **Sudipto Banerjee, Ph.D.**
Vice President, Retirement Thought Leadership

(Fig. 2) Out-of-Pocket Expenses Are Highly Variable

Different percentiles of annual out-of-pocket expenses for individuals ages 65 and above under different types of Medicare coverage

	MEDICARE PARTS A, B + D	MEDICARE ADVANTAGE (HMO + DRUG PLAN)	MEDICARE PARTS A, B, D + MEDIGAP
Low Cost (1 in 4 retirees will pay less than)	\$300	\$300	\$500
Medium Cost (half of retirees will pay less than)	\$800	\$900	\$1,100
High Cost (1 in 4 retirees will pay more than)	\$2,400	\$1,900	\$2,300
Very High Cost (1 in 10 retirees will pay more than)	\$4,700	\$3,800	\$4,600

Source: T. Rowe Price estimates based on projected 2020 Medicare premiums and data from the HRS. All costs are rounded up to the nearest hundred.

What You Can Do to Prepare

Prior to retirement (and filing for Medicare), consider:

- Comparing the premiums and out-of-pocket costs of different Medicare coverage options. Include prescription drug plans in the comparison, and choose the option that best suits you.
- Calculating your monthly premiums based on the type of coverage you choose and budgeting for that amount from your monthly income.

- Keeping enough liquid cash to meet your out-of-pocket expenses for the year. This amount can be based on past years' expenses.

It's hard not to be intimidated by extreme estimates regarding future health care expenses. But recognize that your actual health care expenses will be a combination of regular, predictable expenses that you can budget for and, for most people, a smaller component of variable expenses that you can manage from your savings.

ABOUT THIS STUDY

We analyzed nationally representative data on retiree health care expenses and projected 2020 Medicare premiums to estimate annual health care expenses for different types of Medicare coverage and to break down the costs between insurance premiums and out-of-pocket expenses.³ We also provided guidelines on how retirees can plan to meet their annual health insurance premiums and out-of-pocket expenses.

³Health and Retirement Study public use dataset. Produced and distributed by the University of Michigan with funding from the National Institute on Aging (grant number NIA U01AG009740). Ann Arbor, MI.

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