Will Your Spending Match Your Income in Retirement?

Research finds that spending in retirement declines, mostly by choice

KEY INSIGHTS

- Retirees’ spending is not constant. It declines by an average of 2% annually throughout retirement.
- Once retired, households adjust their nondiscretionary spending to match their new level of guaranteed income, rather than spending at preretirement levels.
- Meaningful financial planning based on spending preferences will better prepare you for your future retirement expenses.

Conventional retirement income planning assumes that retirees want to maintain a certain standard of living and level of spending throughout their retirement. If your spending exceeds any retirement income you might receive through Social Security benefits or pension, the assumption is that you will take money out of savings to make up any gap.

Our research, however, revealed a difference in that assumed spending behavior. Current retirees tend to adjust their essential spending to match their guaranteed income, choosing to re-budget based on their Social Security, pension, and annuity income sources, rather than trying to maintain their preretirement lifestyle and spending.

Why Retirement Spending Patterns Matter

T. Rowe Price analyzed the spending behavior of a group of retirees over 15 years using data from the Health and Retirement Study¹ and focused on two types of spending: nondiscretionary and discretionary expenses.² Nondiscretionary, sometimes referred to as fixed spending, includes essential and recurring expenses like housing, food, and utilities, etc. Discretionary spending, on the other hand, may be more variable like entertainment, vacations, dining out, etc.

¹ Health and Retirement Study, public use data set. Produced and distributed by the University of Michigan with funding from the National Institute on Aging (grant number NIA U01AG009740). Ann Arbor, MI.
² See Appendix A, page 5.
We found that total household spending in retirement decreases by 2% each year and most of that decline is driven by nondiscretionary expenses. While nondiscretionary expenses are often thought of as fixed, they really aren’t as rigid as we assume. Many retirees cut down on their nondiscretionary or essential expenses and align these expenses with their guaranteed income. By doing this, they lessen the likelihood of having a gap between their guaranteed income and these expenses so that they don’t have to dip into their savings to pay for their essential expenses.

For example, you may choose to move to an area where housing costs and taxes are lower or to shop at cheaper supermarkets. This spending behavior may indicate a stronger preference for asset preservation rather than a desire to maintain a set lifestyle.

It might take you a couple of years to settle into a new lifestyle once you retire. Our research found that at the start of retirement, nondiscretionary spending was higher than retirees’ guaranteed income for a brief period. However, that spending level is short-lived. After a few years, we saw retirees gravitate toward spending close to their guaranteed income.


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— Sudipto Banerjee, Ph.D. Vice President, Retirement Thought Leadership
Combining Guidelines With Personal Preferences

If current retirees are not spending down their assets as we assume, what does that mean for retirement planning guidelines?

T. Rowe Price provides broad retirement planning guidelines for investors, which can be useful benchmarks for many individuals, but they aren’t tailored to individual circumstances. They include:

- **75% income replacement rate in retirement:** This is a helpful shortcut for people who are many years from retirement. It is a guideline for how much of your preretirement household income you’ll need to cover retirement expenses. While it does assume expenses will decrease at the start of retirement, further spending reductions aren’t considered.

- **15% savings rate:** We suggest that individuals try to save 15% of their income (including any employer match) for retirement. The assumption is that you will rely on your personal savings and Social Security benefits to fund a retirement that could last decades. This doesn’t consider other sources of income in retirement (e.g., pension benefits, work, rental income) or that you are willing to make spending changes as this research suggests.

- **4% withdrawal rule:** The idea is that you will not run out of money if you withdraw 4% of your portfolio balance in the first year of retirement. That amount is assumed to increase by the rate of inflation each subsequent year to maintain purchasing power. This is a starting point. It is not a spending plan. As this research shows, current retirees do not spend a constant, inflation-adjusted rate throughout their retirement. The 4% rule can be a helpful benchmark, however, to track your retirement readiness.

General retirement planning guidelines are meant to help you get on a good retirement savings track. As you get closer to retirement, you should move past a general guideline and examine your specific spending needs and preferences.

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**Retirees Adapt Spending to Their Income**

(Fig. 2) After age 65, the ratio of nondiscretionary spending to guaranteed income quickly approaches 1:1

![Graph showing the ratio of nondiscretionary spending to guaranteed income over age]


As you get closer to retirement, you should move past a general guideline and examine your specific spending needs and preferences.

— Judith Ward, CFP®
Vice President, Senior Financial Planner
What Actions Can You Take?

1. **Understand your sources of income in retirement.** How much guaranteed income will you be getting in Social Security and pension benefits, for example? Are there any other predictable sources of income you plan to receive—wages from part-time work, rental income, etc.

2. **Make a list of what your nondiscretionary and discretionary expenses in retirement might be.** Keep in mind that nondiscretionary and discretionary expenses could be considered your personal “needs” and “wants.” Understand how you might modify your expenses in retirement, even those that may be recurring and essential.

3. **Align income sources to retirement spending.** This will give you an idea of how much you may have to rely on your personal savings to supplement your spending needs for the retirement lifestyle you envision.

4. **Know what gives you financial peace of mind.** What helps you sleep at night? Knowing you have “enough” in your account in case of a big expense or that you are spending some savings without worrying about running out of money? Be honest about what gives you security and enjoyment. Review your plan each year to make any modifications.

Finally, but most importantly, give yourself time to adjust to your new retirement lifestyle. Retirement is referred to as a destination, but it really is the beginning of another chapter in your life. Start with a plan, and remember, like with any journey, you can change course along the way.

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Appendix A

Nondiscretionary and Discretionary Spending

The Consumption and Activities Mail Survey (CAMS) collects information on six durable and 33 nondurable spending categories. Durable spending (such as a refrigerator or washing machine) is infrequent, and the use of durable goods is spread over many years. So, it is not useful to look at durable spending in relation to annual income. Therefore, we consider only nondurable spending and divide it into discretionary and nondiscretionary spending.

Nondiscretionary Spending:
Mortgage, rent, utilities, homeowners’ or renters’ insurance, property taxes, home repairs and maintenance, housekeeping supplies, auto payments, auto insurance, auto maintenance, clothing and apparel, health insurance (including supplemental insurance), prescription and nonprescription medication, health care services, medical supplies, food and beverages (excluding dining out), gasoline.

Discretionary Spending:
Trips and vacations; household furnishings and small equipment; charitable and political contributions; cash or gifts to family or friends; dry cleaning and laundry services; home cleaning services; supplies and services for gardening and yard; personal care products and services; tickets to movies, sporting events, and art performances; gym and other sports activities; hobbies and leisure equipment; dining out and takeout food.

ABOUT OUR RESEARCH

We use data from the Health and Retirement Study (HRS)\(^1\) and its supplement Consumption and Activities Mail Survey (CAMS). CAMS started in 2001, and we used data from 2001 through 2015. Income data corresponding to each CAMS wave are used from HRS.

More importantly, we used data only from the original CAMS cohort first interviewed in 2001 and then every other year since then. Therefore, this is a panel data analysis as we follow the same group of retirees from 2001 to 2015.

However, we used some filters to make the data suitable for analysis. First, to ensure the integrity of the panel, we kept households that were observed in at least two consecutive surveys. Second, to contain spending outliers we dropped households whose total household spending exceeded three times their total household income in any given year, and change in household spending between two consecutive waves did not exceed 50% in absolute terms. Our final analysis sample consisted of 1,470 households.

All spending and income numbers were inflation adjusted using the consumer price index and presented in 2019 dollars.

\(^1\) Health and Retirement Study, public use data set. 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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