A new way to plan for health care costs in retirement

Workers approaching retirement have become increasingly concerned about the effect that health care costs may have on their postretirement financial security. A new Vanguard research paper, *Planning for Health Care Costs in Retirement*, lays out a new model developed in partnership with Mercer Health and Benefits to forecast the range of U.S. retiree health care costs.

Although health care costs—a crucial component of retirement readiness—keep rising, there are important steps people can take to prepare for the challenge, and the Vanguard-Mercer model offers critical guidance for individuals, advisors, and plan sponsors alike.

“Most Americans understand that annual health care costs have been growing faster than inflation, as workers are experiencing rising premiums and out-of-pocket costs within their current employer benefits,” said Jean Young, a senior research associate with the Vanguard Center for Investor Research and one of the paper’s authors.

Many people also realize they are likely to consume more health care services each year as they age, Ms. Young said. Thirty-eight percent of baby boomers surveyed listed health care costs as their top fear about retirement, ahead of running out of money.

### Health care costs are baby boomers’ most important retirement concern

<table>
<thead>
<tr>
<th>Concern</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not being able to meet monthly expenses</td>
<td>20%</td>
</tr>
<tr>
<td>Not being able to maintain a standard of living</td>
<td>25%</td>
</tr>
<tr>
<td>Health care costs</td>
<td>35%</td>
</tr>
<tr>
<td>Health issues</td>
<td>30%</td>
</tr>
<tr>
<td>Running out of money</td>
<td>30%</td>
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</tbody>
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*Notes: Responses are based on the views of 1,600 full-time employed adults representative of the U.S. population by age and gender. Respondents could choose up to two answers to the question.*

*Source: PwC Employee Financial Wellness Survey, 2016.*

Vanguard and Mercer, based on their analysis, recommend several important changes to the way health care costs are typically discussed and modeled:

- **Health care cost factors.** Understanding how an individual’s annual health care costs will change at retirement requires understanding the impact of key personal attributes, including health status,
coverage choices, geography, income, and loss of employer subsidies. Routine health care costs include insurance premiums and out-of-pocket expenses associated with paid long-term care.

- **Replacement ratios.** Replacement ratios—the percentage of pre-tax income at retirement that individuals will need to maintain their current lifestyle—are commonly used to provide estimates of retirement spending needs, which in turn are used to estimate required saving rates. For some workers, accounting for changes in health care costs will result in higher replacement ratios than many traditional defaults, especially if their employer offers generous health care benefits.

- **Annual cost framing.** Health care costs in retirement should not be estimated as a lump sum. Instead, individuals should focus on annual costs, especially the incremental annual changes they will experience at retirement and at Medicare enrollment.

- **Substitution effects.** Health care costs are likely to increase during retirement because of both increased health care consumption and faster-than-inflation growth. Planning frameworks need to balance this growth against substitution effects that occur when retirees spend less on other types of expenses as they age.

- **Long-term care.** Long-term care costs represent a separate planning challenge. They should be explicitly addressed as part of the retirement planning process. Individuals need to understand that there is a low but real probability they will experience high long-term care costs.

**Health care spending rises as people age, but overall spending declines**

![Graph showing health care spending by age group](image)

**Notes:** The figure reflects annual spending data over 2015–2016 for one-person households.


An understanding of personal health care cost factors provides a baseline for people to predict incremental anticipated costs in retirement.

“We believe that planning for health care costs in retirement should be personalized to an individual’s attributes,” said Jacklin Youssef, a Vanguard senior wealth planner and also an author of the paper. “Costs
may increase at retirement because of the possible loss of employer health insurance premium subsidies. Health care costs are also influenced by a range of factors over which retirees have varying degrees of control, such as plan choice, geography, income, retirement age, and health status.”

Stephen Weber, a research analyst in Vanguard’s U.S. Wealth Planning Research Group and another author of the paper, noted that some individuals should save at higher rates during their working years to account for potential future incremental health care spending.

“Unless they have an employer-sponsored retiree health care plan, workers with generous employer health care benefits, those at higher risk of chronic conditions, or those planning to retire early might need to target higher replacement rates,” Mr. Weber said.

Long-term care costs may actually be the biggest concern for most retirement planning scenarios, because the consumption of long-term care varies significantly.

“Half of individuals will incur no costs, and a quarter will consume less than $100,000,” Ms. Young said. “However, 15% will consume more than $250,000. Individuals should plan for these potential costs. Factors such as individual health, family history, and presence of support networks will inform each person’s desired long-term care need.”