

# Exploring the Retirement Consumption Puzzle

by David Blanchett, CFP®, CFA

David Blanchett, CFP®, CFA, is head of retirement research at Morningstar Investment Management in Chicago, Illinois. (David.Blanchett@Morningstar.com)

**Acknowledgement:** The author thanks Alexa Auerbach and Hal Ratner for helpful edits and comments.

Retirement income research and financial planning tools generally assume that retiree expenditures, or consumption, increase annually by inflation during retirement. This assumption is counter to a growing body of empirical research that has noted actual retiree expenditures tend to decrease both upon, and during, retirement. This phenomenon has been named the “retirement consumption puzzle.”

Decreased inflation-adjusted spending is inconsistent with general economic theories on consumption, such as the life-cycle hypothesis, which suggests individuals seek to maintain constant consumption over their lifetimes. Decreased inflation-adjusted spending also conflicts with assumptions underlying the majority of retirement income research that assume retirement income should increase annually by inflation.

For this paper, government data on consumption was analyzed to understand how retiree consumption actually changes over time. The results of the analysis suggests that although the retiree consumption basket is likely

## Executive Summary

- Empirical research on retiree spending has noted a “retirement consumption puzzle,” where retiree expenditures tend to decrease both upon and during retirement. This decrease in spending is inconsistent with general economic theories on consumption, which suggest individuals seek to maintain constant consumption over their lifetimes.
- Government data on consumption was analyzed in this study to understand how retiree consumption actually changes over time.
- The results of the analysis suggest that although the retiree consumption basket is likely to increase at a rate that is faster than general inflation, actual retiree spending tends to decline in retirement in real terms. This decrease in real consumption averages approximately 1 percent per year during retirement.
- A “retirement spending smile” effect is noted. This finding has important implications when estimating retirement withdrawal rates and determining optimal spending strategies.

to increase at a rate that is faster than general inflation—a fact that can largely be attributed to the higher weight to medical expenses for retirees—actual retiree spending tends to decline in retirement in real terms. This decrease in real consumption averages approximately 1 percent per year during retirement.

A “retirement spending smile” effect is noted. Changes in real consumption tend to be greater in both early and late retirement. This means that although the basket of goods consumed by retirees may increase faster than total inflation, total spending actually decreases.

## Literature Review

A growing body of literature explores the spending habits and tendencies of retiree households. The majority of these studies note that inflation-adjusted consumption tends to decline at and during retirement. This decrease in real spending is counter to various economic theories on consumption, such as the life-cycle hypothesis (LCH), as well as common assumptions used in retirement income research.

The LCH was introduced by Modigliani and Brumberg (1954) and implies that individuals maximize utility by planning savings and consumption such that lifetime consumption is as smooth