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How People Underestimate Spending in Retirement

When people are told they can get by on 70% of pre-retirement income, they ignore the 30% cut in lifestyle

By Shlomo Benartzi

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It's conventional wisdom among financial advisers: People planning to retire should aim to maintain 70% of their current income in retirement.

It sounds sensible enough. But in reality it can encourage people to underestimate the amount of money that will keep them content in retirement.

The 70% rule leads us astray because it fails to address the emotional cost of losing 30% of our income. Most people focus on the 70% they will keep, not the spending they will give up. They aren't prepared for the changes that will be required in their lifestyles. When they eventually are confronted by the specifics they have to cut, they are unhappy. In short, the 70% rule makes the future seem secure and comfortable, even when it's not.

Behavioral economists refer to this as a framing effect. Similar examples abound in everyday life, as people find choices far more appealing when they are framed in terms of gains rather than losses. For instance, people are more likely to buy ground beef when it's described as 75% lean rather than 25% fat.

Framing effects can even shape our estimates of longevity. Research by a group led by John Payne, a professor at Duke University's Fuqua School of Business, finds that when people are asked to estimate their lifespan using different frames, they come up with strikingly different answers. In particular, asking subjects if they will "live to" a certain age leads to estimates that are roughly six to nine years longer than asking if they will "die by" a given age.

Why? One explanation is the "live to" frame focuses our thoughts on the reasons we might stay alive. When people are given the death frame, by contrast, their minds are naturally drawn to the reasons they might die. Instead of thinking about their healthy exercise habits, they focus on their love of hamburgers.

Framing effects matter because they shape our perceptions of the world and the content of our thoughts. The question hasn't changed, but the frame can determine how we judge alternatives and what we end up choosing.

So how can we ensure that framing effects don't ruin our retirement? Here's my proposal: Before workers settle on a retirement-savings goal, or decide it's time to retire, they should undergo a behavioral stress test. In short, they should be asked to identify three expense categories they will cut in retirement, with instructions to be as specific as possible as to what exactly they will cut. These cuts should be significant enough to add up to approximately 30% of their current spending.

In my experience, while most people find the 70% rule palatable, they find the 30% frame unacceptable. When asked to think specifically about where they would be willing to sacrifice—perhaps dining out, travel, or spoiling the grandchildren—that is when they become more aware of how much they are being asked to give up.

And that's the point of a behavioral stress test.

The key insight is that people need to be exposed to both gain and loss frames to be able to make realistic decisions about the income they will need in retirement. Behaviorally, neither frame by itself is sufficient. While the gain frame can lead people to underestimate the amount of sacrifice that will be necessary, the loss frame might cause them to think too negatively about the consequences of those sacrifices. Indeed, economic research has shown that big differences in income typically result in minor differences in happiness.

The behavioral stress test probably will encourage most people to increase their retirement-savings goals, and thus have more income in their later years, allowing them to avoid giving up certain pleasures and activities.

It is the same for banks when they undergo stress tests in an effort to determine their ability to withstand a financial crisis. The tests help them identify hidden risks and correct mistaken models before it's too late.

By considering both gain and loss frames, we can start to figure out what we really want—and what we definitely don't want to live without.

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