

Notes

Savings Needed for Health Expenses for People Eligible for Medicare: Some Rare Good News, p. 2

A T A G L A N C E

Savings Needed for Health Expenses for People Eligible for Medicare: Some Rare Good News, by Paul Fronstin, Ph.D., Dallas Salisbury, and Jack VanDerhei, Ph.D., EBRI

- Medicare generally covers only about 60 percent of the cost of health care services (not including long-term care) for Medicare beneficiaries ages 65 and older, while out-of-pocket spending accounts for 13 percent.
- The Patient Protection and Affordable Care Act (PPACA) reduces cost sharing in the Part D “donut hole” down to 25 percent by 2020. This year-to-year reduction in coinsurance will continue to reduce savings needed for health care expenses in retirement, all else equal, for individuals with the highest prescription drug use.
- EBRI analysis finds 1–2 percent reductions in needed savings among individuals with median drug use and 4-5 percent reductions in needed savings among individuals at the 90th percentile in drug use since EBRI’s 2011 analysis.
- A 65-year-old man would need \$70,000 in savings and a woman would need \$93,000 in 2012 if each had a goal of having a 50 percent chance of having enough money saved to cover health care expenses (excluding long-term care) in retirement.
- A 65-year-old couple, both with median drug expenses, would need \$163,000 in 2012 to have a 50 percent chance of having enough money to cover health care expenses (excluding long-term care) in retirement, \$227,000 to have a 75 percent chance of covering those expenses, and \$283,000 to have a 90 percent chance of doing so. These estimates are 1–2 percent lower than the savings targets estimated in 2011.

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By Paul Fronstin, Ph.D., Dallas Salisbury, and Jack VanDerhei, Ph.D., Employee Benefit Research Institute

Introduction

When it was established in 1965, Medicare (the federal, health-care-insurance program for the elderly and disabled) was not designed to cover health care expenses in full. Even in 2003, when the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (MMA) added outpatient prescription drugs as an optional benefit, the program included a then-controversial feature known as the coverage gap, or so-called “donut hole.”

The “Donut Hole”

The Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (MMA) added outpatient prescription drugs as an optional benefit. When the program was originally enacted, it included a controversial feature: a coverage gap, more commonly known as the “donut hole.”

The Patient Protection and Affordable Care Act of 2010 (PPACA) included provisions to reduce (but not eliminate) this coverage gap. By 2020, enrollees will pay 25 percent of the cost of prescription drugs for both generic and brand-name drugs that are in the coverage gap.

In 2009, Medicare covered 59 percent of the cost of health care services for Medicare beneficiaries age 65 and older, while out-of-pocket spending accounted for 13 percent, and private insurance covered 14 percent (Figure 1). In the future, individuals can expect to pay a greater share of their costs out of pocket because of the combination of the underfunded financial condition of the Medicare program and cutbacks to employment-based retiree health programs (Fronstin and Adams 2012).

This report updates previous estimates by the Employee Benefit Research Institute (EBRI) on savings needed to cover health insurance premiums and health care expenses in retirement (Fronstin, Salisbury, and VanDerhei 2011). Unlike past reports, it finds that the savings targets for a 65-year-old retiring in 2012 are not higher than the savings target for a 65-year-old in the previous year. In fact, in some cases, savings targets have fallen by 5 percent. This report discusses the EBRI model, the savings targets, and reasons for the decline.

Modeling Technique

Determining how much money an individual or couple needs in retirement to cover health care expenses is complicated. Among other factors, it depends on the age at which he or she retires; length of life after retirement; the availability and source of health insurance coverage after retirement to supplement Medicare; health status; out-of-pocket expenses; the rate at which health care costs increase; and interest rates and other rates of return on investments. In addition, public policy that changes any of the above factors will also affect spending on health care in retirement. While it is possible to come up with a single number that individuals can use to set retirement-savings goals, a single number based on averages will be wrong for the vast majority of the population.

This analysis uses a Monte Carlo simulation model¹ to estimate the amount of savings needed to cover health insurance premiums and out-of-pocket health care expenses in retirement. Estimates are presented for people who supplement Medicare with a combination of individual health insurance through Plan F Medigap coverage and Medicare Part D for outpatient-prescription-drug coverage. For each source of supplemental coverage, the model simulates 100,000 observations allowing for the uncertainty related to individual mortality and rates of return on assets in retirement,² and computes the present value of the savings needed to cover health insurance premiums and

out-of-pocket expenses in retirement at age 65. These observations are used to determine asset targets for having adequate savings to cover retiree health costs 50 percent, 75 percent, and 90 percent of the time. Estimates are also jointly presented for a stylized couple, both of whom are assumed to retire simultaneously at age 65.

Savings Targets to Cover Health Insurance Premiums and Out-of-Pocket Costs in Retirement

Figure 2 contains the savings estimates for a person age 65 in 2012 who purchases Medigap Plan F and Medicare Part D outpatient drug benefits to supplement Medicare. As discussed above, there will be uncertainty related to a number of variables, such as health care costs, longevity, and interest rates. Among people covered by Medicare Part D, there is also the uncertainty related to health status and prescription-drug use. Projections of savings needed to cover out-of-pocket expenses for prescription drugs are, of course, highly dependent on the assumptions used for drug utilization. There are three sets of columns of estimates in Figure 1: one where prescription drug use is at the *median* (mid-point) throughout retirement, one where prescription drug use is *higher* (at the 75th percentile throughout retirement), and one where prescription drug use is *much higher* (at the 90th percentile throughout retirement). Under each set of columns, a comparison of the savings targets is presented for 2011 and 2012.

Separate estimates are presented for men, women, and married couples. Because women have longer life expectancies than men, women will generally have larger expenses than men to cover health insurance premiums and health care expenses in retirement, regardless of the savings target. In other words, women will need greater initial savings than men even when both set the same goal—for example, of having a 90 percent chance of having enough money to cover health expenses in retirement.

Median Drug Expenses: According to Figure 2, a 65-year-old man would need \$70,000 in savings and a woman would need \$93,000 in 2012 if each had a goal of having a 50 percent chance of having enough money saved to cover health care expenses in retirement. If either instead wanted a 90 percent chance of having enough savings, \$135,000 would be needed for the man, and \$154,000 would be needed for the woman.

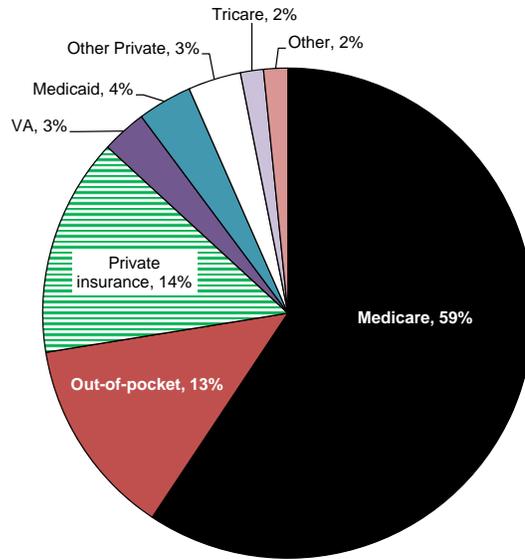
A 65-year-old couple, both with median drug expenses, would need \$163,000 in 2012 to have a 50 percent chance of having enough money to cover health care expenses in retirement. They would need \$227,000 to have a 75 percent chance of covering their expenses, and \$283,000 to have a 90 percent chance of covering those expenses. These estimates are 1–2 percent lower than the savings targets estimated in 2011.

75th percentile in Drug Expenses: Needed savings in 2012 for a 65-year-old man with drug expenditures at the 75th per-centile throughout retirement would be \$79,000 if he wanted a 50-percent chance of having enough savings to cover health care expenses in retirement; For a 65-year-old woman, the savings target would be \$106,000 for a 50-percent chance. If either instead wanted a 90-percent chance of having enough savings, \$153,000 would be needed for the man, and \$176,000 would be needed for the woman.

A 65-year-old couple, both with drug expenses at the 75th percentile, would need \$186,000 in 2012 to have a 50 percent chance of having enough money to cover health care expenses in retirement. They would need \$258,000 to have a 75 percent chance of covering their expenses, and \$321,000 to have a 90 percent chance of covering their expenses. These estimates are about 1 percent lower than the savings targets estimated in 2011.

90th percentile in Drug Expenses: Individuals at the 90th percentile in drug spending at and throughout retirement experienced a 4–5 percent decline in needed savings in the simulation from 2011 to 2012. A 65-year-old man would need \$102,000 in savings and a 65-year-old woman would need \$132,000 in 2012 if each had a goal of having a 50 percent chance of having enough money saved to cover health care expenses in retirement. If, instead, either wanted a 90 percent chance of having enough savings, \$185,000 would be needed for the man, and \$210,000 would be needed for the woman.

Figure 1
Source of Payment for Incurred Health Care Expenses,
Noninstitutionalized Population of Medicare Beneficiaries,
Ages 65 and Older, 2009



Source: EBRI estimates from the 2009 Medical Expenditure Panel Survey.

Figure 2
Savings Needed for Medigap Premiums, Medicare Part B Premiums,
Medicare Part D Premiums, and Out-of-Pocket Drug Expenses for
Retirement at Age 65 in 2011–2012

Chance of Having Enough Savings	Median Prescription Drug Expenses throughout Retirement		75th Percentile of Prescription Drug Expenses throughout Retirement		90th Percentile of Prescription Drug Expenses throughout Retirement	
	2011	2012	2011	2012	2011	2012
Men						
50 percent	\$71,000	\$70,000	\$80,000	\$79,000	\$106,000	\$102,000
75 percent	107,000	105,000	120,000	119,000	154,000	147,000
90 percent	136,000	135,000	154,000	153,000	194,000	185,000
Women						
50 percent	95,000	93,000	107,000	106,000	138,000	132,000
75 percent	124,000	122,000	140,000	139,000	178,000	170,000
90 percent	156,000	154,000	176,000	176,000	221,000	210,000
Married Couple						
50 percent	166,000	163,000	187,000	186,000	244,000	234,000
75 percent	231,000	227,000	260,000	258,000	332,000	317,000
90 percent	287,000	283,000	323,000	321,000	407,000	387,000

Source: Author simulations based on assumptions described in the text.

A 65-year-old couple, who both had median drug expenses, would need \$234,000 in 2012 to have a 50 percent chance of having enough money to cover health care expenses in retirement. They would need \$317,000 in 2012 to have a 75 percent chance of covering their expenses, and \$387,000 to have a 90 percent chance of covering their expenses.

Explaining the Decline in Savings Targets Between 2011 and 2012

As mentioned above, savings targets declined between 1 percent and 5 percent between 2011 and 2012 for a person or couple age 65. For a married couple who both had drug expenses at the 90th percentile throughout retirement and who wanted a 90 percent chance of having enough money saved for health care expenses in retirement targeted savings at age 65 fell from \$407,000 in 2011 to \$387,000 in 2012.

The EBRI model uses projections from the Congressional Budget Office (CBO) and Centers for Medicare & Medicaid Services (CMS) for premium and health-care-cost increases in the future. The main reason for the decline in needed savings is related to slight improvements (reductions) in the projected costs of prescription drugs under Medicare Part D.

CMS projected growth rates in Part D premiums, deductible levels, and other aspects of the program have fallen slightly recently. In addition, using a person age 65 in 2012 instead of in 2011 means one less year until the coverage gap in Part D phases down to 25 percent coinsurance. While the growth rate for Medicare Part B premiums increased slightly and Medigap premiums rose in 2012, these increases were more than offset by the slower projected growth in various aspects of the Medicare Part D program.

Conclusion

Individuals will be responsible for saving for health insurance premiums and out-of-pocket expenses in retirement for a number of reasons. Medicare generally covers only about 60 percent of the cost of health care services for Medicare beneficiaries ages 65 and older, while out-of-pocket spending accounts for 13 percent. Furthermore, the percentage of private-sector establishments offering retiree health benefits has been falling,³ and, even where benefits are still offered, they are becoming less generous. This is true even in the public sector.

This report provides estimates for savings needed to cover health insurance to supplement Medicare and out-of-pocket expenses for health care services in retirement. PPACA is reducing cost sharing in the Part D coverage gap, or so-called "donut hole." By 2020, coinsurance in the coverage gap will be phased in to 25 percent. This year-to-year reduction in coinsurance will continue to reduce savings needed for health care expenses in retirement, all else equal, for individuals with the highest prescription drug use, which is why this analysis finds 1–2 percent reductions in needed savings among individuals with median drug use and 4–5 percent reductions in needed savings among individuals at the 90th percentile in drug use. Improvements in the outlook for growth in premiums and other costs related to the Medicare Part D program also contributed to the decline in savings targets.

Many individuals will need more money than the amounts cited in this report because this analysis does not factor in the savings needed to cover long-term care expenses,⁴ nor does it take into account the fact that many individuals retire prior to becoming eligible for Medicare. However, some workers will need to save less than what is reported if they choose to work during retirement, thereby postponing enrollment in Medicare Parts B and D if they receive health benefits as active workers.

Finally, issues surrounding retirement income security are certain to become an even greater challenge in the future as employers continue to scale back retiree health benefits and as policymakers begin to address financial shortfalls in the Medicare program with solutions that are likely to shift more responsibility for health care costs to Medicare beneficiaries.

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Endnotes

¹ A technique used to estimate the likely range of outcomes from a complex process by simulating the process under randomly selected conditions a large number of times.

² Nominal, after-tax rates of return are assumed to follow a log-normal distribution with a mean of 1.078 and a standard deviation of 0.101. This provides a median nominal annual return of 7.32 percent.

³ See Paul Fronstin and Nevin Adams, "Employment-Based Retiree Health Benefits: Trends in Access and Coverage, 1997–2010." *EBRI Issue Brief* no. 377 (Employee Benefit Research Institute, October 2012).

⁴ See VanDerhei (2006) for estimates of the impact of long-term care expenses on the amounts needed for sufficient retirement income at the 50th, 75th, and 90th percentiles.



Notes

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