How to Plan for Rising Health Care Costs in Retirement

Source: Fidelity Viewpoints, 8/3/2020

If you are like most Americans, health care is expected to be one of your largest expenses in retirement, after housing and transportation costs. But unlike your parents' generation, you won't likely have access to employer - or union-sponsored retiree health benefits. So, health care costs will likely consume a larger portion of your retirement budget - and you need to plan for that.

There are a number of drivers behind this mounting retirement health care cost challenge. In general, people are living longer, health care inflation continues to outpace the rate of general inflation, and the average retirement age is 62 for most Americans—that's 3 years before you are eligible to enroll in Medicare.

"Health care is creating a 'retirement cost gap' for many pre-retirees," says Steve Feinschreiber, senior vice president of the Financial Solutions Group at Fidelity. "Many people assume Medicare will cover all your health care cost in retirement, but it doesn't. We estimate that about 15% of the average retiree's annual expenses will be used for health care-related expenses, including Medicare premiums and out-of-pocket expenses. So, you should carefully weigh all options."

How much is needed for health care costs in retirement?

According to the Fidelity Retiree Health Care Cost Estimate, an average retired couple age 65 in 2020 may need approximately $295,000 saved (after tax) to cover health care expenses in retirement.

Of course, the amount you'll need will depend on when and where you retire, how healthy you are, and how long you live. The amount you need will also depend on which accounts you use to pay for health care—e.g., 401(k), HSA, IRA, or taxable accounts; your tax rates in retirement; and potentially even your gross income.

Tip: If you're still working and your employer offers an HSA-eligible health plan, consider enrolling and contributing to a health savings account (HSA). An HSA can help you save tax-efficiently for health care costs in retirement. You can save pretax dollars (and possibly collect employer contributions), which have the potential to grow and be withdrawn tax-free for federal and state tax purposes if used for qualified medical expenses.

Pre- and early retirees: Make the most of your time to prepare

As retirement nears, you will have several big decisions to make, including when to stop working, when to take Social Security, how to pay for health care, and how to generate cash flow from your retirement assets. These decisions are interconnected and could make a difference in your living costs and lifestyle in retirement—and when you can retire.

Approximately one-third of "early retirees" who claim Social Security at age 62 do so to help pay for health care expenses until they are eligible for Medicare coverage at age 65. But if you can postpone retirement or save enough to cover health care costs until 65, then you may be able to defer your Social Security benefits. Generally speaking, the longer you can wait until age 70 to take Social Security benefits, the more you can collect, assuming you live a long life.

If you're like most people, you probably don't have access to employer-sponsored pre-65 retiree medical coverage. So if you retire prior to age 65, you'll need to find coverage until you are eligible for Medicare. Consider these options that may be available to you (see table).

	COBRA continuation	Spouse's health plan	Public marketplace	Private insurance
Target audience	Former employees	Eligible spouses/partners of covered employees	Anyone	Anyone
Estimated cost	$$–$$$	$–$$	$$–$$$	$$–$$$
Considerations	Few employers subsidize COBRA; you may pay the full cost of the coverage	Not all employers offer this benefit; special rules or surcharges may apply	You may qualify for federal assistance based on your income	Your former employer might provide a reimbursement account that can help you afford the cost of these plans

Turning 65 and retiring: Consider Medicare and other options

When you get close to age 65, spend some time reviewing and considering all your Medicare options. When you do become eligible at age 65, you'll want to remember to sign up during your 7-month initial enrollment period that begins 3 months before the month you turn 65.

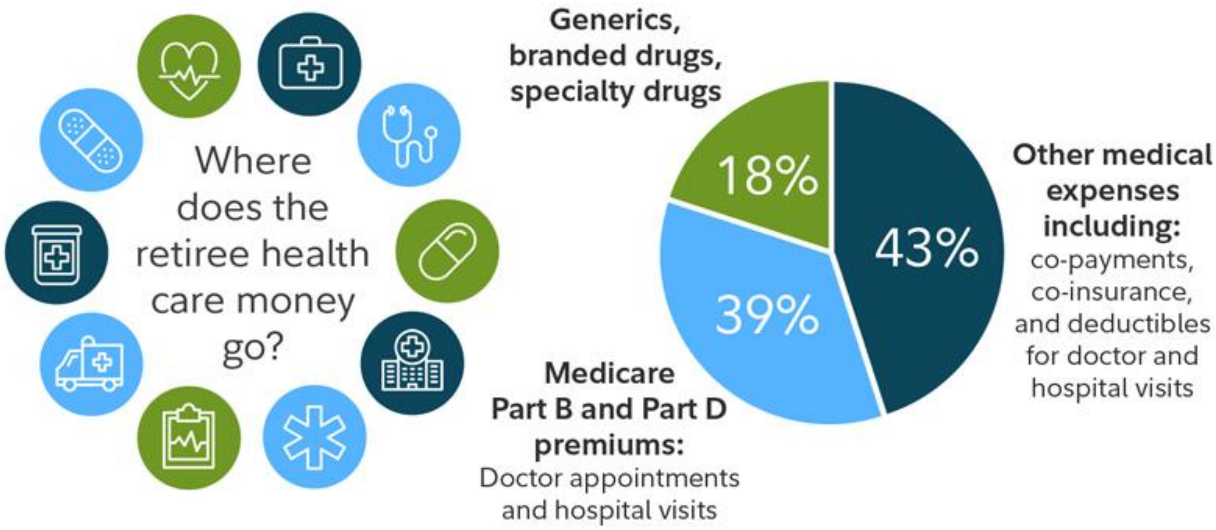
There's a lot to learn about the world of Medicare. You'll need to know about Medicare Parts A, B, and D, as well as Medicare Advantage and "Medigap" supplemental insurance plans.

In brief:

- Part A covers hospital costs after you meet a deductible.
- Part B is optional coverage for medical expenses and requires an annual premium. Part D is for prescription drug coverage.
- Medicare Advantage plans are all-in-one managed care plans that provide the services covered under Part A and Part B of Medicare and may also cover other services that are not covered under Parts A and B, including Part D prescription drug coverage.
- Supplemental policies, referred to as Medigap policies, are offered by private insurance companies to supplement expenses that Medicare Parts A and B do not typically cover.

Tip: You may be better off paying a higher premium but not having to pay out-of-pocket at your office visits. Look at the cost of annual premiums and co-pays at different levels of supplemental insurance. Compare these costs. Then factor in the number of visits and co-pay/co-insurance per visit that you anticipate for the next year.

Once you select a Medicare plan, it's not forever. You can switch Medicare plans as you age and as your situation changes. Generally, it makes sense to enroll in Medicare Parts A, B, and D when you are first eligible because the late enrollment penalty for doing so later is steep (see next section if you are continuing to work after age 65).



Turning 65 and still gainfully employed (or your spouse/partner is)

If you're still working when you're 65 and get health insurance through your employer or your spouse's employer, you'll have the opportunity to enroll in Medicare when you leave your employer plan through a Special Enrollment Period.

In addition to Medicare options to consider, if your spouse or partner continues to work, they may be able to cover you through their health plan. Talk to your HR department to help you evaluate all your options, costs, and any restrictions. The rules of Medicare are complicated, so to get started, consider the following questions:

- Which plan offers you the best coverage for your health needs?
- Your employer is required to offer you coverage, but is that your best option?
- Is it more expensive to stay in your employer plan or join Medicare?
- Can your spouse or partner remain in your employer's plan if you decide to leave?

Tip: Remember, one of the key goals at this stage is to avoid any gap in coverage.

Health care in retirement: Costs can come later

As you plan for health care expenses throughout your retirement—however long it may be—understand how paying for future health care expenses fits into your overall retirement income planning efforts, because health care utilization tends to increase as we age.

According to the Kaiser Family Foundation, the percentage of household budgets spent on health expenses is nearly 3 times as much for retirees on Medicare as for working households (14% versus 5%).

"Although health care costs continue to rise, there are financial planning steps that you can take today to help prevent health care costs from eating into your retirement lifestyle," Feinschreiber advises. "For example, if you're age 50 or older, you may be able to make up for a savings shortfall with additional catch-up contributions to your 401(k) or IRA. In addition, if you are age 55 or older, you can make an additional $1,000 catch-up contribution annually to your health savings account."