

Bloomberg.com

April 2, 2007

Ready for a Big Retirement Surprise?

Save Now

by

Kevin Hassett

If you are like most people, odds are you aren't saving enough for retirement.

You set some aside when you can, but probably you never analyzed the problem carefully. That likely means you are setting yourself up for a nasty surprise.

Fortunately, you don't need to go to graduate school in economics to acquire the tools needed to avoid a shock. A new study by Dartmouth economist Jonathan Skinner provides a fascinating guide to the best retirement strategies.

The economics of retirement is pretty simple. One of the building blocks of modern economic theory is the idea that people tend to enjoy each bite of consumption less than their previous bite. That means the happiness you feel during a year where you spend a lot more isn't equal to the unhappiness you feel when your consumption goes down by the same amount.

If you accept that principle, then an optimal plan would smooth out your consumption throughout your lifetime.

So, to an economist at least, retirement is a pretty easy problem. You simply figure out how much you need to save, so you can have about the same level of spending every year. When your income is high, you don't consume it all, saving money instead for the years where your income is low.

More Than You Think

Using ESPlanner, a commercially available computer program first developed by economists Laurence Kotlikoff and Jagadeesh Gokhale, Skinner estimates the amount of wealth that people need to have to maintain their standard of living in retirement. The program accounts brilliantly

for any number of complications and includes adjustments for federal retirement programs such as Social Security and Medicare.

The analysis suggests you need a surprisingly large amount of money to keep up your standard of living. A couple that has gone through life with two children and with an income of \$136,000 needs to have \$850,000 in the bank, and a paid-off house, if they expect to maintain their living standard.

Skinner lists a number of markers along the way that can let you know whether you're on track. At 40, this couple should have \$167,000 in the bank, and at 50 they should have \$399,000.

That same couple with an income of \$272,000 needs to save a lot more, of course. They should try to have \$1.53 million when they retire, and would need to have \$316,000 at age 40, and \$590,000 at age 50. Skinner also lays out a wide array of other incomes and scenarios.

Not Saving Enough

The evidence suggests that many people aren't saving nearly that much. One study cited by Skinner found that fully a third of Americans see a drop in their consumption of at least 33 percent when they retire. Some 73 percent of retirees report that they wish they had saved more as they planned for retirement.

Are these targets really big enough? Maybe not. Retiree expenditures on health care have skyrocketed, as out-of-pocket charges in Medicare have gone up. Currently, there is a 20 percent co-payment, and the first day of a hospital stay must be paid by the patient.

When you work these into the analysis, the numbers are really quite startling. In 2004, 15 percent of American retirees paid more than 25 percent of their income in health bills; 6 percent paid more than 50 percent.

Given that such expenses are likely to become bigger, and more common, it is probably a good idea to think of the numbers Skinner presents as minimums. If you want some insurance against scary health expenditures when you retire, you probably will need more.

Why do so many miss the boat when planning for retirement? The evidence indicates that procrastination may be the biggest problem. Individuals who bother to think carefully about the situation and evaluate their likely consumption needs generally do fine when they retire.

It's not that people are unable to save the correct amounts; it's that they tend not to think about what the right amount might be.

Most of us just spent hours and hours gathering up all our financial information for the Internal Revenue Service. Now would be a perfect time to take that information, and use it to make a real plan for retirement. The latest academic work suggests you may have some catching up to do.

(Kevin Hassett is director of economic-policy studies at the American Enterprise Institute. He was chief economic adviser to Republican Senator John McCain of Arizona during the 2000 primaries. The opinions expressed are his own.) To contact the writer of this column: Kevin Hassett at khassett@aei.org .