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Do Financial Planners Advise Us to Save Too Much for Retirement?

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The Program on Retirement Policy

A crosscutting team of Urban Institute experts in Social Security, labor markets, savings behavior, tax and budget policy, and micro-simulation modeling ponder the aging of American society.

The aging of America raises many questions about what's in store for future and current retirees and whether society can sustain current systems that support the retired population. Who will prosper? Who won't? Many good things are happening too, like longer life and better health. Although much of the baby boom generation will be better off than those retiring today, many face uncertain prospects. Especially vulnerable are divorced women, single mothers, never-married men, high school dropouts, and lower-income African Americans and Hispanics. Even Social Security—which tends to equalize the distribution of retirement income by paying low-income people more then they put in and wealthier contributors less—may not make them financially secure.

Uncertainty about whether workers today are saving enough for retirement further complicates the outlook. New trends in employment, employer-sponsored pensions, and health insurance influence retirement decisions and financial security at older ages. And the sheer number of reform proposals, such as personal retirement accounts to augment traditional Social Security or changes in the Medicare eligibility age, makes solid analyses imperative.

Urban Institute researchers assess how current retirement policies, demographic trends, and private sector practices influence older Americans' security and decisionmaking. Numerous studies and reports provide objective, nonpartisan guidance for policymakers.

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Abstract

There is abundant advice about how much to save, much of which urges individuals to aim to replace 80 percent of their preretirement pretax income. However, those who wait to save for retirement and follow this rule of thumb would save far too much of their gross income, and many would see their annual resources spike upward when they retire. The constant savings rate required to equalize consumption across the preretirement and postretirement years generally is generally much lower than the 80 percent rule.

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Introduction

There is a lot of hand-wringing about the state of Americans' retirement savings, particularly in the wake of large wealth losses during the recent recession, but the concern is based in part on implausible targets for expenditures in retirement. Advice about how much to save for retirement usually focuses on replacing a large percentage of preretirement income, even at the cost of excessive saving in the run-up to retirement. If one aimed to replace four-fifths of preretirement income in retirement, and saved two-thirds of income for 20 years to hit that target, for example, spending would more than double at the moment of retirement, which is clearly not optimal. Who wants to double their spending the day they retire? Target spending in retirement should be lower. Yet advice to pursue this suboptimal oversaving strategy is ubiquitous.

For example, an Associated Press article published widely[1] in March 2001 advises that the "traditional rule of thumb has been that a retiree needs 70 percent to 80 percent of pre-retirement income to cover expenses." The article also cites a variety of resources, including web calculators from Kiplinger.com and Schwab.com, that advocate[2] aiming to have 80 percent of preretirement income available to spend annually in retirement.

The U.S. Department of Labor (2006) advises workers in their mid-fifties to "figure on at least 80-90% of your pre-retirement income to cover expenses." The booklet promises to "help you figure how much more to save each month over the next 10 to 15 years until you retire," showing "five ways to close the gap and boost your savings."

But to hit a target of 80 percent of preretirement gross income, workers retiring at age 62 (the earliest age one can claim Social Security) who began to save in 2010 at age

[1] See, e.g., Eugene Register-Guard, March 18, 2001, p. 3D; The Fredricksburg Free Lance-Star, March 11, 2001, p. D6.

[2] Specifically, http://kiplinger.com/tools/retirement-savings-calculator.html says "80% is a good ballpark estimate—more if you expect to pay for your own health insurance in retirement" and http://www.schwab.com/public/schwab/investing/investment_help/retirement_planning/retirement_calculator says "A common annual retirement spending estimate is 80% of your current annual income" (both accessed December 15. 2011).

45 might need to save 65 percent of their income.[3] That is, their spending is roughly 35 percent of gross income (ignoring taxes) from today through 2027 and then jumps up to 80 percent the next year. They should be saving less today and consuming less when retired. Perhaps that implies targeting a replacement rate of 50 percent of gross preretirement income. But one cannot optimize by targeting a percentage of gross preretirement income. Instead, one must target spending.

Simulation design

As a simple example of the impact of switching focus from replacing income to keeping spending level at retirement, we focus on a set of prototypical workers planning for retirement in a recent year.

We model three types of earners (low, medium, and high) born in January 1944, who are single or married (to spouses who never work or save, but generate favorable tax treatment), have two children living with them from 1968 to 1985, and retire at one of two different ages, 62 or 66. We show results for those beginning to save a fixed percentage of gross income for retirement at ages 25, 35, 45, and 55. We assume all savings comes out of gross earnings, and there is no defined benefit pension available. Savings are assumed to earn investment returns of 4 percent per year. We assume that retirees spend 6 percent of their accumulated savings in the early years of retirement and it is taxed as if it were ordinary (interest) income. (Optimal extraction of the accumulated savings depends on life expectancy but is typically low in early years and rises as the end of life approaches).

We use the Social Security average wage index[4] as our earnings history for our medium earner (half that amount for a low earner and twice that amount for a high earner) who retires in 2006 (at age 62) or 2010 (at age 66). The 2006 retirement date is the earliest possible claiming date for Social Security, and such early claiming[5] reduces the Social Security benefit by 25 percent in 2006 and every subsequent year. Someone born in 1944 reaches the normal retirement age in 2010. We compute federal income

[3] Calculation shown in Munnell, Golub-Sass, and Webb (2011).
[4] Available at http://www.ssa.gov/oact/COLA/AWI.html#Series.
[5] Reductions in Social Security due to early claiming or credits for delayed claiming are available at http://www.ssa.gov/oact/quickcalc/early_late.html.

taxes in every year using Taxsim9[6] assuming savings are exempt from tax until they are spent. We compute the constant savings rates rate needed to equalize after-tax consumption in the last year of work and the first year of retirement equal, thus smoothing expenditures at retirement.

We could also assume a reduction in expenditures at retirement, which would reduce required savings rates (to 80 or 90 percent of preretirement spending, for example, instead of 100 percent), but perfect smoothing represents an upper bound on required savings rates and may in fact represent the right target.[7] We could also model variable savings rates, perhaps with savings rates increasing and then decreasing over time, but in simple models the variance of the optimal variable savings rates is very close to zero, so constant saving rates are a reasonable approximation.

A bigger problem with the path of savings is the absence of a rationale for why savings rates would be zero and then jump to 30 percent at age 45, but that is an assumed feature of the simulation model that seems to mimic actual behavior: People suddenly realize that they should start saving for retirement. In some cases, there is saving for other purposes (such as children's education) that can partly explain this seemingly odd pattern of saving, but we do not model such features to keep the examples simple.

Changes in assumptions about rates of drawing down assets or returns on savings could produce very large changes in optimal savings rates, but will not change the comparison of interest—a target replacement rate of 80 percent versus equalizing consumption—nearly so much. That is, both the savings rate needed to equalize consumption across retirement and the savings rate needed to achieve 80 percent of preretirement income might be much higher if the return on savings is 3 percent instead of 4 percent per year, or much lower if the return is 6 percent, but those differences do not affect the comparison of the two rates much.

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[6] See http://www.nber.org/~taxsim/stata.html for the program used.

[7] Hurst (2008) documents that spending is constant on average across retirement except for food and work-related expenses, and even though food spending declines during retirement, actual food intake remains constant. Palmer (2008) defines income replacement in terms of the income needed to continue the preretirement standard of living into retirement years (i.e., consumption unchanged at retirement). Tacchino and Saltzman (1999) claim spending declines 20 percent between the ages of 65 and 75 due to voluntary reductions (not because of decreased income).

Simulation evidence

In a few cases, the savings rate needed to achieve 80 percent of preretirement gross income does produce a savings rate that equalizes after-tax consumption in the year before retirement and the year after (table 1). For low earners who start saving before age 45, the savings rate as a percentage of gross pretax earnings is similar using either method of determining a rule-of-thumb target savings rate. The savings rate target is roughly 15 to 25 percent for those who start saving at 25 or 35, which helps explain why the two rates are similar. Savings rates of 19 percent would equalize consumption and 22 percent would replace 80 percent of pretax gross income among married medium earners retiring at 62 and beginning to save at 25, for example.

Low earners need to save less in general because Social Security replaces earnings at a more generous rate. Those who retire later need to save less because they get more from Social Security and their savings grows over a longer time. (In this simplified model, the fact that they would spend less time in retirement does not play a role). The differentials in required savings rates are nonlinear, however, and the required rate rises much faster if the criterion is to replace four-fifths of preretirement income than if it is to equalize consumption in the years before and after retirement.

Looking just at married medium earners retiring at 62, the 80 percent rule requires a savings rates that is twice as high for those who begin savings at 45 than for those who begin saving at 25 (44 versus 22 percent). The rate required to equalize consumption, however, increases much less for late savers (30 versus 19 percent).

Similarly, for single medium earners retiring at 62, the required rates using the 80 percent rule double from 23 to 46 percent as one delays the beginning of retirement savings from age 25 to 45. The rate required to equalize consumption, however, increases only from 18 to 28 percent. The pattern holds up across all the cases shown in table 1, where the savings rate required to hit an 80 percent target roughly doubles, but the rate required to equalize consumption rises by about half. This indicates that an 80 percent target is too high if one waits to start saving, and instead one should split the difference and consume a bit more before retirement and a bit less after retirement.

Table 1. Savings rates needed to equalize consumption at retirement (first number), and achieve 80 percent of preretirement gross income (second number) (%)

	Retire at 62			Retire at 66		
	Start saving at 25	**Start saving at 35**	**Start saving at 45**	**Start saving at 25**	**Start saving at 35**	**Start saving at 45**
Married, low earner	17,18	20,22	26,35	12,10	14,12	19,18
Married, medium earner	19,22	22,28	30,44	15,15	17,19	22,27
Married, high earner	22,30	25,38	34,59	17,22	20,27	25,39
Single, low earner	16,18	19,23	25,35	11,10	13,12	16,18
Single, medium earner	18,23	21,30	28,46	13,16	15,19	20,28
Single, high earner	22,33	25,42	33,66	17,25	19,31	24,45

Conclusions

Americans are not necessarily saving too little for retirement, and the traditional rule of thumb that one should aim to replace 80 percent of preretirement income is clearly misguided. Instead, one should aim to save enough so that spending does not need to drop precipitously in retirement.

Social Security benefits will almost certainly be lower in future decades, but it is also likely that Social Security taxes will be higher. These have offsetting impacts on the savings rate needed to equalize preretirement and postretirement spending. Health policy will also affect desired asset accumulation, but it is a mistake to put too much faith in projections of what policy will be in 20 years.

Even if the typical American is saving exactly the right amount for retirement, nearly half will save too much and nearly half will save too little. Scholz, Seshadri, and Khitatrakun (2006) found that 58 percent of the recently retired had accumulated at least an optimal amount of wealth, meaning that a majority had too much wealth and a minority had too little. The sizes of individual errors in savings tend to be small and are partially offset by tax and transfer policy.

It is still true that the recent recession has left many approaching retirement with far less than they had anticipated, and current workers may need to work longer[8] in order to compensate for financial losses. It is also true that cuts in Social Security benefits are

[8] As the unexpectedly good performance of the stock market in the 1990s caused many to retire early (Sevak 2002), we expect a financial reversal to cause many to retire later.

almost certain to be a part of future corrective action needed[9] to balance the books on Social Security, and that current workers are virtually assured to get less from Social Security than current retirees. However, it would be a mistake for current workers to overreact and save so much that their consumption actually rises the day they retire.

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[9] See Favreault and Karamcheva (2011) on the effects of likely reforms to Social Security.