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A smoother way to save for your future

by Scott Burns and Laurence J. Kotlikoff

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Do you have recurrent idle thoughts, such as, "If I had a million dollars, I would ..." or "If I could just increase what I can spend by . . ."

We do too.

But we think there is something better to do than sit around waiting for money to appear. We can do some financial planning. Do it, and we may be able to raise our standard of living without breaking a sweat.

The question is what works? And what doesn't?

The answers comes from economics. Combined with high-powered math and modern computers, it can determine how these and other decisions affect your sustainable living standard, using an idea called consumption smoothing. Rather than focus on a single economic project consumption smoothing synthesizes every major life decision and evaluates its impact on your lifetime standard of living. Because it solves the complicated math problem of providing the same standard of living throughout your life, consumption smoothing never borrows from Peter to pay Paul. And it never reduces today to increase tomorrow.

This type of analysis has the potential to revolutionize financial planning. Want some proof?

Here's what consumption smoothing can do for a hypothetical couple, Jessie and Josie Jay. The Jays are 40, married, live in Wisconsin, make \$40,000 each and have a 6-year-old named Jenny and a 10-year-old named Jamie. The Jays also have \$150,000 in regular assets, a \$300,000 house, and a \$150,000, 20-year mortgage with a \$1,000-per-month payment and other commensurate housing expenses.

Jessie and Josie plan to pay college expenses for the little Jays of \$20,000 per year each (in today's dollars) for four years. They also plan to retire and start collecting Social Security at age 62. Being conservative, the couple invests only in Treasury Inflation Protected Securities yielding 2 percent above inflation.

Consumption smoothing recommends the couple save \$3,452 this year and consume (apart from housing expenses) \$45,214 until Jenny goes to college, \$38,671 thereafter until Jamie goes to college, and \$31,551 once both kids have left the nest. These numbers are all in today's dollars. Is that smooth and stable? You bet. In adjusting recommended spending to the number of mouths to feed, consumption smoothing takes into account economies in shared living and the relative cost of children.

Although spending changes over time, consumption smoothing delivers a stable \$19,719 living standard per adult. It does this year in and year out.

That's nice, but can they do better? Yes.

Suppose Jessie and Josie open up individual retirement accounts, contribute \$3,000 a year each through retirement to these accounts, and withdraw their balances smoothly starting at age 65. Doing so raises their living standard to \$20,197 -- not a trivial increase.

The Jays can do even better -- achieve a \$20,675 living standard -- by withdrawing all of their IRA balances between ages 62 and 67, and electing to start receiving Social Security at 68.

Finally, if the Jays move to Texas, with its zero state income tax, and maintain their same housing expenses, they can get their living standard up to \$21,690. This is a 10 percent increase over the original \$19,719!

This increase isn't for a single year. It is a benefit, in real dollars, that they enjoy every year from the start of their plan, age 40, until they die.

None of these results would be suggested by conventional financial planning. It would suggest a college savings project that would crush their current living standard. It would suggest a separate retirement savings project that would lower their standard of living, and it would miss the impact of lifetime changes in taxes.

Can anyone do these calculations in their head? No way. But a good laptop with consumption smoothing software can spin out results out in seconds.

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