

TIME

July 2, 2006

The Time to Plan Is Now

NEW TOOLS AND A LITTLE FORESIGHT CAN SMOOTH A PATH
TO RETIREMENT BETWEEN SCRIMPING AND SPLURGING

By

Laurence J. Kotlikoff

Let's face it--Uncle Sam is broke. The gap between the U.S. government's future expenses and tax receipts is \$63.3 trillion. No surprise. The nation has 77 million retiring baby boomers on track to collect well above \$30,000 a year--the average amount we're paying today's elderly--in Social Security, Medicare and Medicaid benefits. If you're planning for a cushy retirement, forget it. Get ready for much higher taxes, lower benefits and inflation.

Why this glum scenario? To close our fiscal gap, we face a menu of pain: raise income taxes 70%, hike payroll taxes 109%, cut Social Security and Medicare a combined 41%, eliminate 79% of federal discretionary spending, or some combination. Waiting only makes the options worse and could lead to hyperinflation. Countries that can't cover their spending with taxes end up printing money to pay their bills. That leads to runaway prices, sky-high interest rates, a weakening currency and economic decline.

Given what's coming, we all need to do very careful financial planning. For starters, avoid those simplistic financial calculators on the Net. Relying on them can lead to huge financial mistakes. TIAA-CREF, for example, asks just five questions in its online Simple Life-Insurance Needs Calculator. Fidelity's Retirement Quick Check saving calculator is equally primitive. Next, think twice about using financial planners. Their software isn't much better. Most programs make you set your own future spending targets. Doing so correctly is terribly difficult given all the interconnected variables. And small targeting mistakes can lead to horrendous saving, insurance and investment advice.

There's no way (and no need) to do financial planning in your head. Economists are developing new consumption-smoothing software that does the targeting for you. (Full disclosure: I've co-developed one such program, called ESPlanner.) The goal of the new software is to help you make the financial and life-cycle decisions that will generate your highest sustainable living standard. Targeting for a smooth spending path makes a lot more sense than scrimping now for a few years of luxury or living it up and then throwing yourself on the mercy of your kids and Social Security.

In addition to planning better, you can also make smarter investments. Given the U.S. fiscal mess, investing abroad is a good idea. Try to avoid inflation-sensitive investments, like long-term bonds, and other potential traps, including waiting to withdraw your 401(k) balances until after tax rates have risen. You may also want to purchase real estate, commodities and collectibles that should retain their purchasing power over time. Borrowing at what are still very low long-term interest rates and investing in U.S. inflation-protected bonds may also make sense.

Every financial decision ought to be taken with a wary eye toward the future. New college grads ought to think twice about taking a job offering low current but high future wages. Those future wages may not materialize and may be taxed to death. Middle-age and middle-class workers should consider contributing to Roth rather than conventional IRAs. The conventional IRA lowers your current taxes but raises your future taxes, including taxes on your future Social Security benefits. New retirees should consider cashing out their 401(k)s early and delaying receipt of Social Security. That dramatically raises Social Security benefits and lowers the taxes on those benefits.

No approach to financial planning is perfect, but consumption smoothing, done properly, can prepare you for our less than rosy fiscal future.

Laurence J. Kotlikoff is a professor of economics at Boston University and co-author of the book *The Coming Generational Storm*