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What is the price of retiring early?

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Fifth in a series By SCOTT BURNS and LAURENCE J. KOTLIKOFF

Economists, it is said, know the price of everything and the value of nothing.

We disagree.

When it comes to financial planning, economists are in the same boat as everyone else. They know the value of everything but the price of nothing.

They know the value – the pleasure – they'll get from retiring early, taking the dream vacation, purchasing a vacation home or giving gifts to their kids. But they don't know what these pleasures cost in terms of reducing their ongoing living standards.

Take retiring early. It may seem easy to determine the drop in your living standard from hitting the links at 61 rather than 62 or 65. But knowing the real price is difficult.

Say you're married, age 50, a fanatic golfer (your nickname is Tigress), and you earn six figures plus benefits. If you retire at 62, you take a spending hit not just at age 62, but every year in the future. The reason is consumption-smoothing – the desire to have a steady living standard through time.

Yes, you could take the entire hit at age 62, but that would be much more painful than spreading it out. You might be too hungry to play golf.

So how can you calculate how much your steady spending needs to drop? You can't do it in your head because there are too many complex factors to consider. For starters, consider federal and state income taxes. You'll pay less in taxes at age 62. But before 62, you'll pay more taxes on the income earned by the assets you need to accumulate to make up for the loss of earned income at 62.

Next, consider Social Security benefits. Having a year's less earnings can reduce your retirement and survivor benefits by a lot or a little, depending on past earnings.

Then there's your 401(k). Working one year less means less in contributions by you and your boss and, therefore, lower future withdrawals.

And a fourth factor is the change in your life insurance. You'll have a year's less earnings to protect and won't need to buy as much insurance or pay as much in premiums.

A fifth factor is paying for an extra year of private health insurance.

A sixth factor is ... well, you get the point.

Economists experiment

As we said, you can't do these calculations in your head. Indeed, Larry Kotlikoff just attended a conference with 13 economics professors who specialize in saving and retirement decisions. He used Tigress as an example and asked each economist two things:

First, what was the most that Tigress, her husband and their two kids could spend in the current year if they wanted to have the same living standard per person over time?

Second, how should this spending should change if Tigress were to retire a year early?

The economists were allowed to use only paper, pencil and their cerebral cortex – the same planning tools most frequently used by the general public. Meanwhile, Mr. Kotlikoff used ESPlanner (his company's consumption-smoothing software) to solve each problem in seconds, determining that the couple should spend $78,186 this year if Tigress retires at 62 and 3.2 percent less if she retires at 61.

The professors were very nervous about handing in their answers. They folded over their answer sheets, left off their names and slipped their sheets inside the pile. They had good reason.

They were way off the mark. Their recommended spending for this year ranged from $40,000 to $135,000. The median response of $60,000 was 23 percent too low.

Talk about not being able to hit the broadside of a barn. Their assessment of the ongoing living standard reduction that Tigress would need to retire early ranged from 1.3 percent to 12.5 percent, with a median reduction of 5 percent.

They got the direction right – retiring early meant a loss of lifetime purchasing power – but they typically overestimated the true price of retiring early by more than 50 percent. Worse, some economists were wildly low and others were wildly high.

Basically, they didn't know the price of an extra year of retirement.

Need to know

Does it matter?

We think so. Without an accurate price, all of us have trouble making economic decisions. Some, thinking the price might be a 10 percent drop in standard of living, would choose to work another year. Others, recognizing that the price of the extra year is "only" 3.2 percent of their future living standard, would take the additional 48 weeks of freedom and run.

Our point, however, is not about the costs and benefits of retiring early. It's about consumption-smoothing and lifetime consumption – a reasonable benchmark you can use to make major life decisions.

Laurence J. Kotlikoff is a Boston University economist and the co-author of The Coming Generational Storm with Scott Burns.

Scott Burns answers questions of general interest in his Thursday columns. Write Scott Burns, The Dallas Morning News, P.O. Box 655237, Dallas, Texas 75265, or send an e-mail.

E-mail sburns@dallasnews.com

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