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Intelligent Money

Current thinking from Haven Financial Advisors

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Special Notes of Interest:

The average interest rate on new 30 year fixed-rate mortgages was 4.44% for the week ended August 12. That is lower than at any time since Freddie Mac began tracking them in 1971

There were 6.6 million fewer jobs in the United States in July 2010 as there were at the recession's onset in December 2007.

How Much do People Spend in Retirement

If you work in the world of personal finance, one of the key questions that is routinely asked is "How much do I need to retire?" It's a reasonable question but a vexing one. There are numerous variables that weigh in the answer and their future impact must be projected in some reasonable way. This issue will address the spending patterns among retirees and will provide some guidance based on survey data.

The financial planning literature is replete with rules of thumb to determine expenditure patterns. Like investment returns, there is a considerable amount of dispersion around an expected result.

One school of thought holds that retiring couples tend to spend a fraction of the living standard that they enjoyed just prior to retirement. Various common sense adjustments can be made to establish good guidelines. Less spending on clothing and commuting. More spending on health care. The general rules of thumb suggest that a fraction of 75% to 85% of preretirement income is sufficient for new retirees.

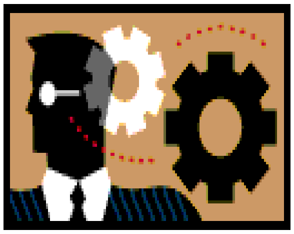
Analysis of more recent spending data indicates that retiree spending levels tail off more rapidly than the foregoing models suggest. In a 2005 FPA journal article, financial planner Ty Bernicke argued that Department of Labor (DOL) surveys pointed to a more rapid spending decline. The data he referenced was from 2002. We looked at most recent available data from 2008 to see if the observation was robust through time. The table at bottom indeed indicates that spending levels decline rapidly once retirement age is reached. In fact, the consumer spending of 65-74 year olds is only 58% of reported income of the 55-64 year old cohort.

Of course, this is only a survey. It does not include retirees that are in nursing homes – where their spending levels are almost certainly higher. The absence of long term care costs might bias retiree spending downward. And perhaps the reduced spending is an involuntary response to reduced income levels.

The question of voluntary reduction in expenditures is difficult to parse. The reported incomes of retirees are lower than their younger cohorts. We could infer that diminished spending in retirement is involuntary and prompted by reduced resources. However, data compiled at www.bundle.com aggregates patterns of spending by income cohort. We reviewed spending in the Austin, Texas area and found spending decreased through time holding income constant. As an example, married couples with children earning between $75,000 and $100,000 spent 32% less after age 65 than they spend in the ten years prior to retirement. That's remarkably similar to the non income stratified data compiled by the DOL.

The income data may be skewed as well. It is compiled from survey responses rather than tax returns. Surveyors are in agreement that income is

Expense Category	45-54 years	55-64 years	65-74 years	75 years and older
Food	$8,201	$6,882	$5,681	$4,079
Housing	$19,562	$17,611	$13,845	$12,035
Apparel and services	$2,228	$1,622	$1,381	$755
Transportation	$10,691	$9,377	$6,740	$4,392
Healthcare	$2,930	$3,825	$4,779	$4,413
Entertainment	$3,297	$3,036	$2,418	$1,349
Personal insurance and pensions	$7,853	$6,943	$2,616	$1,003
Miscellaneous	$6,418	$5,487	$3,975	$3,666
Total Expenditures	$61,180	$54,783	$41,435	$31,692
% Change from previos age cohort		-10.5%	-24.4%	-23.5%



underreported. But do reporting biases exist across age groups?

Most likely underreporting of income is more prevalent among retirees. They may not consider income from municipal bonds or life insurance payouts in survey responses as this is not taxable. Retirees may take distributions from stock portfolios in the form of capital gains and return of principal. Again, these are not fully taxable transactions.

We can review net worth data as a reality check on our hypothesis about retiree spending habits. Just how fast does the family nest egg erode in retirement? The most recent data compiled by the Federal Reserve Board indicates – not very fast.

"Transportation and entertainment costs plummet almost 60% between the ages of 55 and 75."

If spending is bumping up against resource constraints, one would expect that the net worth of the elderly would be dissipating quickly. The median figures indicate that families where the head of household is over 75 are worth only about 16% less than families that are presumably in their peak earning years.

Age of family head	2007 Median net worth
35-	11.8
35–44	86.6
45–54	182.5
55–64	253.7
65–74	239.4
75+	213.5

The foregoing analysis is hardly conclusive but it raises a few suspicions. Retired people, as a group, appear to spend less in reality than they anticipate as younger adults. The elderly are no longer contributing to their personal pension or social security plans. Transportation and entertainment expenses plummet by almost 60% between ages 55 and 75. Perhaps people project themselves as more active than they actually become.

It's difficult to conclude how much of this voluntary – or whether it is a rational response to diminished income levels. To the extent we've observed survey data stratified by income, spending seems to drop with age. Family net worth also seems to dissipate slower than would be expected if families were income constrained.

It may be that retirees are ratcheting down expenses in an abundance of caution. If so, there may be room for life annuities to supplement social security to create an income floor for older couples. A life annuity alleviates the risk of outliving ones assets and may allow an elderly couple to spend more than they otherwise would.

There are some cautionary notes. Long term care recipients are not counted in the DOL survey data and their costs are almost certainly higher than represented here. And general health care costs continue to increase in retirement according to the survey data. There is every indication that health care costs will crowd out discretionary spending and this may threaten the financial security of older Americans.

Aggregated survey data are no substitute for knowing thyself. It still makes sense to take a bottoms up approach to your own retirement spending needs. Use the survey results for areas where your expectations are less defined.

"If Congress fails to act by December 31, the estate tax will return with a rate of 55% that kicks in after an exemption of $1 million."

Update on the Estate Tax

In the early part of this decade, congress voted to phase out the estate tax. The estate tax exemption was gradually increased from $1 million to $3.5 million in 2009. This year, there is no estate tax as we have a temporary holiday. If Congress fails to act by Dec. 31, the rate will revert to 55%, with a $1 million exemption. The House did pass a bill late last year 225 to 200 that would have permanently set the estate tax rate at 45%, with a $3.5 million exemption. It was an attempt to forestall the estate tax holiday that is in place today. Notably, Republicans opposed this bill en masse. The Senate passed no estate tax extension last year so nothing happened.

The earliest the upper chamber can be expected to act is late September. There are two major bills floated in the Senate. Bernie Sanders (D-VT) has proposed an increase in the exemption to 3.5 million with a graduated tax rate of 35% to 55%. An alternative bill cosponsored by Blanche Lincoln (D-AR) and John Kyl (R-AZ) would gradually raise set the exemption to $5 million with a permanent rate of 35%.

The congressional elections may play an important role in the shape of upcoming negotiations. The House bill was the product of a congress with a Democrat majority. Right now, the Intrade futures contract assigns a 63% likelihood to a Republican takeover of the House. That suggests a more lenient estate tax if action is delayed into November. Given the range of proposals currently in play, it looks like we'll have an exemption in the range of $4 million.