Government Executive

# A Fresh Look at How Much Money You Need To Retire

By Tammy Flanagan

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The Government Accountability Office this week released a report assessing the latest data on how much income people need in retirement. The study sought to evaluate how retirement replacement rates are developed to gauge whether a target of 80 percent of pre-retirement income is accurate for employees to use when they plan for their retirement years.

GAO studied the spending patterns of different age and income groups to see if younger people spend more or less than older retirees and whether spending patterns were different among low-income groups compared to those with higher income. The study noted that without improved financial literacy and better retirement planning tools, workers may over- or underestimate the amount of income they'll need in retirement.

In the past couple of decades, employment-based retirement plan coverage has shifted from defined benefit plans (such as the Civil Service Retirement System and, to a lesser extent, the Federal Employees Retirement System) to defined contribution plans (such as the Thrift Savings Plan). Federal employees have a leg up on most of their private sector counterparts because the "defined benefit" leg of their three-legged retirement planning stool is still attached.

But the more complex nature of planning under FERS, (which also involves taking into account Social Security benefits, Individual Retirement Accounts and personal savings) requires more time and effort.

Under CSRS, a federal employee ending a long government career could expect replacement of 60 percent to 80 percent of their income without a dime of retirement savings or any Social Security benefit. Those under FERS get a much smaller defined benefit. Still, when that benefit is combined with Social Security and consistent investments in the TSP, it can produce a generous retirement income as well.

FERS also allows for greater control and portability, facilitating a gradual transition into retirement. Even when officially retired, FERS employees can delay drawing on their TSP earnings and claiming Social Security to allow for post-federal service employment that can increase their retirement savings and provide a greater monthly income. FERS employees can move in and out of federal service without losing momentum with Social Security or the ability to add to their retirement savings. (The biggest disadvantage of leaving federal service before being eligible for retirement is the loss of lifetime health and life insurance coverage and an immediate pension benefit.)

The GAO report pointed out that many Americans (and this includes some federal employees) lack basic financial literacy, such as understanding the benefits of compound interest and risk diversification and the potential impact of inflation. The good news is that federal workers, on the whole, have learned to set aside savings for their retirement. Recent statistics show that 88 percent of FERS employees contribute to their TSP accounts. While a whopping 35 percent of the total TSP balance still is invested in the super-safe government securities G Fund, the relatively newer Life Cycle Funds are drawing increasing interest. Now 17 percent of TSP dollars are invested in the L Funds, which automatically shift participants' money from a mix of riskier to more conservative investments as they age.

So how much is enough retirement income? The GAO report referenced a recent Bureau of Labor Statistics survey that concluded spending peaks between the ages of 40 and 50 and then gradually begins to decline. For example, those aged 45-49 spend an average of $7,800 a year on personal insurance and pensions, while for those aged 65-69, the figure is only $4,100. The survey also found that young retiree households spend about 83 percent of the amount that mid-career households spend on housing. The only expense that increased for the older age groups was health care. Older retiree households devote 15 percent of their total spending to health care—more than double the share that mid-career households spent. Transportation, food, entertainment and apparel expenses all went down as the age of the survey population increased.

Many of the financial advisers I have worked with over the years say it's dangerous to set a specific goal of maintaining, say, 70 percent or 80 percent of pre-retirement income without first analyzing how you spend your money now and how that will change in retirement. The GAO study also concluded that accounting for how a household's spending may change is an important step in determining a target replacement rate. For example, members of a retired household may spend less on housing if they pay off a mortgage or move to a smaller dwelling. But housing costs could increase if a retiree moves into specialized senior housing. Entertainment spending could go up because retirees have more leisure time. But senior discounts could end up saving them money if they don't increase leisure activities.

Lower-income households, the GAO report found, may need a higher income replacement rate if a higher proportion of their spending is on non-discretionary items, such as food.

Taxes in retirement are also an issue. Not only do tax liabilities vary across households, they can also vary before and after retirement. For example, retirees may shift to a lower tax bracket. In addition, Social Security benefits are partially or fully tax-free, depending on adjusted gross income. Many states provide property tax breaks to seniors and some exempt pension income and Social Security benefits from taxation altogether. Low-income seniors or those with high medical expenses receive tax breaks on the federal level.

If you're a federal employee planning for retirement, you need to evaluate your spending habits now and try to determine how they will change after you retire. You also need to fully understand how all of your federal benefits, from your pension to your TSP funds to Social Security, fit together. It's still possible to have the American dream of a life of leisure, learning and more time with family in retirement. But it takes work.

*Photo courtesy American Advisors Group*

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