How Much Money Will You Need When You Retire?

Retirement planning can be stressful and discouraging. With all the variables, how can you possibly know how much to save? You don't know how long you'll live or how expensive your health care costs will be in your later years. And there's always inflation to consider.

Leisure

Slow down and take a deep breath. Then take the first step: Figure out how much money you'll need each year when you retire.

Although there is some guesswork involved, you can systematically think about what your needs are likely to be and then calculate a reasonable estimate of your retirement expenses. It will probably be a lot less than you feared.

Make a Realistic Estimate of Your Retirement Expenses

Don't rely exclusively on the "experts" to tell you how much you'll need to live comfortably when you retire. Most retirement articles or website calculators say you need 70 percent to 80 percent of your current income during retirement (some even say 100 percent). For most people, this is a gross overestimation of what they'll really need. Most retirees live quite comfortably on 40 percent to 60 percent of their pre-retirement income.

Consider who pays for advertising in the financial magazines and websites—financial firms selling retirement plan products. Then ask yourself whether it's surprising that most articles overestimate retirement needs.

This is not to suggest that journalists are strictly catering to their advertisers, but if a magazine's bread and butter is advertisements, the articles are unlikely to consistently downplay the need for retirement products.

So how much will you need to live comfortably when you retire? To arrive at a realistic number, use your common sense and keep your planning simple. First, determine how much you spend now. Then subtract the expenses that you will not have in retirement.

This number can be quite high and often accounts for a big reduction in needed income during retirement. Finally, add any additional expenses that retirement will bring. The final number is the amount you'll need to live each year.

Step One: Determine How Much You Spend Now

Determine your after-tax income from last year's federal tax return. Then subtract money you put into savings or simply gave away (to kids, charity or something else.) Your contributions to a tax-deferred retirement plan will already have been subtracted. Your total will more or less reflect what it costs you to live now.

Step Two: Subtract Expenses You Won't Have When You Retire

The good news is that many expenses you now have will be gone by the time you retire. Determine what those items are and how much you currently spend on them each year. Here are some of the common costs that are often reduced, or eliminated, in retirement.

- **Mortage**. In 2006, 81 percent of U.S. householders over 60 years old owned their own homes and most were fully paid for. Not having to make mortgage payments is the biggest factor in many retirees' reduced cost of living.

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- **Child-related expenses.** Sports equipment, after-school activities, braces, college—these are some of the expenses that disappear after children leave the home. The typical middle-class family spends about $8,000 to $10,000 per year for a teenager that goes to public school. If your children attend private school, this number, of course, increases dramatically.
- **Everyday transportation.** Not having to commute to work saves at least $100 to $200 per month. Once you drive less, your car will last longer, too—another big source of savings.
- **Travel.** Retirees often have more flexibility as to when they fly—so they can take advantage of cheaper plane tickets. Also, many organizations, such as Elderhostel, offer reasonably priced educational travel programs for seniors.
- **Entertainment and leisure activities.** Retirees can save significantly by taking advantage of the many generous senior discounts on entertainment, travel, lodging, meals, and recreation. For example, at many golf courses, seniors pay as much as 70 percent less than non-seniors.
- **House-related expenses.** Many older people move to a smaller house, condo or co-op apartment, often in a less-expensive part of the U.S. or sometimes to a less-expensive country (like Mexico). This means a reduction in property taxes, homeowner's insurance and maintenance costs.
- **Clothing.** Many people spend less on clothes in their late 60s, and even more so in their 70s and 80s. These savings are usually because:
  - Retirees don't need to purchase clothes for work
  - People with more time can scope out the sales or other good deals.
- **Income taxes.** Although future state and federal income tax rates are not entirely predictable, it's reasonable to assume that if your income drops when you retire, so too will your tax rate.

Step Three: Add Costs You Are Likely to Incur After Retirement

Although most retirees find that their overall expenses decrease, several types of expenditures are likely to increase during retirement. Add these into your estimate.

- **Adult children needing financial help.** Your child-related costs may continue if you have a mentally or physically challenged child that needs your care, or if your children are still in the nest when you retire.
- **Extensive travel.** Many seniors take advantage of free time and senior discounts to travel extensively. Even if you aren't staying in luxury hotels, your travel bill is likely to increase if you plan to take more trips than in your pre-retirement days.
- **Health care.** Most people spend more on health care as they age. Many relatively healthy retirees today cover health care costs by supplementing free Medicare with a reasonably priced "medi-gap" insurance policy. However, you'll probably spend more on medicines and unreimbursed medical care than you do now. And certainly, if you or your spouse needs long-term care or in-home skilled nursing, your expenses will increase.

Take the Next Steps in Retirement Planning

Arriving at a realistic idea of how much income you'll need each year during retirement is a great start to your retirement planning. Doing this math gives many people peace of mind, especially if they discover that the income they'll need is much less than they originally thought.

Once you've taken this first step in retirement planning, you're ready to tackle the next steps: Estimating how much income you are likely to receive from Social Security and other retirement savings plans and then adopting a plan to close any retirement savings gap (while adjusting for inflation).