Will Reduced Tax Rates Help Your Retirement?

By Henry K. (Bud) Hebeler
5/25/03

In light of the new reductions in basic tax rates, capital gains rates, and taxable dividends, you are probably considering the impact on your investments and retirement plans, especially after listening to your eager security salesman who needs more revenue badly. Will the effects be considerable? The short answer: If you are already retired, "No." If you are still saving for retirement, "Yes, but probably not because you can spend more now and in retirement."

To get a quick answer to these questions for your own situation, download the free "Simplified Financial Planner" from www.analyzenow.com. This will show that getting a very detailed result from "The Retirement Decision Assistant" (also from www.analyzenow.com) is probably not worthwhile for retirement budgeting purposes, but you might want to use the more detailed program to help you with allocation decisions or whether to put new money into deferred-tax accounts.

There are three aspects that are important. (1) The potential of saving more, (2) investment allocations, and (3) the effect on your retirement budget.

Saving more:

Although what I'm about to say is VERY contradictory to the government's purpose for reducing income tax, it's most likely VERY important to your own personal future if you are not already retired. The government wants you to have more money in your hands so that you'll spend more, thereby improving the economy and job outlook. However, remember that the government really only looks to the near-term future. So, if you are smart, you won't bite on the government's hook, and you'll put the extra money you get from reduced taxes into retirement investments instead of spending it.

Unless you are one of the few who are already on the way to having sufficient retirement funds, you are greatly under saving. On the average, workers are saving less than 20% of the amount they should be saving annually, and they've been doing this for a decade now. That means that there is a huge savings deficit that will leave the majority of those who retire ten to twenty years from now at near poverty levels. Therefore a large part of the population won't be spending much to help the economy at that time.

Not only will the elderly be spending less, there will be more of them. The increase in numbers has many effects. Among these is the need for many more people needing expensive medical care. If the elderly can't afford to support these costs themselves, the large voting block of the elderly will be able to force those who are still working to pay higher taxes to support their medical needs. (Both Medicare and Medicaid are already in serious financial trouble.) The problem will be exacerbated by the fact that instead of three workers per retiree, we'll be closer to two workers per retiree. This means that even those who are still working will have less after-tax income to spend.

Also keep in mind that almost every aspect about our economy already has great debt. Industry, individuals, and the government are all at record levels of indebtedness. There are only two ways to reduce this problem and neither are pleasant. The first is to ignore the debt for a long enough period of time that inflation seems to reduce its importance. The second is to take more from every household through higher revenues for industry, more disciplined spending for individuals, and more taxes for the government.

So, if you have the opportunity, I think the wiser action for those who are still working is, first, to save the money from the lower tax bill, not spend it. Then, second, if you believe that tax rates will have to increase in the future as I do, you might preferentially put new savings in taxable or tax-exempt accounts instead of deferred-tax accounts. Of course, that's after you have saved at least as much in your employer's savings plan as will get matching employer contributions. By investing in taxable accounts now, at least the initial part of your growth will be at lower tax rates, and you may still benefit from somewhat lower capital gains and perhaps lower dividend taxes later on.

I personally wouldn't cash out existing deferred-tax accounts such as IRAs and variable annuities unless, perhaps, their values are now less than your cost and you won't incur a penalty tax for early withdrawals, but you might want to go to some better performing funds or use a tax-free exchange to get into a lower cost variable annuity. Still it's good to keep in mind that a cash-strapped government might exacerbate your future tax problems by reinstating the excise tax on deferred-tax withdrawals thereby giving you another reason to prefer taxable or tax-exempt accounts.

Allocation and reallocation:

Before taking ANY allocation action, consider the fundamentals: Do you have the kind of assets you can convert to cash for known purchases within the next, say, five years without having to sell real estate, stocks, or stock funds? Do you have an allocation appropriate for your age, e.g., a percentage between 100 and 110 minus your age? Then, can you afford to lose, say, 30% of your stock or stock fund value at a crucial time early in your retirement?

Some allocation action may be in order if you are faced with an investment decision such as where to put new savings from your wages or if a bond matures and you wonder what to do with the proceeds. If you are investing in individual stocks or sector funds, you should probably consider giving a little more weight to stocks or stock funds with higher dividends. If you are considering the trade between short-term or intermediate-term tax-exempt bonds versus taxable bonds, you should use the new marginal tax rates in the comparison. If you are comparing long-term bonds, you should consider that tax rates likely will increase in the longer-term future.

On the other hand, if you've been waiting for some kind of an opportunity to diversify out of some stocks or stock funds with large unrealized capital gains, now is probably the time. It's unlikely tax rates will decrease any more in the future in my view.

Lower tax rates influence on retirement forecasts:

There are many uncertainties in financial planning, particularly long-term forecasts as required for retirement planning. If I were to list the uncertainties in the order of greatest uncertainty first and least uncertainty last, this would be my list: Life-expectancy, returns and inflation, OSIFs, and tax rates last. Returns are likely to be ahead of inflation for pre-retirement saving, but inflation is likely to be ahead of returns for a retiree, especially a retiree with a large fixed pension. OSIFs are "Oh, shoot, I forgot!" These are the things you can't foresee like a daughter with children getting a divorce from her husband and nowhere to turn but to retired parents for financial help. Or perhaps an aged parent is in desperate need for support. Or maybe a spouse needs prolonged uninsured medical assistance. These kinds of things can make a percent or two change in tax rates seem insignificant.

You can use the free "Simplified Financial Planner" on www.analyzenow.com to make your own trades. Just set up a base case where you determine the most you can spend in retirement and still have enough investments to support you until death. Then separately make a change of a percent or two in each of the following: returns, inflation, and tax rates. In an illustration I did for a 65 year old retired couple planning on living to age 90, both a 2% reduction in return and a 2% increase in inflation left them without any investments at age 85 instead of 90. On the other hand, even an increase in their taxes from 15% all the way to 20% still left them with investments at age 88.

Conclusion:

So, if your object is to determine the amount you should save before retirement or the amount you can spend after retiring, changing tax rates a few percent is likely to have a small effect on your results. However, if you haven't retired, putting that extra couple of percent into new savings may make a very significant difference on your future retirement life style.