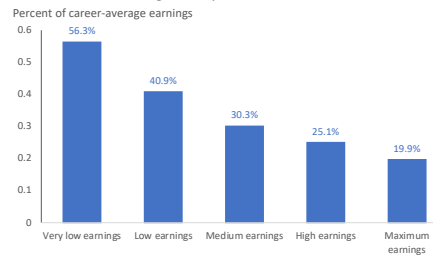




The Working World, Part 2

Scheduled Replacement Rates for Recipients Born in 2000
for Different Earnings Groups



Note: In 2017, "Very low" corresponded to an average of ~\$12K; "Low" an average of ~\$22K; "Medium" an average of \$50K; "High" an average of ~\$80K; and "Maximum" an average of ~\$122K.

Department of Economics
Personal Finance Workshop
Professor Karen Dynan
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We kept the assumptions simple in Part 1 to help you understand the “big picture” about saving

Let’s take a look now at some things you should understand a little more about ...

Practical issues—e.g. how to deal with your taxes, what happens to your 401(k) when you change jobs

Protecting yourself against downside risk—so far, we’ve offered a conservative take on how you’ll cover your expected future needs but things can go wrong!

Outline

More background on taxes

Insurance decisions coming soon

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How federal income taxes are computed

Start with your **adjusted gross income** [total income subject to tax so not including some items that you don't by law have to pay taxes on, like payments your employer has made for your health insurance)

Minus **deductions**—standard or itemized

Equals **taxable income**

Then apply tax rates from the appropriate tax rate schedule [which differs depending on whether you are single, married filing jointly, etc ...]

Take the standard deduction or itemize?

Choose the best option based on what gets you the largest deduction

In general, **you'll be more likely to want to itemize if you:**

- Live in a state with **high state income taxes**

- Own a home with **a mortgage**

- Give a lot to **charity**

Because you can deduct all of these things

Federal tax calculation (example for single filer, 2018 income)

Tax Rate	Taxable income bracket
10%	\$0-\$9,525
12%	\$9,526-\$38,700
22%	\$38,701-\$82,500
24%	\$82,501-\$157,500
32%	\$157,501-\$200,000
35%	\$201,000-\$500,000
37%	\$501,000 or more

This table tells you to apply a rate of:
10% to the first \$9,525 of taxable income
12% to the next \$29,174
22% to the next \$43,799
... and so on

Sum it up to get your total tax liability

Source. [Tax Policy Center](#)

Recall that Professor's Miron's \$100K earner owed only a little more than \$15K in federal taxes even though the table shows a 24% rate for taxable income of \$100K

That's partly because of the adjustments and deductions

But also because (as I just showed you) much of a person's income gets taxed at rates below his or her marginal rate

Withholding

For various reasons, it's not good for either the IRS or most people to have a huge tax bill come once a year

So your employer will **withhold some money** from each paycheck and send it directly to the IRS on your behalf

Withholding

You'll fill out a [W-4 form](#) from the IRS to calculate how much your employer should withhold

The two things for you to know are:

For people with relative simple finances, the W-4 does [a pretty good job](#) of estimating the right amount

But, it's [only an estimate](#) so you might have to pay more when you file your taxes (or you might get a refund)

Form W-4 (2019)

Future developments. For the latest information about any future developments related to Form W-4, such as legislation enacted after it was published, go to www.irs.gov/FormW4.

Purpose. Complete Form W-4 so that your employer can withhold the correct federal income tax from your pay. Consider completing a new Form W-4 each year and when your personal or financial situation changes.

Exemption from withholding. You may claim exemption from withholding for 2019 if both of the following apply.

- For 2019, you had a right to a refund of all federal income tax withheld because you had no tax liability, and
- For 2019, you expect a refund of all federal income tax withheld because you expect to have no tax liability.

If you're exempt, complete only lines 1, 2, 3, 4, and 7 and sign the form to validate it. Your exemption for 2019 expires February 17, 2020. See Pub. 505, Tax Withholding and Estimated Tax, to learn more about whether you qualify for exemption from withholding.

General Instructions

If you aren't exempt, follow the rest of these instructions to determine the number of withholding allowances you should claim for withholding for 2019 and any additional amount of tax to have withheld. For regular wages, withholding must be based on allowances you claimed and may not be a flat amount or percentage of wages.

You can also use the calculator at www.irs.gov/W4App to determine your tax withholding more accurately. Consider using this calculator if you have a more complicated tax situation, such as if you have a working spouse, more than one job, or a large amount of nonwage income not subject to withholding outside of your job. After your Form W-4 takes effect, you can also use this calculator to see how the amount of tax you're having withheld compares to your projected total tax for 2019. If you use the calculator, you don't need to complete any of the worksheets for Form W-4.

Note that if you have too much tax withheld, you will receive a refund when you file your tax return. If you have too little tax withheld, you will owe tax when you file your tax return, and you might owe a penalty.

Filers with multiple jobs or working spouses. If you have more than one job at a time, or if you're married filing jointly and your spouse is also working, read all of the instructions including the instructions for the Two-Earners/Multiple Jobs Worksheet before beginning.

Nonwage income. If you have a large amount of nonwage income not subject to withholding, such as interest or dividends, consider making estimated tax payments using Form 1040-ES, Estimated Tax for Individuals. Otherwise, you might owe additional tax. Or, you can use the Deductions, Adjustments, and Additional Income Worksheet on page 3 or the calculator at www.irs.gov/W4App to make sure you have enough tax withheld from your paycheck. If you have pension or annuity income, see Pub. 505 or use the calculator at www.irs.gov/W4App to find out if you should adjust your withholding on Form W-4 or W-4P.

Nonresident alien. If you're a nonresident alien, see Notice 1392, Supplemental Form W-4 Instructions for Nonresident Aliens, before completing this form.

Specific Instructions

Personal Allowances Worksheet

Complete this worksheet on page 3 first to determine the number of withholding allowances to claim.

Line C. Head of household please note: Generally, you may claim head of household filing status on your tax return only if you're unmarried and pay more than 50% of the costs of keeping up a home for yourself and a qualifying individual. See Pub. 501 for more information about filing status.

Line E. Child tax credit. When you file your tax return, you may be eligible to claim a child tax credit for each of your eligible children. To qualify, the child must be under age 17 as of December 31, must be your dependent who lives with you for more than half the year, and must have a valid social security number. To learn more about this credit, see Pub. 972, Child Tax Credit. To reduce the tax withheld from your pay by taking this credit into account, follow the instructions on line E of the worksheet. On the worksheet you will be asked about your total income. For this purpose, total income includes all of your wages and other income, including income earned by a spouse if you are filing a joint return.

Line F. Credit for other dependents. When you file your tax return, you may be eligible to claim a credit for other dependents for whom a child tax credit can't be claimed, such as a qualifying child who doesn't meet the age or social security number requirement for the child tax credit, or a qualifying relative. To learn more about this credit, see Pub. 972. To reduce the tax withheld from your pay by taking this credit into account, follow the instructions on line F of the worksheet. On the worksheet, you will be asked about your total income. For this purpose, total

Separate here and give Form W-4 to your employer. Keep the worksheet(s) for your records.

Form W-4 **Employee's Withholding Allowance Certificate** **OMB No. 1545-0074**

Department of the Treasury Internal Revenue Service **2019**

1 Your first name and middle initial Last name 2 Your social security number

Home address (number and street or rural route) 3 ☐ Single ☐ Married ☐ Married, but with child at higher Single rate. Note: If married filing separately, check "Married, but with child at higher Single rate."

City or town, state, and ZIP code 4 If your last name differs from that shown on your social security card, check here. You must call 800-772-9292 for a replacement card. ☐

5 Total number of allowances you're claiming from the applicable worksheet on the following page(s) 6 Additional amount, if any, you want withheld from each paycheck 7 I claim exemption from withholding for 2019, and I certify that I meet both of the following conditions for exemption. Last year I had a right to a refund of all federal income tax withheld because I had no tax liability, and This year I expect a refund of all federal income tax withheld because I expect to have no tax liability. If you meet both conditions, write "Exempt" here. ☐

Under penalties of perjury, I declare that I have examined this certificate and, to the best of my knowledge and belief, it is true, correct, and complete.

Employee's signature (This form is not valid unless you sign it.)

8 Employer's name and address (Employer: Complete boxes 8 and 10 if sending to IRS and complete boxes 8, 9, and 10 if sending to State Directory of New Hires.) 9 First date of employment 10 Employer identification number (EIN)

For Privacy Act and Paperwork Reduction Act Notice, see page 4. Cat. No. 1020202 Form **W-4** (2019)

Filing your taxes

Early in the new year, you'll get a [W-2 form](#) from your employer that reports your income and what has been withheld (your employer also sends it to the government so everyone is on the same page); **you'll need this W-2 to file your taxes**

As for actually doing your taxes, **using tax software will make filing easier**, but help you learn more about our tax system [which is fun for some people 😊]

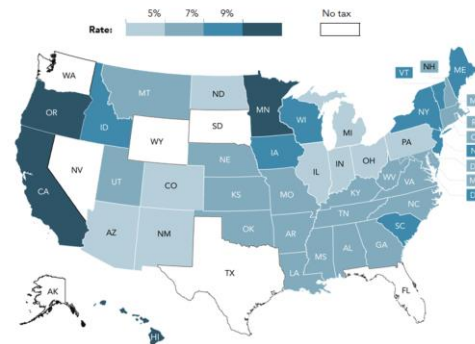
But do some homework to find a good tax package—read reviews, think about cost both now and over the longer (“free” versions like may be part of a strategy to get you to buy an expensive package down the road)

A few other things to know about taxes

As Professor Miron discussed:

You will pay FICA tax to cover SS and Medicare

If your state has income taxes, you will need to pay them—and they vary across states



A map of top individual income tax rates from the [Brookings/Urban Tax Policy Center](https://www.brookings.edu/urban-tax-policy-center/)

If you employ someone (e.g. a housekeeper, a nanny) you need to file a W-2 for that person and pay FICA taxes if their pay crosses some threshold [to read more, see [this](#) piece]

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The most important things to know about health insurance

You need it even if you are young and healthy

Because you don't know what's going to happen and health care is expensive—[the average cost of a 3-day hospital stay is around \\$30,000](#)

You'll probably be able to purchase it through your employer or your grad school; but, if that's not an option:

You can stay on your parents' plan until you are 26

You can buy it through [HealthCare.gov](#) or [your state's marketplace](#)

The most important things to know about health insurance

To actually pick a plan, you'll need to compare features of plans—the **type of plan** (e.g. an HMO or a plan where you pick your own doctors), the **network you'll be able to access**, the **out-of-pocket costs**, the **benefits offered** (e.g. what drugs, services are covered)

So you'll need to do some research and think about what's right for you

As a general matter, if you are healthy and have enough savings or income pay your deductible upfront, you may save money by choosing a high deductible plan, as you'll pay (perhaps considerably) lower monthly premiums

The most important things you need to know about **life insurance**

How it works—you pay in on a regular basis and then it pays some amount to beneficiaries you specify if you die

You fully insure your car and your house, so **does that mean you should fully insure your future income** (e.g. buy a plan that would pay out the PDV of all future income)?

Certainly not if you are only supporting yourself—you are gone so you won't need the money any more

That changes if you have dependents (a non-working partner, a child) who need to be supported

The most important things you need to know about life insurance

Even if you have dependents, **trying to replace all of your future income would be very expensive** and probably unneeded

So,

Think about how much your dependents will need

Certainly take your employer up on any basic amount offered at no or very low cost

Purchase some more as your income rises and your life changes, and do it before you run into health problems (because that will greatly raise your costs)

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If you change jobs, you'll probably have the following options for your 401(k)

Cash it out—gives you some extra money to spend but you take a big hit as you'll need to pay the taxes you deferred AND pay a 10% early-withdrawal penalty if you are < 59½ years old => *generally a bad choice if you have other options*

Leave the money in your former employer's plan (perhaps subject to having some minimum amount) => *a better choice if offered; easy in the short run but complicates your life to have multiple accounts to keep track of*

Roll it over to a 401(k) with your new employer => *good choice if allowed*

If you change jobs, you'll probably have the following options

Roll it over into a traditional individual retirement account (IRA)

=> can be a good option

What's not to like?

You are complicating your life a bit with more accounts

You lose some protections you had with the 401(k)—most importantly, brokers who help you with IRAs are not required to act in your best interest so they can steer you toward products with high commissions

[Bergstresser, Chalmers, and Tufano](#) (2009) find that broker-sold funds underperformed by 14-90 basis points per year relative to funds purchased without the advice of a broker [to read more, see [this](#) piece]

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The basics of Social Security (public pension)

You pay 6.2% of your earnings into the system while working, and your employer pays in another 6.2% [up to a limit of \$132,900 per year]

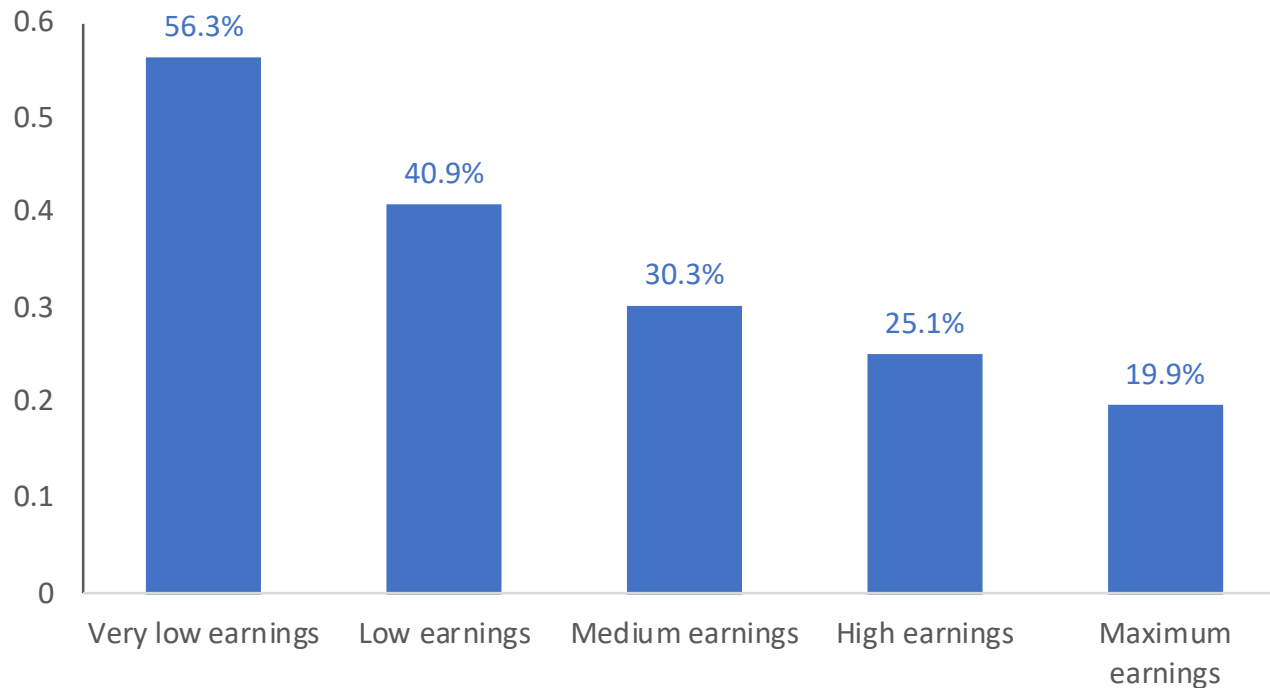
The **standard retirement age is rising to 67**—that's when you are scheduled to be eligible to start claiming full benefits

Alternatively, you can elect to retire at age 62 and receive reduced benefits

Your benefits will be a function of your contributions, but people with lower earnings receive benefits that are larger relative to those earnings than people with higher earnings (it's progressive)

Scheduled Replacement Rates for Recipients Born in 2000 for Different Earnings Groups

Percent of career-average earnings



Note: In 2017, "Very low" corresponded to an average of ~\$12K; "Low" an average of ~\$22K; "Medium" an average of \$50K; "High" an average of ~\$80K; and "Maximum" an average of ~\$122K.

Source: [Social Security Administration](#)

Will Social Security be there for you?

As you probably have heard, **the system's finances aren't sustainable as currently structured**

With the retired population having grown relative to the working-age population (thanks to retiring baby boomers), the benefits paid out now exceed the revenues coming in

For now, the program can continue paying full benefits by drawing down a “trust fund” of surpluses accumulated when the boomers were working and paying a lot in

But, according to the [2018 Social Security Trustees Report](#), **the trust fund will be depleted by 2034; at that point the revenues will only be enough to pay out $\frac{3}{4}$ of scheduled benefits**

Will Social Security be there for you?

Congress will need to enact legislation to fix the program before the trust fund is depleted, which will involve some combination of:

- Raising Social Security taxes

- Reducing benefits (including by raising then retirement age further)

- Taking money from the general government budget [*maybe*]

Overall, the odds are extremely high that the program *will* be there for you (especially since it is very popular and people like that it is *for everyone*) but it is likely to be somewhat less generous

Employer-provided defined-benefit plans

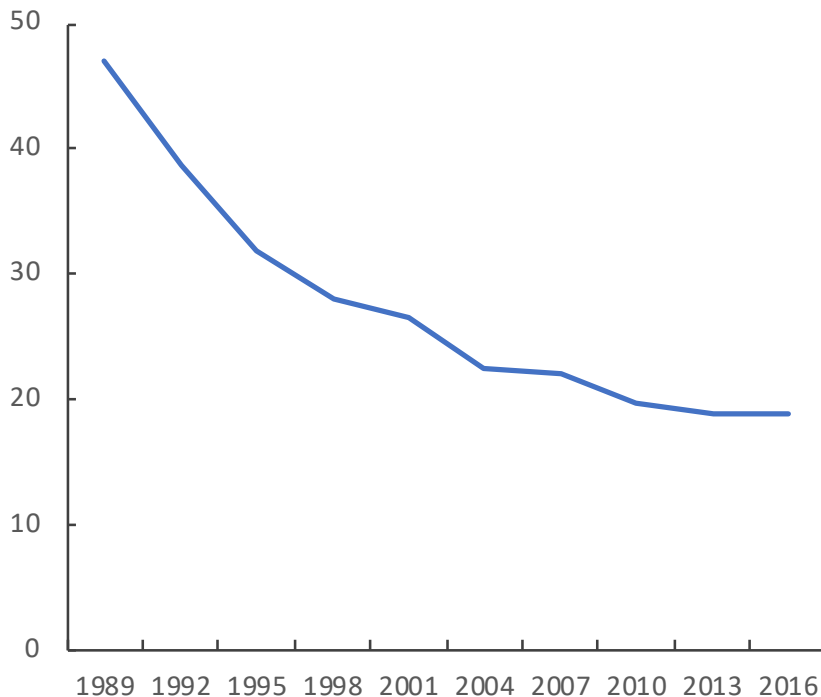
“DB” plans are offered by some employers and they are another potential source of income in retirement

The way they usually work: Your employer funds your future benefits through contributions to the plan while you are working, and you get some regular payout in retirement, which is a function of your salary and how long you worked for the company

You probably shouldn't factor having a DB pension into your plans

Young Households with Defined-Benefit Pensions

Percent



Source. Young households are those with heads 35-44.

Data from the [Survey of Consumer Finances](#)

While many of you may know people from earlier generations who had these plans, there has been a steep drop in the share of employers outside of the government offering them

Only 19% of households headed by 35-44 year olds have a DB pension and the numbers for your cohort are likely to be even lower

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An important source of downside risk in retirement is health shocks:

Because **the cost of health care** is so high (and because old people sometimes need a lot of health care)

Because **the cost of personal care** after a health shock can be high

The importance of Medicare

[Medicare](#) provides insurance to cover much of the cost of health care once you reach the age of 65 [although, like Social Security, the public financing of this program is going to need fixing]

And you can buy supplementary insurance to cover expenses not covered by the standard Medicare program

Long-term care costs

Medicare and supplementary health insurance **only cover medical expenses**

If you fall and break your hip and end up having to live in a nursing home, most of the cost you'll incur will be for personal care, not health care and will not be covered by health insurance

This is what we call “long-term care” costs

According to [Genworth](#), the median monthly cost of a private room in a nursing home was \$8365 in 2018 (over \$100K a year)—and even just a health aide to help you at home cost half that amount

Long-term care costs

The average person will need 2 years of long-term care, but there's a material risk of needing long-term care for much longer

That's why some middle-income families wipe out their savings when older and end up in poverty (at which point, Medicaid will pick up the costs)

Your choice will be self-insuring (through additional saving) or eventually buying **long-term care insurance** (a market that has problems but hopefully will be fixed by the time you need it)

A final thought on retirement and risk

We know it is a long time away for you

But remember that the risk you face goes beyond developments that will directly affect you

The risks you face also include bad outcomes for people you care about

And some of them may be approaching retirement much sooner than you