INTRODUCTION

A large body of literature in economics has tried to explain the relationship between social insurance, labor supply, savings and the consumption behavior of individuals. An increasingly influential branch of this literature tries to accomplish this by solving complex models of rational behavior. A critical assumption of these models is that people know the set of rules of the Social Security system. In this paper we first investigate how much people know about some of the basic rules of the Social Security system, and then present a life-cycle model that incorporates imperfect information, and study the consequences on retirement decisions, and ultimately on welfare.

We believe our research is crucial from a policy perspective because the incentives generated by the Social Security rules are dependent on people's understanding of these rules. If individuals do not know the rules of the system, or do not understand the implications of the rules on the value of their benefits, models that assume perfect information of the Social Security system would not yield accurate measures of the incentives created by the social insurance system.

We first study people's knowledge of the Social Security system by analyzing data from two surveys funded by Stony Brook's Center for Survey Research and the Michigan Retirement Research Center. The first survey was fielded in August 2007. We surveyed 500 individuals about their knowledge of some of the basic Social Security rules and how that knowledge was acquired. The follow-up was fielded in December 2008 with 507 observations. The follow-up allows us to test whether the respondents have improved their knowledge of the system, and helps model the information problem faced by individuals.

Second, we provide a measure of the cost brought about by Americans' lack of information on the Social Security system's rules. To that end, we present a framework in which we can compute the individuals' welfare gain from acquiring information regarding the Social Security system, by solving and simulating a life-cycle model of retirement behavior under different informational assumptions.

Third, we discuss possible strategies that might increase individuals' awareness of the rules of the system, and evaluate which strategies would lead to more welfare-improving outcomes.

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METHODOLOGY, RESULTS, AND POLICY IMPLICATIONS

The surveys included about 20 questions on respondents’ knowledge of several rules that affect their Social Security benefits, such as the age of early and normal retirement, and the reduction factors with respect to the normal retirement age, how they obtained their information, and their level of financial literacy with respect to calculations involving social security benefits, among others. The surveys also included a standard battery of socioeconomic, and demographic questions, as well as health and longevity expectations questions.

We find that there is significant variation in people's knowledge of Social Security rules, and that this knowledge varies by the year of the survey. For example, only 42 percent of the respondents interviewed in 2007 correctly answered the question “What is the youngest age at which an eligible worker can apply for his or her own Social Security retirement benefits?” but this percentage goes above 54 percent in 2008, and almost to 56 percent among those reinterviewed in that year. This suggests that in an election year individuals are more informed about policy issues. The percentage of individuals answering correctly varies considerably by age, and in 2008 varies from around 20 percent among those 18 to 34, to around 72 percent for those 55 to 64. The variation with respect to income and education is considerably lower.

A much lower percentage, 22.8 percent, gave the correct answer in 2007 to “What is the maximum age at which you can claim Social Security retirement benefits so that Social Security will adjust your benefits upward?” and the percentage is almost identical to the new respondents of 2008, however, it goes up to 45 percent among those reinterviewed. Respondents who were reinterviewed regarding the minimum number of years of work required to be eligible to receive benefits or the earnings test also showed a large increase in knowledge. This shows considerable promise for policies that aim to encourage individuals to educate themselves about Social Security rules.

The second step in our methodology is to compute the cost that an individual incurs due to his/her lack of information on Social Security rules by comparing his/her welfare under full information to his/her welfare under imperfect information. In the benchmark model, individuals choose how much to consume and save, how much to work and when to retire, and when to claim benefits from Social Security under the assumption that they have perfect knowledge of all the retirement incentives.

We then present characterizations of partial information regarding Social Security rules. A key characterization we explore, which is an extreme case of unawareness, is when individuals do not know anything about the details of the system, and they decide when to claim Social Security benefits based on what they observe others to be doing.

The final step of our research discusses policy alternatives aimed at increasing the public's knowledge of the Social Security system. The policies that we consider include customizing the Social Security statement highlighting different messages according to the individual’s characteristics, such as age, family situation, or earnings. For example, younger individuals might receive highlighted messages regarding the features of the system on which they lack information based on our survey findings, while older individuals might receive more detailed information about the consequences of claiming benefits and continue working. We believe that Social Security can exploit the knowledge heterogeneity we find to reach specific populations with more targeted messages.

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