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Haas School of Business
University of California Berkeley

Making SMART Financial Decisions

Social Security

Professor Terrance Odean

In 1935, the country was in the midst of the Great Depression. Unemployment was 20%. More than half of senior citizens lived in poverty. A retirement system into which citizens paid taxes during their working years and received benefits in retirement was a great idea. But it wasn't going to do much for people who had worked for many years and were approaching retirement. If the system had waited for workers who were young in 1935 to retire, the first benefits wouldn't have been paid until around 1970. Instead, social security started issuing monthly retirement checks in 1940. The first check, for $22.54, was sent to Ida May Fuller. Ida was 65 years old. She had only worked three years under the social security system and had contributed $24.75 in payroll taxes. Ida lived to be 100 years old. During her lifetime, she collected $22,888.98 in social security benefits. That's a pretty good return for an investment of $24.75. But who paid for Ida's $22,888 in benefits?

Social security was set up as what's called a PAYGO system. The payroll taxes paid by current workers are used to pay current retirement benefits. From 1935 through 2010, payroll taxes collected were always greater than the retirement benefits paid. The surplus each year was put in the social security trust fund and invested in US Treasury bonds. Workers alive when social security was founded did not pay payroll taxes for their entire working lives. Their retirement benefits, like Ida's, tended to be larger than their contributions and were essentially subsidized by later generations. In today's dollars, this subsidy was around $14 trillion. So social security started out with a huge unfunded liability, without which it'd be in pretty fine shape today. Of course, millions of people benefited from the policy decision to start payments immediately.

Today, 37 million retirees receive Social Security with an average annual benefit of about $15,000. For more than nine million of these people, social security is more than 90% of their income. Are you retired? Are you nearing retirement? If so, how much would you estimate social security is worth to you? If you're still many years away from retirement, do you have a relative or a friend who's retired or about to retire? What do you think their future social security payments are worth today? Go ahead. Take a guess. Write down the age of your friend or your age. And then write down your best guess as to how much your or your friend's investment in social security is worth. One of the things we're going to do this week is look up our estimated social security benefits and try to put a value on them. You can start collecting social security retirement benefits as early as age 62. But if you're healthy, you really should wait until age 70 to start collecting your benefits. The added benefits are going to be more than worth waiting for. Every year you wait, your annual benefits are going to increase significantly. However, once you reach 70, be sure to claim your benefits. There's no point to waiting any longer, even if you are still working. Claim your benefits at 70 and, in the long run, you're going to receive much more money.

Let's take a look at an example. Sue. Sue's going to turn 62 tomorrow. Her life expectancy is 86. So she's probably going to live around 24 more years. She currently earns $50,000 a year. She's been working since she was 18. If she claims her social security benefits tomorrow, she'll receive a monthly payment of $1,027. If she quits working now but holds off on claiming benefits until she's 70, she'll receive a monthly payment of $1,798. And that's in today's dollars. If she keeps working until she's 70 and keeps

earning the same salary, adjusted for inflation, her monthly social security benefits will be $2,000. But let's assume she quits working tomorrow. How much will Sue get if she waits until she's 70 to claim her social security, rather than claiming it right now?

Social security benefits are adjusted for the cost of living. So to simplify this comparison, I'm giving you these examples in today's dollars. So we simply need to calculate how many months Sue will collect payments and how much she'll get each month. If Sue retires tomorrow and claims social security benefits right away and then she lives to be 86, she's going to collect $1,027 a month for 24 years. That's a total of 24 times 12 times 1,027, which works out to be $295,776. But if she waits until she's 70, she'll get $1,798 a month for 16 years. That's 16 times 12 times 1,798, for a total of $345,216. You know, that's a big difference. Sue gets almost $50,000 more in total payments if she waits to 70 to claim her benefits. True, if she dies in her 60s or 70s, she'll collect more in total payments if she starts claiming at 62. But if she lives longer than expected and she waits until 70 to start claiming benefits, her yearly benefits will be $21,576 instead of $12,324. This extra money is going to go a long ways towards a more comfortable and secure life in old age.

For most healthy people, it's a smart move to wait until age 70 before you start claiming social security retirement benefits. Your benefit payments will be bigger. And you will better protect yourself against running out of money if you live longer than you expect to. Of course, there are some people for whom it may make sense to claim benefits before age 70. And there are situations in which married people may get more total benefits through a file and suspend strategy. You know, we're not going to go into such strategies in this course. If you're trying to decide when and how to claim social security benefits, there are a couple of social security benefit calculators that you might find useful. The first is the AARP's social security calculator, which is free. The second is a calculator developed by professor Laurence Kotlikoff at Boston University. That one will cost you $40 to use. But it takes more information into account and covers strategies such as the file and suspend. If this calculator helps you make a better social security decision, it's well worth the $40. You can find links to these calculators and additional information on social security on the course website.

You've probably heard some alarming rumors that social security is running out of money and may not be there for you when you retire. You know, that's a scary thought. But let's look past the headlines and get to the reality of the situation. If no changes are made to social security, it will still be able to continue paying benefits that are currently promised until about 2033. After that, benefits would decrease by about 25%. But it's most likely that some changes will be made to keep social security balanced. One probable change is an increase in the retirement age.

In 1935, a 35-year-old man had about a 50-50 chance of living until retirement. Suppose that man did live to 1965 and retired at age 65. He could expect to live about 13 more years. Today, not only do most workers live to retirement age, but they live much longer after they retire. A 65-year-old man today can expect to live for over 19 more years. That means that these days social security is making retirement payments to more people and for more years. So to keep social security balanced and healthy, the retirement age is likely to gradually increase beyond age 67. Social security faces a future shortfall not because the payments workers make today aren't enough to finance future benefits. They are. The problem is the system is still on the hook for unfunded payments made to Ida May and workers of her era. That is, our parents, grandparents, and great grandparents.