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Thank you, Chairman Kohl, Ranking Member Martinez, and other distinguished members of the committee, for giving me the opportunity to provide testimony on the American public's understanding of the benefit rules of the Social Security system and on possible ways of reducing misperceptions of these rules. While many of the findings discussed in this testimony are based on a joint research project[1] with my colleague Jeffrey Liebman, this testimony is purely on my own behalf.

1. Introduction

Why the Public's Understanding of the Social Security Benefit Rules Matters
When individuals decide how much they need to save for retirement, they must predict how much they will receive from Social Security. Having accurate predictions of future benefit levels is valuable because individuals need to save more themselves if their Social Security benefits are lower. Thus, individuals who overestimate their Social Security benefits would save too little and would discover they cannot afford the retirement they had planned. To make optimal decisions, people do not only need to forecast their future level of Social Security benefits but also need to understand how these benefits depend on their work, retirement, and benefit claim decisions. The Social Security benefit rules provide three major types of implicit incentives.[2] First, they provide implicit incentives for working more prior to claiming benefits because the benefit level generally depends on one's earnings history. Second, they provide incentives for when to claim benefits because benefits are generally higher when first claimed at a later age (up to age 70). Third, they affect incentives for working after benefits are taken up due to a provision called the earnings test. If individuals misperceive these incentives, they may work less or more than is optimal, they may retire sooner or later than is optimal, and they may claim Social Security benefits at an earlier or later age than is optimal. Hence, it is not only important for individuals to have a good understanding of how much Social Security they will receive, they also need to understand how benefit levels depend on the decisions they make.

Research on Perceptions of the Social Security Benefit Rules
To obtain insights into individuals' understanding of Social Security benefits, Jeffrey Liebman and I conducted a survey about Social Security in the fall of 2008. The survey required about 30 minutes to complete, has a sample size of 2500, and is nationally representative of 50- to 70-year old Americans. Based on the results of this survey, I will discuss which aspects of Social Security benefits the public understands relatively well and which aspects are poorly understood. There are two principle ways in which misperceptions of Social Security benefit rules can be reduced. First, one can provide better information to the public about these rules. Second, complicated rules can be replaced with transparent rules, so that it is easier for the public to understand what determines their benefits. I will discuss both of these possibilities below.

2. Perceptions and Misperceptions about Social Security Benefits

People Generally Are Well-Informed about the Level of Social Security Benefits
We find that the average respondent who does not yet receive Social Security benefits expects about $1300 per month in benefits if benefits are first claimed at the full retirement age. This expectation is close to the actual figure as reported by the Social Security administration. Moreover, the distribution of expected benefits among those respondents who do not yet receive benefits is similar to the distribution of reported benefits among respondents already receiving benefits. Hence, perceptions of the level of benefits appear to be relatively accurate in this population.

People Understand the Incentive to Delay Claiming Benefits Moderately Well
On average, individuals appear to be moderately well informed about the effect of delaying claiming Social Security benefits. We find that only slightly more than 60 percent of our survey respondents indicate that their monthly benefits would increase if they delayed claiming between the ages of 62 and 70, whereas, in fact, almost everybody would experience a benefit increase from delayed claiming. However, those who report that their benefits would increase have a reasonably accurate perception of the size of the benefit increase per year of delay. We find that the median perceived return to delaying claiming by one year between the ages of 62 and 66 is 5 percent of the benefits they would receive at their full retirement age, which is somewhat lower than the actual return of about 6.25 percent. While the median perception is about right, there is nevertheless a fair amount of dispersion in the perceived return to delayed claiming; a quarter of respondents believe that the return is less than 4 percent while another quarter believes it exceeds 7 percent. In short, while the average perception is moderately accurate, we also find that a large fraction of individuals misperceives the incentive to delay claiming.

Most People Perceive an Incentive to Work Additional Years
Even if individuals keep constant the date at which they start claiming benefits, their benefits will generally increase if they postpone retirement by a year because the additional year of work generally improves their earnings history, which in turn determines their benefits. This incentive only applies to individuals who claim on their own earnings record (as opposed to claiming on the earnings record of a spouse) and

those whose last year of earnings would be included among the 35 years of highest indexed earnings, which is what determines the level of benefits. About two thirds of respondents believe that working an additional year (holding claim age constant) would increase their benefits. This percentage is somewhat less than the approximately 80 percent that, according to our estimates, have a positive incentive, but overall this finding indicates a reasonably high awareness of the existence of a link between years of work and benefit levels. However, perceptions of the strength of the link between work and benefits are not as accurate. The median respondent believes that his benefit will increase by about 7 percent per additional year of work, which is roughly twice as high as our estimate of the true figure for a typical worker.

Poor Understanding of Incentives to Work after Having Claimed Benefits
A person who has already claimed Social Security benefits but has not yet reached the full retirement age faces the earnings test. The earnings test cuts current benefits if earnings exceed a certain threshold (currently about $14,000 per year), but on average repays these benefit cuts by increasing future benefits once an individual reaches the full retirement age. Most individuals have a poor understanding of the incentive effects of complicated Social Security benefit rules like the earnings test. Only about 40 percent of individuals are aware that current benefits would be reduced in response to earning $20,000 per year between the earliest claim age of 62 and the full retirement age. Of the 40 percent that are aware of the earnings test, only about one third knows that future benefits will increase to offset the earnings test's cut in current benefits.

People Understand Simple Benefit Rules, But Not the More Complicated Ones
Misperceptions of the incentives discussed above can stem from individuals' lack of understanding of the rules that determine their benefits. For example, someone who does not understand the rules regarding spousal benefits might not take into account that his additional year of work could also affect his spouse's benefits. Or someone who does not know that only the 35 highest years of indexed earnings count towards her benefits might work an additional year in the mistaken belief that this would raise her benefits even if that year is not among the 35 highest years of indexed earnings. To examine some of the sources of misperceptions of the incentives discussed above, we also ask our survey respondents explicitly about their knowledge about specific provisions in the Social Security benefit rules.

We find that individuals have a relatively good understanding of simple rules. For example, 70 percent of respondents know that the earliest age at which Social Security retirement benefits can be claimed is 62. Individuals also appear to have a reasonably clear understanding of the provisions on survivor benefits. Among those for whom we are most confident that an increase in benefits would occur if they became widowed, 85 percent respond that their benefits would increase if their spouse died. Similarly, among those for whom we can determine with confidence that their benefits would not be affected by their spouse's death, 84 percent respond that their benefits would remain the same if they became widowed.

Individuals, however, have a poor understanding of more complicated provisions of the benefit rules. Less than one third of the respondents know that benefits are based on a given number of years of highest indexed earnings, and among those who do know this, the typical person believes it is based on just the 10 years of highest earnings rather than the 35 years of highest earnings on which it is actually based. Similarly, the rules on spousal benefits are poorly understood. About half the married respondents believe their spouse would receive no Social Security benefits whatsoever if the spouse had never worked, whereas for the overwhelming majority of these respondents their spouse would have been eligible to receive about 50 percent of the respondent's benefits.

3. Possible Ways of Reducing Misperceptions about Social Security Benefits

Despite recent scholarship, there are still sizeable gaps in our knowledge of the extent, causes, and remedies of misperceptions of Social Security incentives. It would therefore be premature for me to derive strong specific policy implications. Let me instead offer two general ideas based on the current knowledge of individuals' perceptions of Social Security incentives.

Investing in Information Dissemination
Current research indicates that the annual Social Security statement has been successful in increasing the accuracy of benefit expectations. Well over 90 percent of our respondents report that they read the mailer, and they rate it as the most useful information source on Social Security benefits. A recent research paper shows that these mailings, which were phased in by age group in the mid- to late 1990s, improved knowledge about benefit levels.[3] The Social Security statements have also likely contributed to increasing the accuracy of the perception of certain incentives. Perhaps it is merely coincidence, but it is nevertheless striking that the benefit rules that our survey respondents understand best are exactly those rules that the Social Security statement covers in most detail. In particular, the Social Security statement provides an estimate of one's level of benefits, explains that benefits rise with delayed retirement, mentions survivors' benefits, and says that the earliest claim age for retirement benefits is 62. These are also the provisions best understood by our survey respondents. In contrast, the statement does not mention that the 35 highest years of indexed earnings count towards benefits and the statement does not discuss how spousal benefits are determined. These correspond to the provisions of which our survey respondents had a poor understanding. I believe it would therefore be worthwhile to explore whether the statement can better clarify certain incentive effects that are not currently explained in the statement.

Similarly, it would be worthwhile to explore the effectiveness of other channels, such as the Social Security website, that provide information about Social Security benefits. At the end of our survey, we randomly selected one of three ways of presenting the effect that delayed claiming has on Social Security benefits. One of these three ways reflected the Social Security website's presentation of this information. We found that the way this information is currently presented on the Social Security website leads to a significant increase in the fraction of respondents that favor retiring at age 62 rather than at age 65.

While this evidence is merely suggestive of effects of information provision on actual retirement behavior, it does show that it would be valuable to investigate how information can best be presented in the various channels that are used to explain Social Security benefits.

Simplifying the Social Security Benefit Rules
While improved information dissemination can contribute to a better understanding of what determines Social Security benefits, there are limits to what information dissemination can achieve when rules are complex. Our finding of the poor understanding of the spousal rules does not seem surprising in light of the rules' complexity and their interaction with other rules. For example, someone claiming spouse benefits will not experience a benefit increase from delaying claiming beyond the full retirement age, but someone claiming retired-worker benefits will. Thus, a more ambitious approach to reducing misperceptions about Social Security benefits would be to simplify the benefit rules. Below, I offer four thoughts for possible simplifications of the benefit rules. In offering these simplifications, I took the basic structure of the current Social Security system as given. In other words, I focused on making the current system more transparent rather than questioning more fundamental features of Social Security, such as the pay-as-you-go nature of the system.

(a) *Let couples average their earnings for the purpose of calculating each person's earnings history.* In this scenario, earnings that occur in a year when the person is married are replaced by the couple's average earnings in that year. This provision could replace the many special rules governing benefits calculated on the records of a current spouse, ex-spouse, or deceased spouse. If all benefits were based on this modified earnings record, it would greatly increase the transparency of which years of earnings matter. This change would also make the Social Security system more consistent with the tax system, which generally considers the combined income of a couple for the purpose of taxation. However, this simplification would also have distributional consequences, the desirability of which needs to be evaluated.[4]

(b) *Use a uniform rate to calculate the increase in benefits per year of delayed claiming.* Currently, the exact rate depends on (i) birth cohort; (ii) whether benefits are based on the person's own earnings record, on the earning record of a living (ex) spouse, or on that of a deceased spouse; (iii) whether the delay takes place before or after the full retirement age; and (iv) whether the delay takes place less or more than 36 months before reaching the full retirement age. Eliminating this multitude of rates and establishing a uniform rate of increase would help policymakers more clearly communicate the incentive for delayed claiming.

(c) *Eliminate the vesting rule of 40 quarters of earnings.* This rule effectively reduces the work incentives for workers who have not yet reached the required 40 quarters of earnings because their incentive will depend on whether or not they will ultimately fulfill this vesting requirement. Removing the vesting rule would make it easier to explain the work incentives to all individuals, regardless of the length of their earnings history.

(d) *Eliminate the provision that only the 35 years of highest indexed earnings count toward Social Security benefits.* Instead, all years of earnings would count but the formula would be adjusted so that average benefits are not affected. Currently, the incentives for earning additional wages and increasing the number of years of work depend on whether or not the current year will be part of the 35 highest years (which is hard to assess given that most people do not know what they will earn in the future). If, ultimately, the current year is part of the 35 highest years, a person's benefits also depend on which year is not counted as a result of this year's inclusion. In short, the 35-year rule makes it hard to assess the link between work and benefits; our survey evidence also indicates that this provision is very poorly understood. If, instead, all years of earnings counted toward the calculation of benefit levels, one's benefits would consistently increase with additional earnings. This situation would create a more transparent system where it would be easier to explain the impact of current earnings on future benefits.

Thank you again for giving me the opportunity to provide testimony on the perceptions and misperceptions of Social Security benefits and on possible ways of reducing the misperceptions. I would be happy to answer any questions that you might have.

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[1] The full results of this research project can be found at: www.nber.org/~luttmer/ssperceptions.pdf.
[2] The Social Security benefit rules can also affect incentives to marry, divorce, or have children.
[3] Mastrobuoni, Giovanni. 2006. "Do Better-Informed Workers Make Better Retirement Choices? A Test Based on the Social Security Statement." Unpublished Manuscript, Collegio Carlo Alberto.
[4] The distributional consequences of earnings sharing are analyzed in: Iams, Howard M., Gayle L. Reznik, and Christopher R. Tamborini. 2009. "The Effects of Earnings Sharing on U.S. Social Security Benefits in 2030: An Application of the MINT Microsimulation Model." Paper presented at the 2nd General Conference of the International Microsimulation Association. Ottawa, Canada, June 8-10, 2009.