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Subjective Expectations, Social Security Benefits, and the Optimal Path to Retirement

María J. Prados and Arie Kapteyn *

The financial aspects of retirement can be a challenging experience for many individuals. Americans reach retirement with varying degrees of preparation and, thus, government-provided social insurance plays an important role, especially when private pensions and personal savings fall short. What workers expect to receive in Social Security retirement benefits may affect how they prepare financially for retirement. Survey data indicates that most retirees find that the amount of Social Security retirement benefits they receive is lower than what they had expected before claiming, which contributes to their regrets about retirement. Ex-post, most retirees would like to have planned for more income or to have timed their retirement and claiming decisions differently.

We analyze the extent to which workers' expectations about retirement benefits are mistaken, and the consequences of these errors. Using unique survey data about workers' expectations of future retirement benefits, we find that most workers face significant uncertainty about the Social Security retirement benefit amount they will receive after retirement. Moreover, according to our estimates, they tend to overestimate these benefits amounts. We use survey data about earnings history and personal characteristics, including intended claiming age, complemented with forecasts about the survey respondents' future labor earnings, to forecast their retirement benefits. We compare these forecasts to the respondents' expectations and compute their expectation biases. The average expectation bias for monthly retirement benefits in our sample is $307 (in present-value dollars).

One factor behind imprecise and biased expectations can be lack of knowledge about

* **María Prados** is an economist at University of Southern California's Center for Economic and Social Research. **Arie Kapteyn** is an economics professor and founding director of the University of Southern California Dornsife Center for Economic and Social Research. This research brief is based on MRDRC working paper WP 2019-405, UM19-06.

the program rules. Forty-nine percent of current workers in our survey declare having no knowledge about their future benefit amount. Not appropriately adjusting for early or delayed claiming could further contribute to expectation biases about retirement benefits. In particular, our data indicates this would be most relevant for those with lower educational levels. Another factor behind these imprecise benefits expectations may be related to the workers' imprecise expectations about their future labor earnings. Our data indicates that workers are, on average, too optimistic about the future evolution of their labor earnings.

We find that the level of uncertainty about retirement benefits decreases with age, and the probability of overestimating retirement benefits decline as the individual approaches his claiming age. Therefore, expectations about benefits become more precise as individuals approach retirement. On average, men display lower expectation bias and are less likely to overestimate their retirement benefits. Having more uncertainty about future retirement benefits is positively associated with a higher expectation bias and is associated with an increased probability of overestimating future benefits. However, those who claim to have no knowledge of their future benefits show much lower expectation bias. They are more likely to err on the conservative side and underestimate their future benefits. Personal attitudes about finances, such as financial literacy levels and propensity for retirement planning, are correlated with retirement benefit expectation bias, but not with the probability to overestimate retirement benefits.

To measure the extent to which inaccurate expectations about retirement benefits can affect retirement readiness, we simulate a life-cycle model calibrated to match our survey data. Our simulation results indicate that there are welfare losses from lack of accurate knowledge about expected Social Security retirement benefit amounts. This lack of accurate knowledge about retirement benefits results in inadequate levels of asset accumulation before retirement and suboptimal levels of consumption. We find that this leads to a 1% loss in welfare when compared to the optimal behavior, which considers the correct level of earnings uncertainty and the appropriate Social Security rules governing the determination of retirement benefits. The welfare losses become even larger when the individuals have inaccurate expectations, and are too optimistic, about their future labor earnings. ❖

Michigan Retirement and Disability Research Center
Institute for Social Research
426 Thompson Street, Room 3026
Ann Arbor, MI 48104-2321
Phone: (734) 615-0422 **Fax:** (734) 615-2180
mrdrcumich@umich.edu www.mrdrc.isr.umich.edu

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