Majority of people don't know about spousal benefits

Leveraging Social Security

By Paul Norr December 28, 2016

Had one's fill of being lectured on why clients need to delay Social Security benefits?

Read enough about the phased-out file and suspend rules?

Before advisers stuff their Social Security notes in the nether regions of their file cabinets and get back to worrying about the new Department of Labor rules, they might want to look at a recent Government Accountability Office report.

The report, released Sept. 14, raises red flags about the continued lack of understanding among the public of how Social Security works, and it should be of interest to all advisers. It additionally identifies important behavioral biases that interfere with smart claiming decisions.

The GAO initiative surveyed existing Social Security research, which either evaluated how well people understand benefits or explored the important factors that govern their decision-making behavior.

Social Security is the primary source of retirement income for many people, providing an aggregate of 52% of all income for people over 65. The report found a shocking lack of basic consumer knowledge about these benefits even in the face of dramatically increased adviser expertise about the program and its features.

SPOUSAL BENEFITS

Spousal benefits are a core feature and benefit of the program. They allow a person to collect a benefit based on the work history of their spouse, regardless of whether that person ever worked a day in his or her life.

A full 50% of respondents didn't know that a Social Security payroll tax-paying history wasn't required to qualify for spousal benefits. Even more surprising, 52% of respondents didn't even know that there was such a thing as a spousal benefit.

There is also confusion about taxation. As much as 85% of Social Security benefits could be taxed, depending on one's total income level, but 42% of respondents didn't even know that benefits could be taxed.

Although many people are woefully uninformed about the mechanics of Social Security, better information alone isn't enough to guarantee better claiming behavior. The report also describes the significant effect of behavioral biases on decision-making.

Behavioral research shows that individuals are strongly influenced by how information is presented. Different ways of framing a topic, for instance, can strongly affect decision-making.

Here are two examples from the GAO report.

BREAK-EVEN ANALYSIS

Break-even analysis is a very common tool used by the Social Security Administration and financial professionals alike to explain the effects of delaying claiming benefits.

Break-even analysis demonstrates that whether one claims as early as 62, as late as 70 or somewhere in between, the cumulative lifetime benefit will be the same at a future break-even age, usually in one's early 80s.

This isn't by chance. The benefit structure is set up to provide an actuarially equivalent benefit, regardless of the initial claiming age.

Break-even analysis was developed to help individuals understand the system and make informed choices. Research shows, however, that using break-even analysis can cause people to make worse decisions by inducing individuals to claim benefits at earlier ages, not later ages.

There appear to be strong behavioral biases at work due to the way that break-even analysis frames the issue. This tool seems to stimulate the very well-researched aversion to loss, which most people exhibit.

This loss aversion plays out in a few ways.

Individuals seem to irrationally fear the potential loss of lifetime benefits due to an early death, no matter how unlikely that scenario is when they view the break-even analysis results. They also view the option of delaying claiming as placing them in a stressful situation of needing to "catch up" to the lifetime benefits they would have collected by claiming early.

The net effect is that more people chose earlier filing when presented with the break-even analysis than if they weren't.

LONGEVITY RISK

Using break-even analysis also appears likely to contribute to greater longevity risk.

Longevity is increasing and represents one of the main financial risks that people face in later life.

One in four people over 65 is expected to live to at least 90. A 65-year-old couple has a 50% chance that one of the spouses will live till at least 92.

Delaying claiming Social Security provides a crucial "longevity insurance" type of benefit. Delaying claiming insures against financial challenges of longer lives by providing significantly higher lifetime monthly income.

This is especially important the older one gets and as the cost of living increases.

Unfortunately, break-even analysis implicitly de-emphasizes the essential "longevity insurance" feature of delaying claiming. It causes individuals to fixate on perceived short-term losses while ignoring long-term needs.

Compounding longevity risk is the fact that many individuals don't understand the real probability of living a long life. Two of five respondents over 45 underestimated average life expectancy by five years.

Furthermore, even if they accurately estimate life expectancy, people tend to anchor onto this lifetime average as a practical life expectancy for planning purposes. They often don't realize that almost 50% of people will live beyond this age.

IMPORTANT WAKE-UP CALL

This report is an important wake-up call to the still unfulfilled need for client guidance about this pillar of retirement planning. There remains a clear need for advisers not only to continue to provide information about the Social Security system but also to help clients avoid the snares of these behavioral traps.

Make sure clients really understand the realistic chances of living a long life. Help them anchor the discussion on claiming at later ages and let them perceive early claiming in terms of loss.

And let's retire the break-even analysis.

This story is part of a 30-30 series on Social Security. It was originally published on Oct. 24.

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