

Social Security Benefit Considerations in Early Retirement

by Clarence C. Rose, Ph.D., and L. Keith Larimore, Ph.D.

Social Security retirement benefits provide the major portion of their total retirement income for most retirees, according to the Social Security Administration. However, 60 percent of U.S. workers elect to take early Social Security retirement benefits, and early retirement permanently reduces the amount of eligible benefits. Furthermore, the percentage of reduction in benefits for early retirement is gradually being increased. This article calculates the economic breakeven points for someone collecting early retirement benefits versus waiting until full retirement age, taking into account life expectancy and the time value of money. It also calculates the present value of early retirement versus full retirement.

Dr. Rose is a professor of finance in the College of Business and Economics at Radford University in Radford, Virginia.

Dr. Larimore is a professor of marketing in the College of Business and Economics at Radford University.

With life expectancies in the United States on the rise, many retirees can expect to spend 20 to 30 years or more in retirement. In spite of living longer, U.S. workers increasingly elect to retire before age 65. According to the Social Security Administration, 60 percent of U.S. workers elect to begin Social Security retirement benefits at age 62, the youngest eligible age to begin benefits. While many important factors should be considered before making the decision to retire, Social Security retirement benefits are an important part of many individuals' total retirement income.

Everyone's situation is unique. There are a number of real-world factors that financial planners should consider in each client's situation and retirement decision. Included in an individual's early-retirement decision is consideration of that person's health and family history of a long life. Someone who is in excellent health and who has a family history of longevity would generally benefit from delaying retirement, especially if the individual still enjoys his or her job.

Other important considerations are an individual's wealth, sources of retirement income, and desire or need to continue employment after early retirement. Part-time employment after early retirement may reduce Social Security benefits until beneficiaries reach their full retirement age, while early retirement without sufficient wealth or adequate retirement income presents the need for continued employment.

Another consideration is the effect of early retirement on an individual's current fringe benefits such as health insurance, dental insurance, long-term care insurance and life insurance. The out-of-pocket costs of replacing one's employer-paid fringe benefit package could be a substantial amount of money. Complete financial knowledge of the client is important on the part of the financial planner to help the client make the right early-retirement decision.

The Role of Social Security in Early Retirement

Up until the year 2000, opting for early retirement at age 62 meant a 20 percent permanent reduction from the amount payable from full Social Security retirement at age 65. In the year 2000, the age for unreduced Social Security begins to gradually increase each year until it reaches age 67 in 2027. The earliest retirement age for Social Security remains at 62, but the reduction in benefits for early retirement gradually increases to 30 percent by 2022.¹ The exact amount of this reduced benefit for each individual depends upon the individual's salary history up to the maximum Social Security wage base and when the individual chooses to begin receiving Social Security retirement benefits.

In spite of the scheduled gradual reduction in future benefits for workers who opt for early Social Security retirement, 66 percent of working Americans who responded to a recent survey on retirement planning reported that they want to retire before age 65. Of these same individuals, however, only 27 percent indicated that they have begun planning the financial aspects necessary for retirement.²

Generally, financial planners recommend that an individual should strive to maintain 70 to 80 percent of his or her final working year's income during retirement years and have provisions to increase income in retirement to keep up with inflation. A small but growing number of financial planners recommend that individuals should strive for 100 percent or more income replacement during retirement years.³ The logic behind this recommendation is that people tend to spend more money when they have time to do what they want to do.

Financial planners also suggest that an individual's retirement plan include at least three important sources of retirement income. These sources usually include Social Security benefits, personal savings/investments and employer/ employee retirement accounts such as defined benefit plans, 401(k)s, 403(b)s and individual retirement accounts (IRAs). According to the Social Security Administration, of the total aggregate income received by retired Americans, Social Security benefits provide 42.5 percent of the total retirement income, individual savings and investments generate 36 percent, and employer/employee retirement benefits make up 21.5 percent. Also, according to the Social Security Administration, for one out of every three retired Americans, Social Security is their only source of retirement income, and for two out of every three Americans, Social Security provides at least half of their total retirement income.⁴ For the year 2000, the reported average Social Security individual monthly retirement benefit was \$804. The maximum individual monthly benefit was \$1,428.⁵ Social Security Administration projections indicate that by the year 2030, Social Security retirement benefits are still expected to exceed 40 percent of the total retirement income.

The Economic Value of Social Security

There are many reasons why an individual may retire before the age required for unreduced Social Security retirement benefits. Some of these reasons may include poor health, forced retirement, employer downsizing or—on the positive side—retirement savings that allow for early retirement. When an individual has a free economic choice to pick the time to begin Social Security benefits, a basic question is, “Which course of action will provide the greatest value?”

If an individual elects to begin receiving Social Security benefits before eligibility for full benefits, he or she will receive more monthly checks than if he or she had waited, but each check will be for a smaller amount. The exact amount of the reduction depends upon the individual's date of birth and age at which benefits begin (see Table 1). Once an individual elects to begin receiving Social Security early retirement benefits, the reduction in benefits is permanent.

Year of Birth	Early Retirement Year	Reduction Percentage of Full Benefits (if retirement is age 62)	Age Needed for Full Benefits
1938	2000	20.833% *	65 and 2 mo.
1939	2001	21.666%	65 and 4 mo.
1940	2002	22.500%	65 and 6 mo.
1941	2003	23.333%	65 and 8 mo.
1942	2004	24.166%	65 and 10 mo.
1943–1954	2005–2016	25.000%	66
1955	2017	25.883%	66 and 2 mo.
1956	2018	26.666%	66 and 4 mo.
1957	2019	27.500%	66 and 6 mo.
1958	2020	28.333%	66 and 8 mo.
1959	2021	29.166%	66 and 10 mo.
1960 and later	2022 and after	30.000%	67

The amount of the monthly benefit for early retirement is one minus the reduction percentage multiplied by the individual's eligible amount for full retirement benefits. [For example, if early retirement at age 62 is between 2005 and 2016, the immediate benefit is (1 – .25) or 75 percent of full benefits.]

An individual who opted for Social Security early retirement at age 62 in the year 2000 would receive 79.166 percent (1 – .20833) of the full monthly eligible benefit available at age 65 and 2 months. A person meeting the requirements for the maximum monthly benefit of \$1,428 at the full retirement age would thus receive \$1,130.50 ($\$1,428 \times .79166 = \$1,130.50$) a month.

Early retirement would generate an additional 38 months of benefits or \$42,959 ($\$1,130.50 \times 38 = \$42,959$), as may be adjusted for inflation, by the time full retirement eligibility was obtained. However, the individual would permanently lose \$297.50 a month, adjusted each year for inflation, for the balance of his or her life. Without taking into consideration the time value of money, it would take a person retiring at full benefits 144.4 months, or just over 12 years, to recover the \$42,959 they would have received between age 62 to 65 and 2 months ($\$42,959/297.50 = 144.4$ months) if they had retired at age 62. This means they would have to live past age 77 and 2 months (age 65 and 2 months plus 12 years) to begin to benefit from waiting to receive full benefits.

According to the standard annuity/ mortality tables, the life expectancy for a man in the United States aged 62 is 17.5 years. The life expectancy for a woman aged 62 is 21.5 years. This means at age 62, men can expect to live to age 79.5 and women to age 83.5.

When time-value-of-money analysis is introduced into the calculations, it takes longer to recover the benefits of early retirement when compared with waiting to receive full Social Security retirement. Assuming a four percent interest rate can be earned, the value of the 38 months of benefits increases to \$45,718.03 at age 65 and 2 months, and it takes 215.75 months—or just under 18 years—to recover the amount lost by not taking early retirement at age 62 ($215.75 \text{ months}/12 = 17.979$ years). Assuming a four percent interest rate, a person must live past age 83 and 2 months to benefit from delaying to full retirement if he or she turned 62 and began benefits in the year 2000 (age 65 and 2 months plus 18 years required to break even).

Applying the same calculations for individuals born between January 1, 1943, and December 31, 1954, where the scheduled percentage of full Social Security benefit reduction at age 62 is 25 percent and the full retirement age is 66, the results are very similar. Early retirement at age 62 would produce 75 percent of the eligible full retirement benefits—or by today's amounts, \$1,071 a month at age 62—compared with \$1,428 at age 66. A person opting for early Social Security retirement benefits at age 62 would receive \$51,408 ($\$1,071 \times 48 = \$51,408$) by age 66, but then receive \$357 a month less for the balance of his or her life ($\$1,428 - 1,071 = \357) or ($\$1,428 \times .25 = \357). All Social Security retirement benefits are subject to annual cost-of-living increases.

Without adjusting for the time value of money, it would take 144 months, or 12 years, to break even. A person would have to live past 78 ($66 + 12 = 78$) in order to benefit from delaying retirement to age 66. When time-value-of-money analysis is applied, again assuming a conservative four percent interest rate, \$1,071 a month for 48 months compounded monthly at an annual rate of four percent is worth \$55,649.25 at age 66. The \$357-a-month extra a person gains for waiting until age 66 would take 220.29 months, or 18.36 years, to equal the value of the early benefits received between age 62 and 66. A person would have to live past age 84 and 4 months to recover the value of the monthly benefits not received between age 62 and 66 if early retirement is not taken.

Looking ahead for individuals born January 1, 1960, and later, the analysis again produces similar results. Early retirement is still allowed at age 62; however, the benefits are reduced 30 percent from the individual's full Social Security eligible retirement benefit. By today's amounts, an individual eligible for maximum benefits who opts for early retirement at age 62 would receive \$999.60 a month adjusted for inflation for 60 months before age 67, or \$59,976.

It would take 140 months to equal the amount received before age 67 without considering the time value of money. A person would have to live past age 78 and 8 months in order to break even from delaying full benefits to age 67. When a four percent annual interest rate is again applied to the calculations, \$999.60 a month for 60 months is worth \$66,272.93 at age 67. Discounting the \$428.40 monthly difference at four percent annual interest compounded monthly, it takes 217.84 months, or 18.15 years, to break even. In the year 2022, a person not opting for early retirement at age 62 and waiting until age 67 will have to live to age 85 and 2 months to break even when a four percent interest rate is applied to the monthly benefit. Table 2 is a summary of the years needed to break even for not opting for early Social Security retirement at age 62.

TABLE 2		
Years Needed to Break Even From Delaying to Receive Full Benefits		
Without Time-Value-of-Money Considerations		
Year of Early Retirement at Age 62	Years Needed	Age
2000	Age 65 plus 12 years	Age 77
2005 – 2016	Age 66 plus 12 years	Age 78
2022 and after	Age 67 plus 12 years	Age 79
Using a four percent annual interest rate in the analysis, the break-even time period is as follows:		
Year of Early Retirement at Age 62	Years Needed	Age
2000	Age 65 plus 18 years	Age 83
2005 – 2016	Age 66 plus 18.4 years	Age 84 and 5 mo.
2022 and after	Age 67 plus 18.2 years	Age 85 and 3 mo.

As can be seen in Table 2, when using a conservative four percent interest rate in the analysis, a retiree would have to live over 18 years past the age for unreduced Social Security benefits to recover the value of the money lost by not taking early retirement. Thus, although future Social Security benefits will be reduced for early retirement, early retirement still will be economically favorable for many individuals.

Determining the Present Value of Early Retirement Versus Full Retirement

Another application of business financial analysis that may be used to estimate the economic value of beginning Social Security retirement benefits at age 62 versus full retirement age is to conduct a present value analysis of the benefits from each course of action.

Table 3 is a summary of the present value of early retirement versus full retirement for men and women at different years in the future based upon the scheduled reduction in benefits for early retirement. As previously noted, the life expectancy at age 62 is 17.5 years for men and 21.5 years for women. Assuming that a male is eligible for the maximum retirement benefit and attained age 62 in the year 2000, the present value of \$1,130.50 a month for 17.5 years discounted at four percent is \$170,625.00. If the same individual decides to wait to begin Social Security retirement benefits at age 65 and 2 months, the value at age 62 of the \$1,428 a month beginning 3 years and 2 months later and received for his life expectancy, is \$163,454. A man expected to attain his life expectancy has a greater economic value at age 62 of beginning to receive early Social Security retirement benefits than waiting to collect full benefits later.

TABLE 3

Estimated Value of Future Social Security Retirement Benefits

Assumptions used in calculating the estimated value:

1. Benefits are discounted to the present at four percent.
2. At age 62, current life expectancy for men (17.5 years) and for women (21.5 years) are used.
3. Future benefits are based on the maximum current monthly individual retirement benefit (\$1,428) for the year 2000.

Year	Age	Men	Women
2000	Value of early retirement age 62	\$170,625.00	\$196,025.00
	versus Value at age 62 of waiting to age 65 and 2 months	\$163,450.00	\$196,550.00
2005–2016	Value of early retirement age 62	\$161,650.00	\$185,500.00
	versus Value at age 62 of waiting to age 66	\$152,610.00	\$184,250.00
2022 and after	Value of early retirement age 62	\$150,850.00	\$173,150.00
	versus Value at age 62 of waiting to age 67	\$138,370.00	\$169,950.00

Performing a similar present value analysis for women who attained age 62 in the year 2000, the present value of waiting to age 65 and 2 months is slightly higher than the value of beginning early retirement at age 62 in the year 2000. The longer life expectancy of women produces slightly more favorable results for waiting when a present-value analysis is used.

As can be seen in Table 3, the present value of Social Security benefits is higher for women than it is for men because of a longer life expectancy for women. Women, on average, can expect to receive benefits for four years longer than men. For women, the decision to receive early Social Security retirement benefits at age 62 versus waiting to receive full retirement benefits produces rather similar economic values. Delaying retirement is slightly more favorable for women in the year 2000, but selecting early retirement is slightly more favorable after year 2005. For men, however, the economic value of beginning Social Security retirement benefits at age 62 is noticeably higher than waiting for full retirement. The present-value analysis produces similar results for individuals beginning benefits in the year 2000 through the year 2022 and after.

Employment After Retirement Considerations

Careful attention needs to be given to early retirement when continued employment is a possible option. Social Security retirement recipients between the ages of 62 and 65 are subject to the “annual earnings limitation test” that reduces their Social Security benefits by \$1 for every \$2 earned over \$10,680 in the year 2001. This limitation on employment after retirement may present some serious problems for individuals who plan to retire before age 65 and supplement their retirement income with part-time employment. The annual earnings limitations test for Social Security retirement recipients reaching full retirement age was eliminated in the year 2000.

Social Security Spousal Benefits in Early Retirement

A spouse may receive Social Security retirement benefits based upon his or her own employment record or the spousal benefit, whichever is greater. Spousal benefits typically are calculated as a percentage of the primary wage-earner’s benefits. The spousal benefit for a spouse age 62 would be 37.5 percent of the primary earner’s full benefit. The spousal benefit is 50 percent of the primary earner’s benefit at full retirement. Similar to a covered worker, a spouse’s benefits are permanently reduced for early retirement based on the number of months before he or she

reaches full retirement age.

Summary and Comments

While many factors may influence the decision as to when to collect Social Security benefits, the economic value of beginning Social Security at age 62 for men is greater than waiting for full retirement. For women, the economic value of waiting for full retirement is slightly greater than early retirement for those attaining age 62 in the year 2000. However, because of the scheduled extension to age 66 for full retirement between 2005 and 2016, and to age 67 in years 2022 and after, women who opt for early retirement after the year 2005 will gain a slightly higher economic value compared with waiting. The differences in the economic values do not appear to be significant enough in any of the situations to be the major factor influencing the decision as to when to begin Social Security benefits. Many factors should be considered before making the decision to retire. Complete knowledge of the client's situation can help financial planners guide their clients in making the right decisions.

If U.S. workers continue to desire to retire early, proper retirement planning is even more essential in light of the scheduled reduction in benefits from Social Security.

Endnotes

1. *Social Security Retirement Benefits Publication No. 05-10036*, ICN 457500, published by the Social Security Administration, February 1999.
2. "Financial Strategies for Approaching Retirement," *American Express Financial Advisors*, Summer 1999.
3. Lisa Reilly Cullen, Beverly Goodman and Henry Weil, "Steps to a Great Retirement," *Money*, November 1999, pp. 85-102.
4. *Social Security Retirement Benefits Publication No. 05-10036*, ICN 457500, published by the Social Security Administration, February 1999.
5. "Social Security Boosting Benefits: 2.4 percent Increase for Next Year," Landmark Communications Inc., October 20, 1999.
6. *Social Security Retirement Benefits Publication No. 05-10036*, ICN 457500, published by the Social Security Administration, February 1999.