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ISSUE BRIEF

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Means Testing for Social Security

Since Social Security was established in 1935, the program has paid benefits to all retired participants and beneficiaries under uniform formulas based on participants' wages in covered employment, without regard to recipients' wealth or other non-wage income. This concept of Social Security as an earned right has helped ensure its high level of public support.

Recently, public attention has increasingly focused on Social Security's long-range financial problems. According to the most recent report of the Social Security trustees, the program will not have enough money to pay all benefits when due by the fifth decade of this century. A wide variety of possible reforms have been proposed to eliminate all or a portion of Social Security's long-range financial deficit.

Among these proposed reforms is reducing or eliminating benefits for wealthy and/or high-income participants and beneficiaries, generally characterized as "means testing." Advocates of means testing note that reducing or eliminating benefits for those whose income or assets exceed certain thresholds would help preserve Social Security as a safety net for those who truly need it.

This proposal raises some important issues:

- *Would such a profound change in philosophy weaken public support for the program?*
- *How would such a change alter the balance between individual equity and social adequacy?*
- *Would other factors reduce the expected financial gains from means testing?*
- *How would means testing be administered?*
- *Are there other ways for achieving a similar degree of savings without changing the current program structure?*

The purpose of this issue brief is to explore these issues.

Background

The Social Security benefit formula uses as input the wages on which the worker and employer have made contributions. This link between the wages which have been taxed during a worker's career and the benefits the worker receives after retirement establishes an "earned right" in the minds of program participants, which is part of the foundation of the program's popular support.

Since Social Security's inception, the program has paid benefits to all workers who have worked in covered employment for a sufficient period, and to their dependents and beneficiaries, without regard to wealth or other income. This

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universality reinforces the idea of Social Security as an earned right, and is another part of the foundation of the program's popular support.

These twin concepts, earned right and universality, have distinguished the Social Security program from other government income-maintenance programs, such as welfare, food stamps and Medicaid, that provide benefits to more narrowly defined populations. While these latter programs have all been subject to major overhauls or benefit cutbacks in recent years, Social Security has not changed significantly since 1983, and still retains the basic design from its founding in 1935.

Nevertheless, consistent reports from the Social Security trustees showing the system will not be able to pay all benefits when due by the fifth decade of this century have focused public attention on the need for some change to the system. Proposed reforms run the gamut from changing the benefit formula, tax rate and/or retirement age while maintaining the same basic design that has served the program since its inception, to radically overhauling the program by diverting all or a portion of workers' payroll taxes into individually owned accounts dedicated to paying benefits to the workers who contributed to the accounts and to their dependents and beneficiaries. Means testing falls somewhere between these two extremes - while it maintains the basic design of the current program, it introduces important changes to the program's underlying philosophy for providing benefits.

What Is Means Testing?

Social Security expenditures could be reduced over the long term by applying a means test to retired workers and their dependents and beneficiaries otherwise eligible for benefits under the current program. Means testing would reduce or eliminate benefit payments to participants whose current income or assets exceed specified thresholds. There are many ways this could be done. For example:

- An income test could take into account all income or only "wealth-related" income, such as investment income or income from a business;
- Similarly, an asset test could include all assets or exclude widely held assets such as houses and cars;
- The means test could be applied one time when benefits begin or at regular intervals after benefits begin;
- The test could eliminate benefits altogether for those exceeding the threshold, or phase out benefits gradually as income or assets increase beyond the threshold.
- The Medicare reform package enacted by Congress late in 2003 includes means testing provisions, which increase the Part B premium for high-income retirees, and bases the cost to the participant of the new drug benefit in part on current income and assets.

Several proposals for applying means testing to Social Security benefits have been made, but the proposal that has gained the most public attention came from the Concord Coalition, a bipartisan group of fiscal conservatives. The Concord Coalition made its proposal, which it calls "affluence testing," in the mid-1990s and has not updated it recently, so some of the specific dollar thresholds are now outdated. Under affluence testing as originally proposed, Social Security benefits would begin to be reduced if family income exceeds $40,000 with reductions reaching 85 percent if family income exceeds $120,000.

Means Testing and the Earnings Test

Since its inception, Social Security has included a feature that can in some circumstances have effects similar to means testing — namely, the retirement earnings test. The primary purpose of the earnings test is not to save the system money. Rather, the earnings test is based on the principle that Social Security should replace lost earnings and that it is therefore appropriate to reduce benefits for those whose earnings indicate they have not retired or otherwise withdrawn from the workforce. Originally, the earnings test eliminated benefits entirely for any otherwise eligible person who received covered wages. Over the history of Social Security, the earnings test has been liberalized in many ways: the all-or-nothing test was replaced by an earnings threshold, under which full benefits would continue as long as earnings remained below the threshold; the earnings threshold was increased numerous times and is currently indexed to changes in national average wages; total elimination of benefits for earnings over the threshold was replaced by a dollar-for-dollar offset of benefits by excess earnings, later liberalized to a $1 for $2, and in some cases to a $1 for $3 offset; and the earnings test was eliminated altogether, first for recipients over age 72, then over 70, and recently over the Social Security normal retirement age (which varies from 65 to 67 depending on the worker's year of birth).

Strictly speaking, the earnings test is not a means test. Since it takes into account only earned income, the earnings test does not even attempt to measure total income or wealth. Indeed, those less well off are the most likely to have earned income after retirement, because they most often need to supplement their unearned retirement income. Further, benefits not paid as a result of the earnings test are not permanently lost, but cause the benefit amount to be adjusted upward when the participant is no longer affected by the test.

Even though the earnings test is not a means test, experience with the earnings test over the years may be instructive in evaluating the political feasibility of a means test. The many liberalizations in the earnings test came as a result of public pressure for change. The obvious public distaste for the earnings test indicates it could be difficult to implement a means test.

Impact of Means Testing

The means testing of Social Security benefits could impact the system in ways other than the obvious cost savings, some of which are not obvious and could have serious negative consequences:

Erosion of public support for Social Security. Any move toward means testing would represent a significant change in the underlying philosophy of the Social Security program. Past changes to the program have always been made within the universality and earned right principles of the existing system, but means testing would add a new element to the system. Underlying means testing is the principle that government-sponsored retirement programs should be targeted at lower-income segments of the population and should not be used to aid those not in financial need.

In an era of pressing fiscal problems, proponents believe there are more compelling uses for limited government revenues than paying retirement benefits to people who are already well-off. However, tampering with the universality and earned right principles by imposing a means test could undermine public support for the Social Security program. Loss of support might be expected among the well-to-do, whose benefits would be cut. These participants are likely to view the payroll tax as just another income tax, since they would receive little or no direct benefit from it. Even though they may be relatively few in number, they have disproportionate political influence due to their wealth.

A much broader loss of public support could result if a means test caused Social Security to be viewed as a government-mandated income redistribution program rather than an earned right. If this should happen, the political consensus which has supported Social Security throughout its history could break down, leading to possible curtailment or even elimination of the system as we know it.

Individual equity vs. social adequacy. Another basic principle of the Social Security program is that benefits should balance individual equity and social adequacy. Under this principle, the benefit formula takes into account each worker's earnings history, providing higher benefits for higher earnings, but weights the formula in favor of lower-paid workers, so that those whose needs are greater receive disproportionately higher benefits. (Other features of the system also contribute to this individual equity-social adequacy balance.)

Means testing would tilt the balance away from individual equity toward social adequacy by weakening the link between earnings and benefits and by diverting benefits from the better to the less well-off. The proper balance between individual equity and social adequacy is a legitimate subject for debate.

Disincentives from savings and incentives for consumption. If income from savings during retirement reduced or eliminated Social Security benefits, participants would have an incentive against savings toward consumption during their working years. This would apply not just directly to workers, but also to their employers, who might forego maintaining or improving private retirement plans if their benefits reduced participants' Social Security benefits. This outcome would be contrary to the current concern about the low level of national savings and possible consequences for future improvement in labor productivity. Productivity has a major impact on the nation's economic well-being as well as the financial health of Social Security, and any factor that negatively impacts productivity could deepen both the nation's and Social Security's financial problems. Thus, any direct improvement to Social Security's finances from means testing could be partially offset by the indirect effect of lower national savings.

Other unintended incentives. If means testing is based on income, people will have an incentive to take lump-sum distributions from employer-sponsored retirement plans and IRAs rather than annuities or periodic installments. This could cause some people to spend their retirement savings too soon, leaving them in financial difficulties later in retirement. If the income threshold applies to a participant's family, this may be a disincentive for some to get married or stay married.

Potential for fraud and abuse. Experience with other means-tested programs shows that both assets and income can be hidden, "spent down," or transferred to others. Such activity introduces distortions into the economy and can create public suspicion about the integrity of the program. A graduated means test, such as the Concord Coalition proposal, can help minimize incentives for fraud and abuse, but with the result of increased administrative complexity.

Administrative complexity. Despite a complex benefit formula and the need to calculate benefits based on worker careers that may span many employers, Social Security is administered remarkably efficiently, with administrative costs comprising only about 1 percent of payroll tax income. The paperwork, investigations, and litigation associated with implementation of any kind of means test could add a substantial administrative burden to the system with a resulting increase in administrative costs. These cost increases must be counted against any expected savings in benefit payments.

Alternative Ways for Accomplishing the Goals of Means Testing

Many of the same results of direct means testing could be achieved by adjusting the Social Security benefit formula to reduce benefits for the highly compensated. This might include changing the formula weights in favor of the lower paid, or providing a flat minimum benefit to all Social Security recipients while reducing the overall benefit based on a participant's earnings history.

Alternatively, the federal income tax system could be used to recapture Social Security benefits paid to high-income taxpayers. Currently, individuals whose income (including 50 percent of Social Security benefits) exceeds $25,000 and couples whose income exceeds $32,000 pay income tax at regular rates on up to 85 percent of their Social Security benefits. Taxation of Social Security benefits could be extended by applying rates greater than regular tax rates to beneficiaries whose income exceeds some higher threshold level.

Both these methods could reflect wealth without introducing new elements into the current Social Security program and without adding significantly to its administrative burden. Any such alternative that reduces or eliminates the economic benefit for wealthy and/or high-income Social Security participants could have some of the same negative consequences as means testing.

Conclusion

While means testing could achieve significant reductions in Social Security expenditures, it would represent a change in the underlying principles of the program. Before giving serious thought to means testing of Social Security benefits, Congress should consider the following questions:

- Should the Social Security program be modified making it a more traditional government welfare program? Could Social Security even survive such a fundamental change in its underlying philosophy?
- What would be the true savings to the Social Security program if some form of means testing were adopted? Would direct savings from lower benefit payments be largely eaten up by indirect costs, such as lower productivity, legal or illegal avoidance of benefit reductions, and higher administrative costs?
- Are there alternatives that could have similar results to means testing while remaining within the current program structure?