

Key Points

- Means testing would reduce benefits to participants whose current income or assets exceed specified thresholds.
- Advocates argue that means testing would reduce costs to the Social Security program. But such a move could have serious unintended consequences, including erosion of public support for Social Security, savings disincentives during working years, and administrative complexity.
- Social Security already includes an “earnings test” based on the principle that Social Security payments should replace lost earnings, and it is therefore appropriate to reduce benefits for those whose earnings indicate that they have not yet retired.
- Policymakers seeking to avoid means testing could achieve much of the same results by adjusting the benefit formula for highly compensated individuals or by increasing the taxation of Social Security benefits at a higher rate than the one currently used.

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.

Public attention increasingly has focused on Social Security’s long-range financial problems. According to the most recent [report](#) of the Social Security trustees, by the fourth decade of this century the program will not have enough money to pay all benefits when due. A wide variety of possible reforms has been proposed to eliminate or reduce 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 called “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?

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- Are there other ways to achieve 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 that 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 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 Temporary Assistance to Needy Families ("welfare"), food stamps, and Medicaid, that provide benefits based on demonstrated need. While these latter programs have all been subject to major overhauls or benefit cutbacks in recent decades, Social Security has not changed significantly since 1983, and still retains the basic design from its founding in 1935.

Consistent reports from the Social Security trustees showing the system will not be able to pay all benefits when due by the fourth decade of this century, however, 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 contribute 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;
- An asset test similarly could include all assets or exclude widely held assets such as residential property 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;

Members of the Social Security Committee include: Eric Atwater, MAAA, FSA, FCA, EA; Janet Barr, MAAA, ASA, EA - chairperson; Raymond Berry, MAAA, ASA, EA; Michael Callahan, MAAA, EA, FSPA; Douglas Eckley, MAAA, FSA; Jay Jaffe, MAAA, FSA; Eric Klieber, MAAA, FSA, EA - vice chairperson; Timothy Leier, MAAA, FSA, EA; Timothy Marnell, MAAA, ASA, EA; John Nylander, MAAA, FSA; Brendan O'Farrell, MAAA, EA, FSPA, FCA; Zenaída Samaniego, MAAA, FSA; Bruce Schobel, MAAA, FSA, FCA; Mark Shemtob, MAAA, ASA, EA; P.J. Eric Stallard, MAAA, ASA, FCA; Ali Zaker-Shahrak, MAAA, FSA

- The test could be similar to those provisions in the Medicare reform package enacted by Congress late in 2003 that increase the Part B premium for high-income retirees and base the cost to the participant of the Part D drug benefit in part on current income and assets.

The first means testing proposal to gain widespread public attention came from the Concord Coalition, a bipartisan group of fiscal conservatives, which it calls “[affluence testing](#).” Under affluence testing as originally proposed by the Concord Coalition, Social Security benefits would begin to be reduced if family income exceeds \$40,000 with reductions reaching 85 percent if family income exceeds \$120,000¹.

More recently, in late 2011 Rep. Jason Chafetz (R-Utah) offered a [plan](#) to restore sustainable solvency for the Social Security program by a reducing Social Security benefits for beneficiaries whose modified adjusted gross income (MAGI) exceeds \$60,000 for individual taxpayers or \$120,000 for taxpayers who file jointly. For this purpose, MAGI equals adjusted gross income less taxable Social Security benefits plus nontaxable interest income. Benefits would be reduced on a sliding scale starting at 0 percent for beneficiaries whose income is exactly at the threshold and increasing to 50 percent for those whose incomes are at or above three times the threshold. The reductions would start in 2019, and the thresholds would be indexed thereafter by changes in the national average wage.

The conservative Heritage Foundation also has come up with a version of means testing as part of a comprehensive proposal for improving the country’s long-term fiscal outlook called “[Saving the American Dream](#).” The Heritage proposal would start reducing Social Security benefits when non-Social Security income reaches \$55,000 for individual taxpayers or \$110,000 for taxpayers who file jointly, and eliminate benefits entirely for those whose non-Social Security

income exceeds these thresholds by \$55,000 or more, with proportional reductions in between. The reductions would begin taking effect immediately upon enactment of the proposal. At the same time, current-law taxation of some Social Security benefits would cease.

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 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. The earnings test originally 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 has been increased numerous times and currently is 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 offset and in some cases to a \$1 for \$3 offset; and the earnings test was eliminated altogether, first for recipients older than 72, then older than 70, and recently older than 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. In-

¹The Concord Coalition made its proposal in the mid-1990s and has not updated it recently, so some of the specific dollar thresholds are now outdated.

deed, those less well-off often derive the greatest benefit from earned income after retirement, since it is more likely their unearned retirement income will not be sufficient to cover basic needs. In addition, 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 that it may be difficult to implement a means test.

Impact of Means Testing

The means testing of Social Security benefits could affect 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 always have 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. But 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 may 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 that 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 while holding program costs constant. This paper takes no position on whether means testing provides for a more appropriate balance between individual equity and social adequacy, since this is a political question that needs to be debated by the public.

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 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 goal of raising the low level of national savings and have 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 affects productivity could deepen both the nation's and Social Security's financial problems. Any direct improvement to Social Security's finances from means testing therefore 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. This could increase costs for other means-tested programs, such as Supplemental Security Income (SSI) and Medicaid, offsetting some of the direct savings to Social Security. 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 tests described above, can help minimize incentives for fraud and abuse, but with the result of increased administrative complexity.

DISTORTIONS IN THE MANAGEMENT OF PERSONAL FINANCES. In addition to the concerns mentioned above, there are many legitimate ways to alter the timing of income and valuation of personal finances. This includes gifting assets, altering personal business finances, shifting the receipt of income, and managing the mix of assets to favor retaining those that are par-

tially or fully exempted from a means test. This management of finances to minimize the impact of a means test on individuals can be expected to reduce the savings that might be realized from applying a means test while also introducing distortions into the economy.

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 approximately 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.

Alternatives to 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.

As an alternative, the federal income tax system could be used to recapture Social Security benefits paid to high-income taxpayers. Individuals whose income (including 50 percent of Social Security benefits) currently 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 add-

ing significantly to its administrative burden. Any such alternative that reduces or eliminates the economic benefit for wealthy and/or high-income Social Security participants, however, also 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?