September
1996

ISSUE BRIEF

AMERICAN ACADEMY *of* ACTUARIES

Means Testing for Social Security

Since Social Security was established in 1935, benefits have been based on recipients' preretirement contributions. These benefits are paid without regard to wealth. A well-heeled retiree with annual investment income of $100,000 receives the same monthly check as an identically paid former colleague who now depends totally on Social Security for retirement income. This concept of Social Security as an earned right has ensured its almost universal public support, even when other government income-maintenance programs have come under increasing scrutiny.

As Social Security insolvency approaches with the aging of the baby-boom cohort, some reformers advocate reducing benefits for wealthy individuals. The federal government, it is argued, can no longer afford to subsidize the comfortable elderly with the tax dollars of working Americans. By reducing benefits to the wealthy in proportion to their income and assets, Social Security can be preserved as a safety net for the elderly who truly need it. But would such a profound change in philosophy drastically weaken public support for the program? What are the true savings to the system under means testing? And are there other, less radical, ways to achieve those needed savings?

What Is Means Testing?

Social Security expenditures could be reduced over the long term by applying a means test to beneficiaries. Means testing would reduce or even eliminate Social Security benefits to people who have income or assets above specified thresholds. This would represent a dramatic change to the Social Security program. Most changes to the benefit structure have been made within the principles of the existing system, but benefit changes through means testing add an additional criterion outside the current system. Underlying means testing is the principle that government-sponsored retirement programs should be targeted to assist lower-income segments of the population and that government funds should not be used to aid those who do not need financial assistance. In an era of pressing fiscal problems, proponents believe that there are more compelling ways to utilize limited government revenues than to pay retirement benefits to individuals considered wealthy.

One means testing proposal—called affluence testing—comes from the Concord Coalition, a bipartisan group of fiscal conservatives. Under affluence testing, entitlements would be reduced if family income exceeded $40,000. Both earned and unearned income would count toward the $40,000 limit, but not unrealized income from asset appreciation. The Concord Coalition's proposal ultimately would reduce entitlements on a scale ranging from 10% for beneficiaries with annual income from $40,000 to $50,000, to 20% for annual income from $50,000 to $60,000, and increasing to 85% for annual income over $120,000. The proposal would be fully

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phased in after 5 years, and the income brackets would be indexed to price inflation.

The Concord Coalition's affluence-testing plan is one of many current proposals for reforming the Social Security program that may have unintended consequences or policy implications. The Academy recommends a careful examination of the details of each proposal. Such examination is beyond the scope of this issue brief.

Current Environment

Since Social Security's inception, benefits have been paid to all who have contributed to the program for a minimum period of time, without regard to wealth. This universality is one of the foundations of the program's popular support.

Social Security benefits are generally determined by applying a formula for average wages on which the worker and employer have made contributions. This "earned right" feature of the program is another of the foundations of its popular support. Since the benefits paid are linked to earnings that have been taxed over a worker's lifetime to provide the benefits, the notion of an earned right to the benefits has become well established.

These two concepts, universality and earned right, have distinguished the Social Security program from other government cash benefit programs that provide benefits to a more narrowly defined population. Tampering with these principles by imposing a means test could undermine public support of the Social Security program. Nevertheless, one way to solve Social Security's long-term financing problems is to modify the earned right. Modification of earned right is only one of many significant measures to solve Social Security's problems.

In one sense, the Social Security program has had a form of means test since its beginning. This is the earnings test on recipients under age 70 with wages or self-employment income above specified thresholds. The earnings test is premised on the principle that Social Security should replace lost earnings and that it is therefore appropriate to reduce benefits for those whose earnings indicate that they have not retired or otherwise withdrawn from the labor force. This does not result in a permanent reduction or loss in benefits, but a change in benefit formula (i.e. an increase in the earnings limitation.)

Individual Equity vs. Social Adequacy

Another basic principle of the Social Security program is that benefits should balance individual equity and social adequacy. Social adequacy has been achieved by weighting the benefit formula in favor of lower-paid workers and by taxing benefits for beneficiaries with relatively high income. A proposal to means test would further tilt the balance toward social adequacy.

Opponents suggest that those who receive minimal or no benefits under means testing will view the payroll tax as an income tax. In addition to eroding support for the program, this may also result in employee pressure to lower taxable income and correspondingly increase tax-deferred income. High-income employees may attempt to avoid some payroll taxes by shifting compensation away from earnings and into non-taxed savings or stock purchase programs. While opportunities for this type of tax avoidance may be diminishing, the definition of income continues to expand. The consequent reduction in income taxes may reduce the anticipated program savings from means testing.

Social Security benefits are not intended to provide all the income received by retirees. Private savings, private pension plans, and additional income are necessary components of an adequate retirement income. This is an important fact to keep that in mind when discussing social adequacy and the Social Security program.

Impact of Means Testing

The means testing of Social Security benefits could produce several negative consequences. Means testing could:

• **Discourage individuals from saving for retirement and encourage current consumption.** Only those individuals with the highest incomes or accumulated wealth will be unaffected by this disincentive to save. Similarly, some employers may be discouraged from maintaining or improving private pension arrangements, if the improvement reduces the employees' Social Security benefit. This outcome is contrary to the current concern about national savings levels and their consequences for the country's productivity. Future productivity has a major impact on the financial health of the Social Security system. Currently there is general agreement that the national savings rate is below the optimal level; means testing could further reduce the national savings rate.

• **Encourage fraud and abuse.** Experience under other means-tested programs has shown that both assets and income can be hidden, "spent down," or transferred to others. Such activity causes economic distortions and can create significant public suspicion about the integrity of the program. A means test that is graduated, such as the Concord Coalition proposal, can help minimize incentives for fraud and abuse, but at the same time will increase administrative complexity.

• **Require a complex and intrusive administrative structure to support necessary increased government oversight.** Paperwork, investigatory, and legal costs could substantially reduce the anticipated savings. As has occurred with other means-tested programs, potential recipients may try to game the system.

The primary positive consequences of means testing would be to improve the long-range actuarial balance in Social Security and to achieve long-term budget balance. For example, the Concord Coalition proposal would reduce the long-range actuarial deficit by almost 50% according to estimates from the Social Security Administration's Office of the Actuary.

Alternatives to Means Testing

Many of the objectives of means testing can be accomplished by adjustments to the Social Security benefit formula without incurring the problems described above. Although such changes would likely reflect preretirement income rather than accumulated wealth or postretirement income, there is a relatively high correlation between these factors. Alternatively, the federal income tax system provides a more direct and broadly based mechanism to accomplish the objectives of means testing. If it becomes necessary to adjust benefits to reflect wealth, benefit formula adjustments or income tax changes offer a more predictable and less disruptive approach to accomplishing the objective. These alternatives also would produce a much less negative impact on national savings.

Underlying Questions

While significant reductions in Social Security expenditures could be achieved with means testing, it would change the original concept of the program. Congress should consider the following questions before enacting means testing of Social Security benefits.

• What are the true savings to the Social Security program if some form of means testing is adopted? What will be the effect of these savings on beneficiaries? What will be the effect on the economy as a whole?

• Should the Social Security program be modified to resemble a more traditional government welfare program?

• What is the purpose of means testing: To reform Social Security's traditional principles or solve its financial problems? Once the goal is identified, will means testing be able to achieve it?