



Promoting research on retirement and Social Security Policy

Research Brief 306 | October 2014

DISTRIBUTIONAL EFFECTS OF MEANS TESTING SOCIAL SECURITY: AN EXPLORATORY ANALYSIS

ALAN GUSTMAN, THOMAS STEINMEIER, AND NAHID TABATABAI *

Policymakers are again focusing on the question of how best to strengthen the finances of the Social Security system. This paper examines the distributional implications of introducing additional means testing of Social Security benefits where proceeds are used to help balance Social Security's finances.

To provide some perspective on new approaches to means testing, we develop a menu of options involving four different definitions of means: total wealth; an annualized measure of Average Indexed Monthly Earnings (AIME); the wealth value of pensions; and a measure of average indexed W2 earnings. We do not consider means tests based on current income or earnings. There is already an extensive literature exploring the effects of an earnings test on Social Security. More importantly, Congress has worked for decades to eliminate Social Security's earnings test.

All versions of the means test employ a method for reducing benefits that Social Security already uses to reduce the benefits of individuals who worked in and earned a pension from uncovered employment. To be more specific, the benefits of the top quarter of households, ranked according to the relevant measure of means, are reduced using a modified version of the Social Security Windfall Elimination Provision (WEP). Under this approach, the replacement rate in the first bracket of the benefit formula determining the Primary Insurance Amount (PIA) is reduced from 90 percent to 40 percent of AIME.

Our empirical analysis is based on data from the early boomer cohort of the Health and Retirement Study (HRS), where included individuals are from households with at least one member age 51 to 56 in 2004. The analysis is conducted at the household level. It starts with a baseline benefit for each household, calculated as the product of the average benefit-tax ratio under the current system, multiplied by the taxes paid by the household.

* *Alan L. Gustman* is professor of economics at Dartmouth College and holds the Loren M. Berry Chair in Economics. *Thomas L. Steinmeier* is professor of economics at Texas Tech University. *Nahid Tabatabai* is a research associate in Economics at Dartmouth College. This Research Brief is based on MRRC Working Paper 2014-306.

The means tests would reduce total household benefits by 7 to 9 percentage points, amounting to 15.4 to 16.4 percent of the benefits of affected workers at baseline. For example, when a means test based on AIME is imposed, the present value of average benefits paid over the lifetime falls from 268 thousand to 245 thousand. Roughly speaking, this decline in benefits amounts to more than one-third of the benefit decline that would be required to keep the Social Security system solvent under the current tax structure.

Deciding on a basis for means testing would be easy if households with high lifetime covered earnings also had high total wealth and high pension wealth. But we find that is not the case for many households. As a result, as the basis for the means test is changed, different households are affected. It will make a great deal of difference, at least to some households, which definition of means is chosen. Moreover, different means tests may have different effects on the benefits of families in similar circumstance.

Which measure of means is chosen will also make a great deal of difference to policymakers holding specific views as to how best to define means. We show, for example, that if a policymaker believes that wealth is the appropriate basis for a means test, but another basis for means testing is in fact legislated, households that are held by the policymaker to have low means will nevertheless suffer a reduction of benefits. Once again, at the heart of the problem are the imperfect correlations among total wealth, covered earnings, and pension wealth.

There also is some question about internal consistency of the effects of a means test even when a single criterion is used. Households falling in the top quarter when ranked by a particular criterion, whether it is lifetime covered earnings, wealth, or pension wealth, will not have their benefits reduced by the same amount. Within a top quarter group, the decrease in benefits depends on the covered earnings of each spouse; that is, on the mix between own and spouse or survivor benefits within the household.

Our hope is that our analysis will help to make policymakers more aware of the differences that alternative approaches to means testing may make, giving them a better understanding of the strengths and weaknesses of alternative definitions of means. The ultimate choice of policy, as always, depends on the preferences of the policymaker. But it is important that the complexities associated with the different choices are fully understood.

In concluding, it is worth repeating a caveat with regard to disincentives created by each approach, as well as the bases for means tests not chosen. Using current income as a basis for a means test would discourage the population from delaying retirement, even though raising the retirement age has been a goal of policies adopted in recent decades. Basing a means test on potential income assuming a full-time commitment to the labor market, is the most difficult to implement on practical and legal grounds. The approaches we examined here all create disincentives of one type or another – reducing incentives to work, save, choose a pension, or affecting particular choice of assets to hold. These disincentives, which will play a major role in shaping the benefits and costs of any proposal to means test Social Security, are reserved for future work.

University of Michigan Retirement Research Center
Institute for Social Research 426 Thompson Street Room 3026
Ann Arbor, MI 48104-2321 Phone: (734) 615-0422 Fax: (734) 615-2180
mrrcumich@umich.edu www.mrrc.isr.umich.edu

Sponsor Information. The research reported herein was performed pursuant to a grant from the U.S. Social Security Administration (SSA) through the Michigan Retirement Research Center (MRRC). The findings and conclusions expressed are solely those of the author(s) and do not represent the views of SSA, any agency of the federal government, or the MRRC.

Regents of the University of Michigan: Mark J. Bernstein, Ann Arbor; Julia Donovan Darlow, Ann Arbor; Laurence B. Deitch, Bloomfield Hills; Shauna Ryder Diggs, Grosse Pointe; Denise Ilitch, Bingham Farms; Andrea Fischer Newman, Ann Arbor; Andrew C. Richner, Grosse Pointe Park; Katherine E. White, Ann Arbor; Mark S. Schlissel, ex officio