

# The Potential Savings to Social Security from Means Testing

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## Executive Summary

Many people in policy debates have argued that means testing, or reducing Social Security payments to affluent beneficiaries, can be an effective way to save money for the program and to reduce the federal budget deficit. This paper examines the feasibility of saving money through various types of means tests. It shows:

- The vast majority of Social Security benefits go to relatively low and middle class people. More than 75 percent of benefits go to individuals with non-Social Security incomes of less than \$20,000 a year. More than 90 percent of benefits go to individuals with non-Social Security incomes of less than \$50,000 a year.
- A means test that phased out benefits at the rate of 10 cents for each dollar of additional income over \$40,000 of non-Social Security income would save the program 2.77 percent of annual benefits, assuming no behavioral response. It would save 0.74 percent if the floor for the means test were set at \$100,000. After accounting for the lost tax on these benefits, the savings for the two means tests would be 2.18 percent and 0.58 percent of benefits, respectively.
- A means test that phased out benefits at the rate of 20 cents for each dollar of additional income over \$40,000 of non-Social Security income would save the program 4.65 percent of annual benefits, assuming no behavioral response. It would save 1.33 percent if the floor for the means test were set at \$100,000. After accounting for the lost tax on these benefits, the savings for these two means tests would be 3.66 percent and 1.04 percent of benefits, respectively.
- If individuals respond to the 20 percent phase-out means test by reducing their income in the relevant income brackets by 30 percent, then the savings from the two means test would fall to 3.84 percent of annual benefits for the means test that begins at incomes of \$40,000 and 0.85 percent of benefits if it only affects incomes above \$100,000. After accounting for the lost income tax revenue on these benefits, the savings would be 3.02 percent and 0.67 percent of the program's benefits, respectively.
- A behavioral response to a means test would also reduce income tax collections. Assuming that the average tax rate on income for the affected individuals is 25 percent, the behavioral response described above would mean that the net savings to the government from a 20 percent phase out of benefits for incomes over \$40,000 would be 2.01 percent of annual benefit payments. If the threshold is set at a \$100,000, the savings would be 0.07 percent of annual benefits.
- The cost of administering a means test would add substantially to the operating cost of the program. If the means test raised the expense ratio for the retirement program to the same level as the disability program it would increase expenses by an amount equal to 1.70 percent of the program's cost. This would eliminate most, if not all, of the savings from a plausible means test on affluent beneficiaries.

This analysis suggests that the potential savings from a means test of Social Security benefits is likely to be very limited unless the means test is applied to individuals who are very much middle class by any reasonable definition. The percentage of benefits that go to affluent seniors is too small to make very much difference to the program's finances.

## Introduction

An idea that is frequently raised in public discussions of Social Security is means-testing benefits so that wealthy people will not receive Social Security checks from the government. This argument is regularly put forward by billionaire investor Peter Peterson, one of the program's most prominent critics, who eagerly tells audiences that he doesn't need his Social Security.

Polls consistently show that most of the public does not support means testing of Social Security, however the idea of taking away benefits for the wealthy clearly has some resonance. Means testing does raise important moral and political issues about the nature of the program. Apart from these issues, though, there is also a basic economic question as to how much money is potentially at stake. This paper projects the savings from various types of means tests that could be imposed, using alternative assumptions about the extent of evasion from the tests.

## The Distribution of Social Security Benefits by Income

The ability to claw back a substantial amount of money through a means test depends on the distribution of benefits across the income ladder. In order to get back a substantial amount of benefits by applying a means test to the wealthy, it must be the case that the wealthy are getting a large portion of Social Security benefits.

This turns out not to be the case. While the wealthy and very wealthy do claim a substantial portion of personal income, they do not account for a large share of Social Security benefits. The reason is simple: Social Security benefits are capped, so that even the richest beneficiary cannot receive a much higher benefit than what typical workers receive. And, since there are not many wealthy people, their benefits are a relatively small share of the total benefits paid out by the program.

**Table 1** shows the distribution of benefits by non-Social Security income. The numbers in column 1 show the non-Social Security income by person. This means that if a couple had \$30,000 in non-Social Security income, they would appear as two individuals with incomes of \$15,000 each.<sup>1</sup>

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<sup>1</sup> This analysis is done exclusively for individuals as a simplifying assumption. This avoids some of the difficulties that would arise in a fuller analysis, such as the treatment of multi-generational households. It is unlikely that the results would differ substantially using a different unit of analysis.

**TABLE 1**  
**Distribution of Social Security Benefits by Person Income, 2009**

Person Income (\$)	Share of SS benefits (%)	Average SS benefits received (\$)
<10,000	57.6	11,325.94
10,000-19,000	18.4	11,795.52
20,000-29,000	8.1	12,287.42
30,000-39,000	5.9	12,292.35
40,000-49,000	2.8	12,982.10
50,000-59,000	2.1	14,097.20
60,000-69,000	1.4	13,460.72
70,000-79,000	0.8	13,661.75
80,000-89,000	0.6	13,499.15
90,000-99,000	0.5	16,688.98
100,000-109,000	0.5	14,403.84
110,000-119,000	0.2	14,847.23
120,000-129,000	0.4	16,239.31
130,000-139,000	0.1	18,784.52
140,000-149,000	0.0	22,757.00
150,000-159,000	0.0	13,058.50
160,000-169,000	0.0	7,610.01
170,000-179,000	0.0	11,491.85
180,000-189,000	0.4	18,051.12
190,000-199,000	0.1	19,419.76
200,000+	0.6	19,679.05

Notes: The average Social Security benefit received by all individual beneficiaries is \$11,759.11. A person is defined as a single individual 62 years old or older. This table excludes persons with a) zero or negative overall income and b) zero or negative Social Security income.

Source: CEPR extract of 2010 March Current Population Survey (CPS ASEC)

As can be seen, the bulk of Social Security benefits are paid to relatively low and moderate-income individuals. More than 75 percent of benefits are paid to individuals who have less than \$20,000 a year in non-Social Security income. This would correspond to a couple with income of less than \$40,000. The group corresponding roughly to President Obama's definition of wealthy – individuals with incomes of more than \$130,000 (\$260,000 for a couple) – account for just 1.2 percent of Social Security benefits. This means that if a means test were imposed, zeroing out benefits on everyone with a non-Social Security income of more than \$130,000 per person, it would only reduce the cost by 1.2 percent. Even if the income threshold is brought down to \$100,000 (\$200,000 for a couple), this group still only accounts for just 2.3 percent of Social Security benefits.

As a practical matter, it is not possible to impose strict breaks; a means test must be phased in over an income range. If a person lost \$20,000 in Social Security income when their income crossed \$130,000 then a lot of people would report that they earned \$129,900. It is not hard for people to find ways to lower their income and a strict break would provide a strong incentive for individuals

near the threshold to find ways to reduce their income. This is especially likely to be the case with people receiving Social Security benefits, the vast majority of whom are retired.

There are numerous legal ways to reduce income, if there is enough incentive. For example, a relatively wealthy retiree who has a substantial amount of money invested in stock or other financial assets may opt to sell these assets and instead buy a condominium to use as a vacation home. The condominium may not generate income, but would save money on hotels or leasing a condominium for a vacation.

Alternatively, it is not hard to find financial assets that don't provide an annual income, but instead produce capital gains. Many stocks do not pay dividends. It is expected that the price of these stocks will rise enough to compensate for the lack of a dividend. A means test for Social Security will give wealthier seniors incentive to switch their assets to non-income producing assets. They could occasionally sell off assets and incur a capital gain that would subject them to the means test, but this may only be once every 5 or 10 years.

While these moves are entirely legal, wealthy retirees could also find more questionable routes to escape a means test. For example, they could transfer assets to their children, even if they still maintained effective control over them. And, they could just commit outright evasion, hiding income from the Internal Revenue Service.

For these reasons, it would never make sense to have a single breakpoint above which a means test is applied. Rather, a means test must be phased in over an income range. As a result, the income threshold must either be set at a lower level than would be desired, or, alternatively, higher income people must be able to keep more of their Social Security benefits than desired.

In addition, through the income range of the benefit phase out, beneficiaries will effectively be subject to a high marginal tax rate, with the rate of the phase out added to the marginal income tax rate that beneficiaries are already paying. This will provide a substantial incentive to conceal income in the ways noted above. In addition, some older beneficiaries are still in the workforce. If their income from work puts them above the means test threshold, then it will provide a disincentive to work.

Recognizing this problem, it is possible to construct a set of hypothetical means tests that start either at a relatively low level to capture revenue, or a relatively high level to protect middle-income seniors. The lower end means test uses \$40,000 as the threshold for an individual, and \$80,000 for a couple. The higher end means test uses \$100,000 as the threshold for an individual, and \$200,000 for a couple.

**Table 2** shows the potential savings on benefits from each income group. This table assumes a 10 percent rate of phase out. This would mean that a near-maximum individual benefit of \$22,200 would phase out over a \$222,000 range. That would mean that an individual earning \$242,000 of non-Social Security income would see a maximum benefit just phased out. In the high case, the maximum benefit would not be fully phased out until an individual had non-Social Security earnings of \$342,000. The last column shows the marginal tax rate that is implied by this means test.

**TABLE 2**  
**Savings from Phasing Out Social Security Benefits Beginning at \$40,000 and at \$100,000, 10 Percent Rate**

Person Income (\$)	Share of SS benefits (%)	Average SS benefits received (\$)	Phase out beginning at \$40,000			Phase out beginning at \$100,000		
			Average savings (\$)	Savings as share of benefits (%)	Effective marginal tax rate (%)	Average savings (\$)	Savings as share of benefits (%)	Effective marginal tax rate (%)
<10,000	57.6	11,325.94	0	0	0	0	0	0
10,000-19,000	18.4	11,795.52	0	0	15	0	0	15
20,000-29,000	8.1	12,287.42	0	0	15	0	0	15
30,000-39,000	5.9	12,292.35	0	0	25	0	0	25
40,000-49,000	2.8	12,982.10	500	0.11	33	0	0	25
50,000-59,000	2.1	14,097.20	1,500	0.22	33	0	0	25
60,000-69,000	1.4	13,460.72	2,500	0.27	33	0	0	25
70,000-79,000	0.8	13,661.75	3,500	0.21	33	0	0	25
80,000-89,000	0.6	13,499.15	4,500	0.21	36	0	0	28
90,000-99,000	0.5	16,688.98	5,500	0.18	36	0	0	28
100,000-109,000	0.5	14,403.84	6,500	0.24	36	500	0.02	36
110,000-119,000	0.2	14,847.23	7,500	0.10	36	1,500	0.02	36
120,000-129,000	0.4	16,239.31	8,500	0.18	36	2,500	0.05	36
130,000-139,000	0.1	18,784.52	9,500	0.04	36	3,500	0.02	36
140,000-149,000	0.0	22,757.00	10,500	0.00	36	4,500	0.00	36
150,000-159,000	0.0	13,058.50	11,500	0.01	36	5,500	0.01	36
160,000-169,000	0.0	7,610.01	12,500	0.05	36	6,500	0.03	36
170,000-179,000	0.0	11,491.85	13,500	0.05	41	7,500	0.03	41
180,000-189,000	0.4	18,051.12	14,500	0.33	41	8,500	0.19	41
190,000-199,000	0.1	19,419.76	15,500	0.05	41	9,500	0.03	41
200,000+	0.6	19,679.05	18,000	0.52	41	12,000	0.34	41
<b>Total Savings</b>				2.77			0.74	
<b>Total After-tax Savings</b>				2.18			0.58	

Notes: The average Social Security benefits of all individual beneficiaries is \$11,759.11. A person is defined as a single individual 62 years old or older. This table excludes persons with a) zero or negative overall income and b) zero or negative Social Security income.

Source: CEPR extract of 2010 March Current Population Survey (CPS ASEC)

The potential savings to Social Security from these means tests are relatively limited. Even with the lower end means test, the vast majority of beneficiaries are not affected and relatively little money is saved from most of those who are affected. The average savings for individuals with non-Social Security incomes between \$40,000 and \$50,000 is less than \$500; for individuals with incomes between \$50,000 and \$60,000 the savings would be less than \$1,500 per person. For individuals with income over \$100,000 the savings are considerably higher, but there are not many people in this group, so the total savings are relatively limited.

In the case of the means test that kicks in at \$40,000, the total savings are 2.77 percent of the benefits paid out each year. The means test that only affects retirees with non-Social Security



incomes above \$100,000 would save an amount equal to 0.74 percent of the benefits paid out each year.

In addition, there is also the issue that Social Security benefits themselves are subject to tax for higher income beneficiaries. Most of this revenue is refunded back to Social Security.<sup>2</sup> Assuming that 85 percent of the benefits are subject to tax and that the tax rate applied to these benefits is 25 percent (the low end for the relevant range of incomes), the after-tax savings to the program would be 2.18 percent of the programs outlays for the means test applied to incomes above \$40,000. The savings would be 0.58 percent of outlays for the means test applied to incomes above \$100,000.

In other words, even a means test that would affect retirees considered to be very much middle class by most standards would have relatively little impact on the program's finances. A means test that only affected more affluent retirees would barely make a dent in the overall cost of the program.

It is possible to construct a means test that would raise more revenue by having a faster phase out of benefits. **Table 3** shows the impact of phase out at a rate of 20 percent, using the same starting points of \$40,000 and \$100,000 as above. In this case, the maximum \$22,200 benefit would phase out at \$151,000 with the \$40,000 threshold and \$211,000 with the \$100,000 threshold.

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<sup>2</sup> Just under 81 percent of the revenue generated from taxing benefits is paid back to the Social Security trust fund. The rest is paid to the Medicare trust fund.

**TABLE 3**  
**Savings from Phasing Out Social Security Benefits Beginning at \$40,000 and at \$100,000, 20 Percent Rate**

Person Income (\$)	Share of SS benefits (%)	Average SS benefits received (\$)	Phase out beginning at \$40,000			Phase out beginning at \$100,000		
			Average savings (\$)	Savings as share of benefits (%)	Effective marginal tax rate (%)	Average savings (\$)	Savings as share of benefits (%)	Effective marginal tax rate (%)
<10,000	57.6	11,325.94	0	0	0	0	0	0
10,000-19,000	18.4	11,795.52	0	0	15	0	0	15
20,000-29,000	8.1	12,287.42	0	0	15	0	0	15
30,000-39,000	5.9	12,292.35	0	0	25	0	0	25
40,000-49,000	2.8	12,982.10	1,000	0.21	44	0	0	25
50,000-59,000	2.1	14,097.20	3,000	0.44	44	0	0	25
60,000-69,000	1.4	13,460.72	5,000	0.54	44	0	0	25
70,000-79,000	0.8	13,661.75	7,000	0.42	44	0	0	25
80,000-89,000	0.6	13,499.15	9,000	0.42	47	0	0	28
90,000-99,000	0.5	16,688.98	11,000	0.36	47	0	0	28
100,000-109,000	0.5	14,403.84	13,000	0.47	47	1,000	0.04	47
110,000-119,000	0.2	14,847.23	15,000	0.20	47	3,000	0.04	47
120,000-129,000	0.4	16,239.31	17,000	0.37	47	5,000	0.11	47
130,000-139,000	0.1	18,784.52	18,785	0.09	28	7,000	0.03	47
140,000-149,000	0.0	22,757.00	22,757	0.01	28	9,000	0.00	47
150,000-159,000	0.0	13,058.50	13,059	0.01	28	11,000	0.01	47
160,000-169,000	0.0	7,610.01	7,610	0.03	28	13,000	0.05	47
170,000-179,000	0.0	11,491.85	11,492	0.04	33	15,000	0.06	52
180,000-189,000	0.4	18,051.12	18,051	0.41	33	17,000	0.39	52
190,000-199,000	0.1	19,419.76	19,420	0.06	33	18,785	0.06	52
200,000+	0.6	19,679.05	19,679	0.56	33	18,808	0.54	52
<b>Total Savings</b>				4.65			1.33	
<b>Total After-tax Savings</b>				3.66			1.04	

Notes: The average Social Security benefit of all individual beneficiaries is \$11,759.11. A person is defined as a single individual 62 years old or older. This table excludes persons with a) zero or negative overall income and b) zero or negative Social Security income.

Source: CEPR extract of 2010 March Current Population Survey (CPS ASEC)

This stronger means test saves almost twice as much money as the means test shown in Table 2. (It doesn't save exactly twice as much because higher income individuals will have already lost their full benefit under the 10 percent means test.) As shown in the table, it would save an amount equal to 4.65 percent of benefits with the \$40,000 threshold and 1.33 percent of benefits with the \$100,000 threshold. Adjusting for the lost tax revenues, the savings would be 3.66 percent of the program's revenue with the means test that phases in at \$40,000 and 1.04 percent of the program's revenue with the means test that phases in at \$100,000.

However, this is certainly a substantial overstatement of the money that would be saved with this means test. Note that the marginal effective tax rate, based exclusively on the sum of federal income taxes and the phase out of Social Security benefits would be at least 44 percent. For higher income

individuals it would be 47 percent, and for the highest income individuals still in the phase out range it would be 52 percent.

Most states also have an income tax. With a state income tax, the marginal tax rates would average between 49 percent and 57 percent for beneficiaries subject to the means test, within the range in which their benefit is being phased out. This is a strong incentive for relatively well-off retirees to find mechanisms to reduce their income below the level where it is subject to a means test.

Using the condominium example mentioned earlier, suppose that an individual had \$400,000 in assets that generated \$20,000 in income every year. Under the stronger means test shown in Table 3, they would be able to keep between \$8,600 and \$10,200 of the \$20,000 they earn in interest or other income from this wealth. This is likely to give many wealthier retirees a strong incentive to take steps like buying a condominium that they can vacation at for free rather than pay for a hotel or renting one. In addition, these tax rates give them an incentive for finding ways to invest in financial assets that don't generate an annual income, as discussed above.

Given the incentives to find legal or illegal means for reducing reported income, it is likely that the money saved through a means test would be substantially less than what is shown in the tables above. **Table 4** show the money saved through the stronger 20 percent means test with assumptions that individuals respond to the imposition of the means test in ways that reduce the savings to Social Security by 30 percent for the income levels where the phase out creates a higher effective marginal tax rate. This can be seen as an upper bound behavioral response to the means test, while the calculations shown in Table 3, which assume no behavioral response, can be seen as a lower bound.

**TABLE 4**  
**Savings from Phasing Out Social Security Benefits Beginning at \$40,000 and at \$100,000, 20% Rate with Behavioral Response**

Person Income (\$)	Share of SS benefits (%)	Average SS benefits received (\$)	Phase out beginning at \$40,000			Phase out beginning at \$100,000		
			Average savings (\$)	Savings as share of benefits (%)	Effective marginal tax rate (%)	Average savings (\$)	Savings as share of benefits (%)	Effective marginal tax rate (%)
<10,000	57.6	11,325.94	0	0	0	0	0	0
10,000-19,000	18.4	11,795.52	0	0	15	0	0	15
20,000-29,000	8.1	12,287.42	0	0	15	0	0	15
30,000-39,000	5.9	12,292.35	0	0	25	0	0	25
40,000-49,000	2.8	12,982.10	1,000	0.14	44	0	0	25
50,000-59,000	2.1	14,097.20	3,000	0.25	44	0	0	25
60,000-69,000	1.4	13,460.72	5,000	0.50	44	0	0	25
70,000-79,000	0.8	13,661.75	7,000	0.39	44	0	0	25
80,000-89,000	0.6	13,499.15	9,000	0.34	47	0	0	28
90,000-99,000	0.5	16,688.98	11,000	0.27	47	0	0	28
100,000-109,000	0.5	14,403.84	13,000	0.34	47	1,000	0.03	47
110,000-119,000	0.2	14,847.23	15,000	0.21	47	3,000	0.04	47
120,000-129,000	0.4	16,239.31	17,000	0.20	47	5,000	0.06	47
130,000-139,000	0.1	18,784.52	18,785	0.09	28	7,000	0.04	47
140,000-149,000	0.0	22,757.00	22,757	0.01	28	9,000	0.04	47
150,000-159,000	0.0	13,058.50	13,059	0.01	28	11,000	0.06	47
160,000-169,000	0.0	7,610.01	7,610	0.03	28	13,000	0.07	47
170,000-179,000	0.0	11,491.85	11,492	0.04	33	15,000	0.05	52
180,000-189,000	0.4	18,051.12	18,051	0.41	33	17,000	0.05	52
190,000-199,000	0.1	19,419.76	19,420	0.06	33	18,785	0.04	52
200,000+	0.6	19,679.05	19,679	0.56	33	18,808	0.38	52
<b>Total Savings</b>				3.84			0.85	
<b>Total After-tax Savings</b>				3.02			0.67	

Notes: The average Social Security benefit of all individual beneficiaries is \$11,759.11. A person is defined as a single individual 62 years old or older. This table excludes persons with a) zero or negative overall income and b) zero or negative Social Security income. Source: CEPR extract of 2010 March Current Population Survey (CPS ASEC)

Assuming the behavioral response described above, the savings from a 20 percent phase out means test that begins with non-Social Security incomes above \$40,000 would be equal to 3.84 percent of benefits. The savings from the means test that kicked in at \$100,000 would be 0.85 percent of payroll. After deducting the lost income taxes, the savings would be 3.02 percent and 0.67 percent, respectively.

However, it is important to note that the behavioral response would also reduce taxable income more generally, since the avoidance would often involve shifting wealth from forms that generated

income subject to the income taxes to forms that are not.<sup>3</sup> If we assume that as a result of the behavioral response the reduction in income subject to income tax is the same as the reduction of income subject to the means test, and we assume an average marginal tax rate of 25 percent (the low end of the relevant range), then the lost income tax revenue due to the behavioral response would be equal to 1.01 percent of annual benefits paid in the case of the means test applied to incomes above \$40,000. This would leave a net gain to the government equal to 2.01 percent of the program's benefits. In the case of the means test that is applied to individuals with non-Social Security incomes above \$100,000, the assumed behavioral response would reduce income tax collections by an amount equal to 0.6 percent of annual benefits. This would lead to a net gain to the government equal to 0.07 percent of annual benefits. This calculation, along with the savings from the other means tests, is shown in **Table 5**.

**TABLE 5**  
**Net Savings for Social Security Means Tests**

	Threshold for Means Test (non-Social Security Income) (percent of annual benefits)	
	\$40,000	\$100,000
10 percent phase out	2.77	0.74
10 percent phase out, after-tax	2.18	0.58
20 percent phase out	4.65	1.33
20 percent phase out, after-tax	3.66	1.04
20 percent phase out, with behavioral response	3.84	0.85
20 percent phase out, with behavioral response, after-tax	3.02	0.67
20 percent phase out, with behavioral response, after-tax, including lost income taxes due to behavioral response	2.01	0.07

To sum up, a relatively strong (20 cents on a dollar of income) means test that is applied to people relatively far down in the income distribution (\$40,000 in non-Social Security income) can reduce benefits by more than 4 percent annually, assuming no behavioral response. After-tax, the savings would be just under 4 percent of the program's cost. However, if beneficiaries respond to this higher effective tax rate by following tax avoidance/evasion strategies, then the net savings to the government can be cut by more than half. In the case of a means test that only kicks in at non-Social Security income levels above \$100,000, the assumed behavioral response would eliminate most of the savings to the government.

By comparison, the shortfall projected by the Social Security trustees is equal to roughly 11.8 percent of the program's costs. This means that even a 20 percent means test applied to individuals with incomes above \$40,000 would close less than one-third of the projected shortfall assuming no behavioral response. With the response described above, the savings would be roughly a quarter of the program's shortfall. The lost tax revenue to the federal government that results from the

<sup>3</sup> It is important to recognize that not all the mechanisms that lead to avoidance of the means test would also lead to avoidance of income tax. For example, holding assets that produce capital gains rather than income would lead to capital gains tax revenue in the years when the assets are sold. This would also trigger the means test, but only for the year that the assets are sold.

assumed behavioral response would be equal to roughly one third of the projected savings to Social Security.

It is also important to note that this analysis does not incorporate the administrative costs associated with a means test. Currently, administrative costs for Social Security are very low, just over 0.6 percent of the benefits paid out each year for the retirement portion of the program. Administering a means test would raise these costs substantially. By comparison, the administrative costs of the disability portion of the program, which requires extensive review of applicants' eligibility, are equal to 2.3 percent of the program's benefits payments. If the cost of administering a means test for the retirement program raised its expense ratio to the same level as the disability program, then it would eliminate most and possibly all of the savings from a means test applied to affluent elderly.

It is worth noting that the reason for the relatively small potential savings has little to do with the assumption on behavioral responses. The main reason is the fact that the vast majority of benefits are paid to people with low and middle incomes. Reducing or eliminating benefits for people who are viewed as affluent can have very little impact on the cost of the program because these people get a small share of total benefits. The behavioral response to a means test can reduce the savings further, but the main problem with a means test is simply the relatively even distribution of benefits.

The same problem arises with plans that directly change the benefit structure. While this approach does not create the same perverse incentive structure as a means test, its potential to reduce spending by lowering payments to affluent retirees is still limited by the fact that the vast majority of benefits do not go to people who would be considered affluent. Achieving substantial savings by cutting benefits will require cuts to retirees who will generally be viewed as middle income. There is no way to avoid this fact.

## Means Testing Medicare

Many of the proponents of means testing Social Security also advocate means testing Medicare.<sup>4</sup> Imposing a means test for Medicare in addition to Social Security would complicate matters further. The cost of the Medicare benefit per person is projected to rise rapidly relative to Social Security since health care costs are projected to continue to outpace income growth. Per person Medicare expenditures are projected to be more than \$13,000 by 2020 and almost \$20,000 by 2030 (in 2010 dollars). If a Medicare means test was imposed that is comparable to the phase outs shown for Social Security, then it would lead to a further rise in the effective marginal tax rate for beneficiaries.

If both programs imposed a phase out of 20 cents for each dollar of additional income, then many middle-income beneficiaries would face marginal effective tax rates of more than 70 percent, including state income taxes. This would provide a very strong incentive for tax avoidance and evasion. In addition, annual Medicare benefits are even more equally distributed than Social Security benefits. (In fact, higher income beneficiaries tend to be healthier than lower income beneficiaries. This should mean that the wealthy, on average, get less in Medicare services each year

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<sup>4</sup> It is worth noting that Medicare Part B is also already subject to a means test. This program subsidizes the beneficiaries' share of premiums for insurance covering doctors' fees. In 2011 this subsidy amounts to just under \$2,000 a year. It is phased out for individuals over an income range from \$85,000 to \$213,000.

than lower income individuals.) This means that a means test applied to Medicare is likely to recover an even smaller portion of the programs' payouts than a means test for Social Security.

## The Rationale for Means Tests

In addition to considering the narrow economics of means testing, there are also moral and political issues that must be considered. On the moral side, there is an argument that people who pay into Social Security have a right to their benefit, regardless of how rich they are. No one proposes means testing payments from federal flood insurance or interest on government bonds. Arguably, Social Security benefits should be seen the same way.

On the political side, Social Security enjoys broad support presently because almost everyone expects to receive some benefit from the program. If a substantial group of workers and retirees no longer could expect a benefit then this could work to undermine support for the program. This would be especially likely if a means test was gradually expanded through time so that workers further down in the income distribution began to see cuts in benefits.

These are complex issues that need to be considered in reference to any plan to institute a means test. By comparison, the economics are relatively straightforward. The calculations in this paper suggest that a means test of Social Security is likely to provide relatively small savings unless it is designed to hit a substantial number of people who would not fit standard definitions of affluent. The portion of Social Security benefits that is paid to the wealthy is too small to make very much difference in the financing of the program. A means test that only pulls benefits away from the wealthy will have little impact on the finances of Social Security.

## Conclusion

Social Security benefits are relatively evenly distributed among retirees. The vast majority of benefits go to people who are low- or middle-income by any standard. This means that a means test that is focused on taking back benefits from upper income retirees is likely to raise very little money. The savings from means testing Social Security benefits are even smaller when factoring in any sort of behavioral response to what is effectively a substantial increase in the tax rates by seniors. When this response is taken into account, even a means test that would begin at levels that would hit middle-income retirees leads to savings that are just over 2.0 percent of the program's outlays. This suggests that means testing is not an effective route for reducing the cost of Social Security.

## Appendix

Table 1 shows the distribution of benefits by non-Social Security income. It is based on the CEPR extracts from the March Current Population Survey. The March CPS survey asks respondents about their income from any sources and income from Social Security in the preceding calendar year. The calculations exclude individuals less than the age of 62 and those who reported to have earned zero or negative overall income or Social Security income in 2009. The person income is based on the reported person income from any sources excluding the Social Security income. For a married-couple, the person income is calculated by summing the reported person income of each individual and dividing it by two. The same approach is used for calculating the Social Security income of married individuals.

Table 2 shows the savings from a hypothetical means test where 10 percent of Social Security benefits are taken back for each dollar of non-Social Security individual income in excess of \$40,000 and of \$100,000. In both cases it is assumed that the average earnings for individuals in each income bracket is the mid-point of that income bracket (e.g. the average earnings for individuals with incomes between \$40,000 and \$50,000 is assumed to be \$45,000). As a simplifying assumption, all beneficiaries are assumed to receive the average benefit for the income bracket. Both of these assumptions would have the effect of slightly exaggerating the money that would be saved through a means test. The calculations assume that the median income of those earning above \$200,000 is approximately \$220,000. The calculation for after-tax savings assumes that 85 percent of Social Security benefits are taxed at a 25 percent rate.

Table 3 shows the savings from a hypothetical means test where 20 percent of Social Security benefits are taken back for each dollar of non-Social Security individual income in excess of \$40,000 and of \$100,000. The assumptions about the distribution of income and benefits within brackets are the same as for Table 2.

Table 4 starts with the same assumptions on savings as the means test shown in Table 3. For the income brackets where the phase out effectively increases the marginal tax rate for beneficiaries, it assumes that the behavioral response reduces the revenue collected by 20 percent. For income brackets above this level (i.e. where the benefit has been fully phased out), it assumed that the savings from means test are identical to the calculations shown in Table 3.

Table 5 summarizes the before and after tax savings from the means tests shown in the prior tables. The last line shows the savings, factoring the reduction in income taxes that would result from the behavioral response assumed in Table 3. This assumes that the reduction in income assumed in the calculations shown in Table 3 would be taxed at an average rate of 25 percent. Since virtually all the affected beneficiaries would be in at least the 25 percent bracket and many would be in the 28 percent or even 33 percent bracket, this assumption is likely to understate the loss in income tax revenue.