

The Taxation of Social Security Benefits as an Approach to Means Testing

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Policy Abstract

Many Social Security reform proposals suggest cutting benefits in ways that concentrate the benefit cuts on those most able to bear them. The most common approach adjusts the Social Security benefit formula to reduce replacement rates by a greater amount for those with high levels of lifetime earnings. An alternative approach is to means test Social Security benefits – targeting benefit reductions on those with substantial non-Social Security financial resources. Since 1984, a limited amount of means testing has been accomplished by subjecting a portion of Social Security benefits to the income tax. This paper considers the advantages and disadvantages of means testing as an alternative to progressive benefit formula adjustments and analyzes how close the current taxation of Social Security benefits in the U.S. comes to achieving the potential benefits of means testing. The paper finds that retirement income sources other than Social Security benefits have substantial predictive power for consumption levels in retirement, implying that efforts to target Social Security benefit reductions on those most able to bear them may be more effective if done using information on both Social Security and non-Social Security income sources.

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