

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

JEFFREY B. LIEBMAN AND SARENA GOODMAN

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.

Means testing is generally defined as having eligibility for a government benefit or the level of the benefit depend on income or assets at the time the benefit is paid. Social Security benefits are a function of a worker's average lifetime earnings. But, benefit levels do not depend on income at the time of benefit receipt. Thus, the U.S. Social Security program is usually categorized as a social insurance program, rather than as a means-tested transfer program.

In the simplest life-cycle permanent income models, knowing a worker's lifetime earnings is a sufficient statistic for the worker's economic well-being. There would be no gain, therefore, to using information on non Social-Security retirement income as a basis for cutting Social Security benefits. But the real world differs from the stylized world of the simplest life-cycle models in several ways that could make means-testing desirable. In particular, people with the same lifetime earnings can end up with different levels of retirement income due to financial market luck, variation in amounts of employer-provided pensions or inheritances, low savings due to myopia, or adverse consumption shocks (such as medical expenses). Means-testing of benefits is a way of providing partial insurance against these sorts of variations in retirement well-being.

While means testing has the potential to improve welfare in all of these circumstances, it also has the potential to distort behavior. Reducing Social Security benefits for those who experience financial market success may discourage people from optimizing portfolio decisions. Reducing benefits for those receiving inheritances may alter bequest behavior. Reducing benefits for those who reach retirement with a significant amount of capital income may discourage saving. Thus, the decision whether or not to means test (and how much of it to do) will, in general, be an empirical question that will depend on the extent of the equity gains and the efficiency losses.

In the paper we present several facts about the current approach to taxing Social Security benefits. We show that tax revenue from taxing benefits amounts to only 4 percent of benefits paid and that two-thirds of beneficiaries pay no tax on their Social Security benefits. We show that half of the revenue

from taxing Social Security benefits comes from tax filing units with more than \$88,000 of income and that almost none comes from households with incomes below \$45,000. We explain how the taxation of Social Security benefits raises marginal tax rates on both earnings and savings.

Next we investigate whether information on the non-Social Security income sources for Social Security beneficiaries is of any value in determining a person's ability to absorb a reduction in Social Security benefits. It might be that Social Security benefits are close to a sufficient statistic for retirement consumption levels. In this case, the administrative complexity of taxing Social Security benefits is unnecessary. Distributional objectives can be accomplished simply by adjusting the progressivity of Social Security benefits.

It turns out that the correlation between Social Security benefit levels and other income on tax returns of beneficiaries is close to zero. This could mean that other income contains significant additional information on taxpayer's material well being and ability to pay beyond the lifetime earnings information inherent in Social Security benefits. But it could also mean that other income largely represents random noise.

To distinguish between these two interpretations, we examined the correlations between Social Security benefits, other income components, and consumption in the 2002 Consumer Expenditure Survey. We find that the correlation between consumption and non Social Security income is 0.567. The correlation between consumption and Social Security benefits is 0.311. The correlation between consumption and total income (the sum of Social Security benefits and non Social Security income) is 0.600, not much higher than the correlation with non-Social Security income alone. Regression results confirm 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.

The full working paper is available on our website www.nber.org/programs/ag/rrc/books&papers.html as paper NB08-02.

JEFFREY LIEBMAN is the Malcolm Wiener Professor of Public Policy at Harvard's Kennedy School of Government, Associate Director of the NBER Retirement Research Center, and an NBER Research Associate.

SARENA GOODMAN is a graduate student at Columbia University.

This research was supported by the U.S. Social Security Administration through grant #10-P-98363-5 to the National Bureau of Economic Research as part of the SSA Retirement Research Consortium. 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 NBER.