

GAO

Report to the Ranking Minority Member,
Subcommittee on Social Security,
Committee on Ways and Means, House of
Representatives

January 2000

SOCIAL SECURITY REFORM

Information on the Archer-Shaw Proposal



G A O

Accountability * Integrity * Reliability

Contents

Letter		3
Appendixes		
	Appendix I: Criteria for Evaluating Social Security Reform Proposals	22
	Appendix II: The Economic Model and Assumptions	24
	Appendix III: Comments From the Social Security Administration	28
Related GAO Products		30
Figures		
	Figure 1: Archer-Shaw: Unified Deficits/Surpluses as a Share of GDP	9
	Figure 2: Archer-Shaw: Debt Held by the Public as a Share of GDP	10
	Figure 3: Composition of Spending as a Share of GDP in 1998 and Under No Action and Archer-Shaw	11
	Figure 4: Social Security Spending as a Share of Total Federal Revenue in 1998 and Under No Action and Archer-Shaw	12
	Figure 5: No Action Model Assumptions	26

Abbreviations

CBO	Congressional Budget Office
GDP	gross domestic product
OASDI	Old Age Survivors and Disability Insurance
SSA	Social Security Administration



United States General Accounting Office
Washington, D.C. 20548

Comptroller General
of the United States

B-284323

January 18, 2000

The Honorable Robert T. Matsui
Ranking Minority Member
Subcommittee on Social Security
Committee on Ways and Means
House of Representatives

Dear Mr. Matsui:

This report responds to your request that we apply our criteria for assessing Social Security reform proposals to the proposal outlined by Representative Archer, Chairman of the Committee on Ways and Means, and Representative Shaw, Chairman of the Subcommittee on Social Security, Committee on Ways and Means. In November 1999, we issued a report presenting the results of our assessments of several Social Security reform proposals, including Archer-Shaw.¹ Our November report used a briefing slide format, thereby documenting congressional briefings we conducted prior to report issuance, including one to your office. This report responds to your request that we provide you with information from our briefing and some additional information on the Archer-Shaw proposal in the form of a report. Since legislation on the proposal had not yet been introduced at the time we did our work, we based our interpretation of the proposal in large part on the memorandum provided by the Office of the Chief Actuary at the Social Security Administration (SSA) in April 1999 when it estimated the proposal's long-range financial effect on the program.²

As agreed with your office, our report is based on the analytic framework we provided to the Congress last March.³ That framework consists of three basic criteria:

¹*Social Security: Evaluating Reform Proposals* (GAO/AIMD/HEHS-00-29, November 4, 1999).

²Memo from the Office of the Chief Actuary dated April 29, 1999. SSA has informed us that congressional staff responsible for developing the Archer-Shaw proposal provided all specifications cited in the memo.

³*Social Security: Criteria for Evaluating Social Security Reform Proposals* (GAO/T-HEHS-99-94, March 25, 1999).

-
- the extent to which the proposal achieves sustainable solvency and how it would affect the U.S. economy and the federal budget,
 - the balance struck between the twin goals of income adequacy (level and certainty of benefits) and individual equity (rates of return on individual contributions), and
 - how readily such changes could be implemented, administered, and explained to the public.⁴

In evaluating proposals against the three basic criteria, we used a set of detailed questions that help describe potential effects of reform proposals on important policy and operational aspects of public concern. (See appendix I for the list of questions.) The analysis presented below summarizes our results.

The Archer-Shaw Proposal

The Archer-Shaw proposal, known as “The Social Security Guarantee Plan,” would not reduce current-law benefits, and some workers could receive higher benefits under the proposal. The proposal would establish an individual account for each eligible worker and use the balances in these accounts to help finance benefits. The proposal would also remove the limits on how much retirees can earn without having their benefits reduced.⁵ The proposal as estimated in April 1999 by SSA’s Office of the Chief Actuary includes payroll tax reductions in the out-years. Congressional staff working on the proposal have informed us that the payroll tax reductions are under review.

The Archer-Shaw proposal would establish mandatory individual accounts for each eligible worker. To do this, the proposal would provide workers covered by Social Security with refundable tax credits from general revenues equivalent to 2 percent of their Old Age Survivors and Disability Insurance (OASDI) taxable earnings for each calendar year. Accounts would be managed by mutual funds, qualified and supervised by a board of six individuals appointed by the Social Security Trustees. All account

⁴*Social Security Reform: Implementation Issues for Individual Accounts* (GAO/HEHS-99-122, June 18, 1999) and *Social Security Reform: Administrative Costs for Individual Accounts Depend on System Design* (GAO/HEHS-99-131, June 18, 1999).

⁵Currently, the “earnings test” requires the withholding of benefits where beneficiaries under age 70 have earnings in excess of certain amounts. In 1999, for those aged 62 to 64, benefits are reduced by \$1 for every \$2 of earnings over \$9,600; for those aged 65 to 69, benefits are reduced by \$1 for every \$3 of earnings over \$15,500.

balances would be required to be invested in qualified mutual funds maintained with a portfolio allocation of 60 percent stock index funds and 40 percent corporate bonds. Annual administrative expenses would be limited to 25 basis points, and withdrawals prior to reaching retirement (or disability) would not be permitted.

Upon an individual's entitlement for retirement or disability benefits, SSA would compute the monthly payment that could be provided from a life annuity purchased with the holdings in the account. Under the proposal, the annuity calculation would reflect the account's anticipated yield, the indexing of annuity payments for price inflation, and the expected payment of spouse and survivor benefits. If the computed monthly annuity amount exceeded the level of scheduled OASDI benefits under current law, then SSA would guarantee payment from the trust funds of the computed annuity amount for life. If the computed annuity amount was less than the OASDI benefit level, then the OASDI benefit would be payable for life. Each month after benefit entitlement, the computed annuity amount would be transferred from the account to the OASDI trust funds.

Under the Archer-Shaw proposal as specified for the Office of the Chief Actuary in April 1999, the disposition of a worker's account balance at death depends on several factors. If there are no survivors eligible for benefits on the basis of the worker's earnings and the worker dies before receiving benefits, the account balance is transferred to the worker's estate tax free. If there are no eligible survivors and the worker has begun receiving benefits, the account balance is transferred to the OASDI trust funds. If there are eligible survivors, the account balance is transferred to the survivor's (e.g., spouse's) account.

The Archer-Shaw proposal as estimated by the SSA's Office of the Chief Actuary assumes a reduction in the OASDI payroll tax rate from 12.4 percent to 9.9 percent in 2050 and to 8.9 percent in 2060. These reductions reflect the specified portfolio allocation and an assumed real asset yield (after inflation) of 5.35 percent net of administrative expense. This combined yield is based on historical yields for equities and long-term corporate bonds.⁶

⁶In discussing the Archer-Shaw proposal, SSA's Office of the Actuary noted that the assumed long-term average real yield for stocks (7 percent) was based on the work of the 1994-96 Advisory Council, and the assumed real yield on long-term corporate bonds was based on the long-term historical premium paid (0.5 percentage point) over long-term Treasury notes.

Scope and Methodology

As you requested, we used our long-term economic model in assessing the Archer-Shaw proposal against the first criterion, that of financing sustainable solvency. Since 1992, we have provided the Congress with a long-term perspective by modeling the implications of differing fiscal policy paths for the nation's economy.⁷ Although any proposal's ability to achieve and sustain solvency is sensitive to economic and budgetary assumptions, using a common framework can facilitate comparisons of alternative reform proposals. Our simulation results are presented not as forecasts but rather as a useful way to compare the potential outcomes of alternative policies within a common economic framework. For Social Security and Medicare spending, we use the Trustees' intermediate estimates; in other respects, we generally rely on the Congressional Budget Office's (CBO) fiscal and economic assumptions.

In this report we used our long-term model to simulate the potential fiscal and economic impacts of the Archer-Shaw proposal over a 75-year projection period. In so doing, we relied on income and cost estimates for the proposal prepared by SSA's Office of the Chief Actuary, which reflect payroll tax reductions in 2050 and 2060, and adapted our model as appropriate to reflect specific reform proposal provisions. Given our reliance on that Office's estimates in modeling the proposal, the proposal descriptions presented in this report are generally based on its description.⁸ As in our work on other reform proposals, we considered the proposal in isolation. That is, we did not include any other proposals made by reform sponsors, such as proposed non-Social Security related tax cuts or spending increases, that would affect the government's fiscal position.

⁷For more information on GAO's long-term model, see *Budget Issues: Long-Term Fiscal Outlook* (GAO/T-AIMD/OCE-98-83, February 25, 1998).

⁸We supplemented the Actuary's memo with other material prepared by proposal sponsors and discussions with congressional staff.

Our analysis of the Archer-Shaw proposal included comparison with three other fiscal policy paths developed in our earlier work: (1) “No Action,” or “Save the Surplus,” which assumes continuation of current-law fiscal policies, i.e., preservation of the entire projected unified surplus, (2) “Eliminate non-Social Security surpluses,” and (3) “Long-term on-budget balance.”⁹ The No Action path reflects the assumptions of the CBO’s July 1999 baseline, which generally assumed the continuation of then-current law fiscal policies. With respect to discretionary spending, the CBO assumptions implied that there is no future emergency spending and that total actual spending would fall within the existing discretionary caps through 2002.¹⁰ No Action also uses the Trustees’ intermediate or “best estimates” of the program’s income and cost rates, which implicitly assume that all promised Social Security benefits will be paid throughout the 75-year simulation period, including after the projected exhaustion of the OASDI trust funds in 2034. (Appendix II contains more information on the assumptions underlying our long-term model.)

⁹“Eliminate non-Social Security surpluses” assumes that unspecified actions (i.e., spending increases and/or tax cuts) eliminate all projected on-budget surpluses; these changes from current law are then projected through the end of the 75-year simulation period. “Long-term on-budget balance” assumes that on-budget surpluses are eliminated but thereafter the on-budget portion of the budget is kept in balance through unspecified actions (i.e., spending cuts or revenue increases) throughout the rest of the simulation period. See appendix II for further details on the assumptions underlying these paths.

¹⁰In December 1999, CBO estimated that discretionary outlays in fiscal year 2000 would exceed the discretionary caps by \$16.6 billion. CBO also estimated that total fiscal year 2000 spending would be \$31.8 billion higher than its July 1999 baseline estimates. CBO noted that its January 2000 baseline estimates were likely to present a more favorable picture in light of recent economic trends. See CBO’s *Final Sequestration Report for Fiscal Year 2000* and also CBO’s *The Budget for Fiscal Year 2000: An End-of-Session Summary*.

We used qualitative research to examine how well the proposal balances adequacy and equity concerns and provides for reasonable implementation and communication of any changes. In so doing, we relied on our issued and ongoing body of work on Social Security reform. This work addresses various issues raised by reform approaches, including establishing individual accounts, raising the retirement age, and the impact of reforms on minorities and women.¹¹

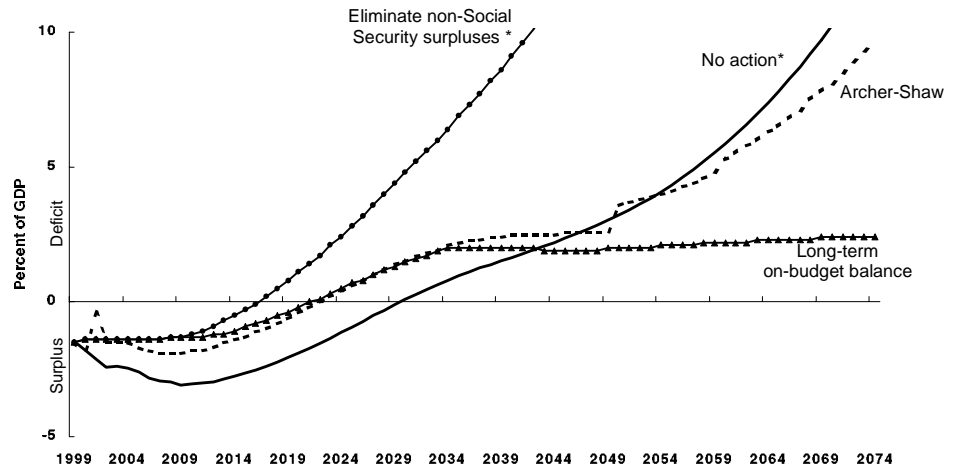
Financing Sustainable Solvency

This criterion assesses the extent to which the proposal, if adopted, would achieve sustainable solvency, including how the proposal would affect the federal budget and the economy. Elements considered in this criterion include a proposal's effects on (1) the federal government's unified surplus or deficit in the long term, (2) debt held by the public, (3) solvency of the OASDI trust funds, and (4) national saving. Other elements, such as how changes would be financed and potential effects on future program liabilities, are also considered.

In examining a proposal's long-term economic and budgetary effects, we compared our simulation results for the proposal with a policy of "No Action," in which the entire surplus would be saved. Compared to this reference point, the Archer-Shaw proposal would increase budgetary pressure through the middle of the next century, then reduce budgetary pressure in the latter years of the 75-year simulation period.

¹¹See *Social Security: Individual Accounts as an Element of Long-Term Financing Reform* (GAO/T-HEHS-99-86, March 16, 1999); *Social Security Reform: Implications of Private Annuities for Individual Accounts* (GAO/HEHS-99-160, July 30, 1999); *Social Security: Issues in Comparing Rates of Return With Market Investments* (GAO/HEHS-99-110, August 5, 1999); *Social Security Reform: Implications of Raising the Retirement Age* (GAO/HEHS-99-112, August 27, 1999); *Social Security Reform: Implications for Women* (GAO/T-HEHS-99-52, February 3, 1999); and *Social Security and Minorities: Current Benefits and Implications of Reform* (GAO/T-HEHS-99-60, February 10, 1999).

Figure 1: Archer-Shaw: Unified Deficits/Surpluses as a Share of GDP



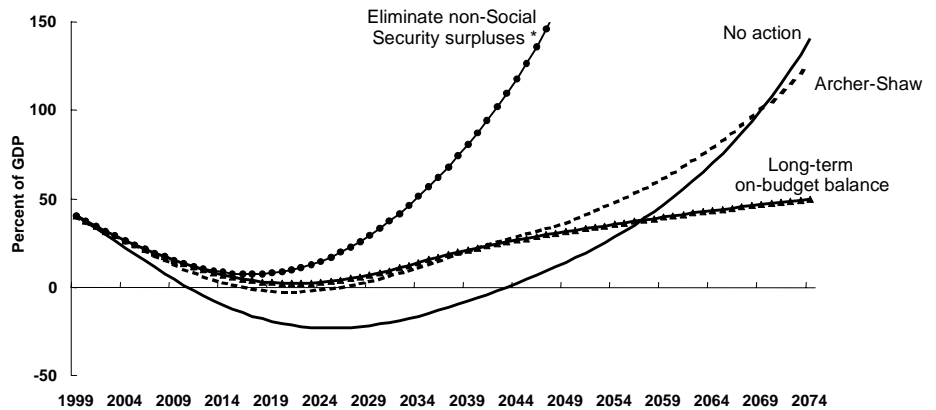
*Data end when deficits reach 10 percent of GDP.

Source: GAO's long-term model.

As shown in figure 1, the proposal compared to the No Action alternative reduces projected unified surpluses and increases projected unified deficits as a share of gross domestic product (GDP) through 2046. Thereafter, due to the estimated increasingly larger amounts being transferred from the individual account balances to the OASDI trust funds, the Archer-Shaw proposal would decrease unified deficits compared to No Action. Beginning around 2030, under the account yield assumptions made by the Office of the Chief Actuary, the recapture of funds from the individual accounts would begin to exceed the general revenue tax credits used to fund the accounts. As shown in our long-term model results presented in figure 1, unified deficits under Archer-Shaw emerge in 2023 and reach 9.7 percent of GDP in 2074; under No Action, unified deficits emerge in 2030 and reach 12.7 percent of GDP in 2074.

Compared to No Action, the Archer-Shaw proposal would increase levels of debt held by the public until shortly before the end of the 75-year simulation period. The levels of debt shown in figure 2 follow from the lower unified surpluses and higher unified deficits under Archer-Shaw than under No Action shown in figure 1.

Figure 2: Archer-Shaw: Debt Held by the Public as a Share of GDP



*Data end when debt reaches 150 percent of GDP.

Source: GAO's long-term model.

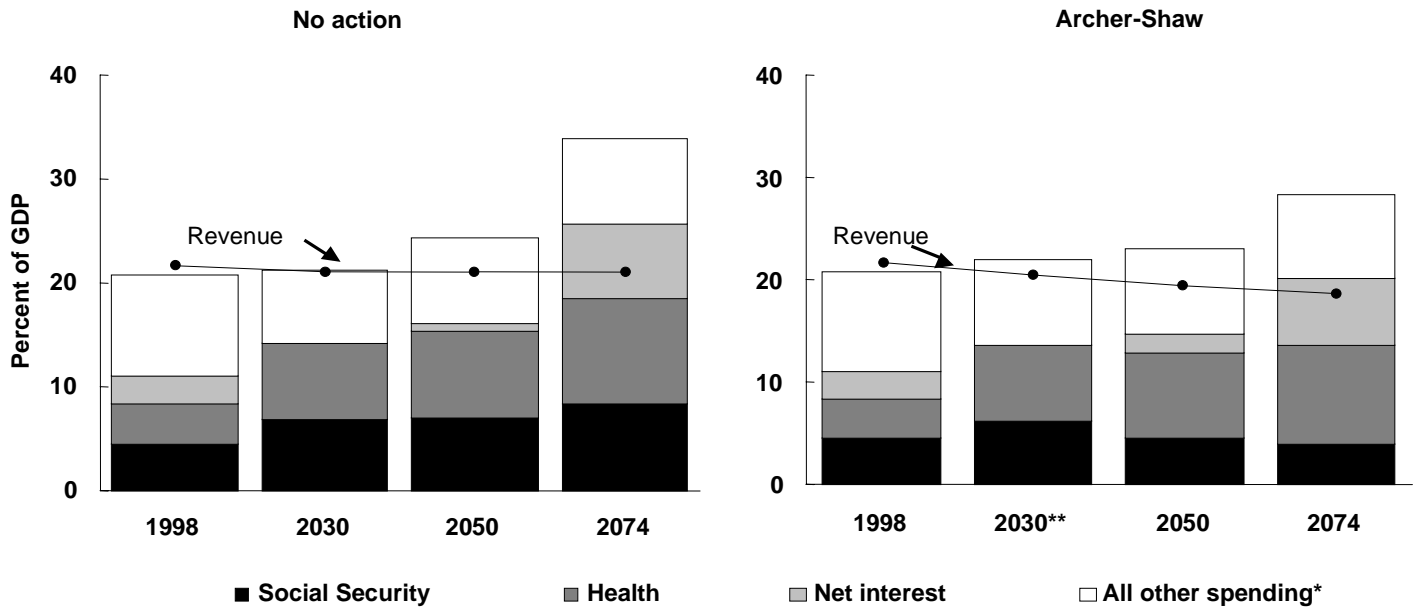
The lower unified surpluses mean less debt reduction than under No Action, and the higher unified deficits under Archer-Shaw mean more government borrowing and hence greater associated interest expense. After 2046, recaptured account balances more than offset the general revenue tax credits used to fund the accounts plus this higher interest expense, resulting in lower unified deficits compared to No Action. These lower deficits under Archer-Shaw slow the build-up of debt so that after 2067, debt held by the public would be lower than under No Action.

The Archer-Shaw proposal does not raise payroll taxes and does not use payroll tax revenue to finance the individual accounts. In effect, it draws on general revenues to finance individual accounts through the mechanism of a refundable tax credit equal to 2 percent of taxable payroll. In congressional testimony, the proposal sponsors stated that the Archer-Shaw proposal would use Social Security surpluses over the next 15 years to finance the accounts.¹² Under the estimates prepared by the Office of the Chief Actuary, the transfers from the individual accounts would exceed the general revenue credits beginning about 2031.

¹²Testimony of Representatives Bill Archer and Clay Shaw before the House Budget Committee Task Force on Social Security, June 29, 1999.

Figures 3 and 4 show program cost under No Action and Archer-Shaw as a share of the economy and as a share of the federal budget, respectively. Figure 3 shows that compared to No Action, the Archer-Shaw proposal has little impact on the net government cost of Social Security as a share of GDP in 2030 but cuts the net cost of the program roughly in half by 2074.

Figure 3: Composition of Spending as a Share of GDP in 1998 and Under No Action and Archer-Shaw



*All other spending includes offsetting interest receipts in 2030 under no action.

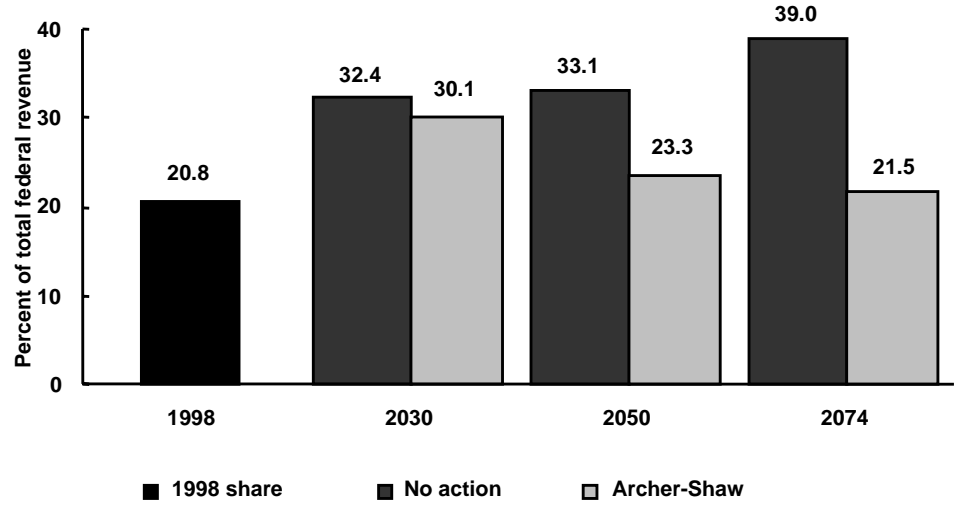
**Net interest is .03 percent in 2030.

Note: Since a tax credit reduces revenue, revenue under Archer-Shaw is net of the tax credit for individual accounts. Social Security spending is net of the offset from the individual accounts.

Source: GAO's long-term model.

Figure 4 shows that compared to No Action, the Archer-Shaw proposal would begin to lower net Social Security spending slightly as a share of federal revenues in 2030. By 2074, net program spending under Archer-Shaw would consume about half as much of federal revenues as in No Action—or about the same share of federal revenues as today.

Figure 4: Social Security Spending as a Share of Total Federal Revenue in 1998 and Under No Action and Archer-Shaw



Note: Since a tax credit reduces revenue, revenue under Archer-Shaw is net of the tax credit for individual accounts. Social Security spending is net of the offset from the individual accounts.

Source: GAO's long-term model.

The analyses presented in figures 3 and 4 assume that total federal revenue under Archer-Shaw is net of the tax credit for individual accounts, and Social Security spending is net of the offset (“recapture”) from the individual accounts. This analysis of net government cost follows the framework implicit in the estimates provided by SSA’s Office of the Chief Actuary.¹³

¹³As of the date of this report, no CBO cost estimate for the Archer-Shaw proposal was available.

You asked that we also provide information in this report on alternative approaches to analyzing the proposal's cost. Alternative approaches might focus on gross cost—that is, on the levels of total benefits provided. Such a measure would indicate the gross cost of the retirement benefits funded with resources flowing through the Social Security system. In this analysis, the amounts recaptured from the individual account balances would be included in total federal revenues, and the cost of the benefits financed by those amounts would be included in the gross cost. Under this approach, Social Security spending under Archer-Shaw would appear larger as a share of GDP than in our analysis of net government cost under the proposal and also larger as a share of total federal revenues. Compared to No Action, however, Social Security spending under the Archer-Shaw proposal would appear approximately the same as a share of GDP and somewhat smaller as a share of total federal revenues in the long run.¹⁴ An analysis of gross cost would not affect our simulation results of long-term fiscal position and debt held by the public under Archer-Shaw.

With regard to national saving, the actual effect of the Archer-Shaw proposal is unclear due to uncertainties in predicting the saving behavior of private households and individuals. On a national income accounting basis, the Archer-Shaw proposal would initially have no net effect. Through the tax credit used to create the individual accounts, government saving would be reallocated to private saving with no net change in national saving. The underlying assets in the economy would be unchanged, as would the total income generated by those assets. However, the government would ultimately receive a greater portion of the returns because of the recapture of the account balances invested in higher-yielding equities. If payroll tax reductions were implemented in 2050 and 2060, the net effect would be to reduce national saving.

In a report issued in June 1999, we analyzed the effects on national saving of several types of individual accounts as proposed in Social Security reform proposals.¹⁵ We found that these effects would depend on several variables. These would include the financing and structure of such accounts, for example, whether funds would come from inside or outside the Social Security system and whether withdrawals would be permitted.

¹⁴As noted above, in this analysis total federal revenue would include the transfer amounts.

¹⁵See *Social Security: Capital Markets and Educational Issues Associated With Individual Accounts* (GAO/GGD-99-115, June 28, 1999), pp. 30-32.

Where the funds used to finance the individual accounts come from outside the Social Security system, the effect on government savings would depend on what would have been done with the surplus or revenue if it had not been used to finance individual accounts.

- If the funds would have been used to pay down debt (as assumed in No Action/Save the Unified Surplus), then the direct effect of using funds to finance individual accounts would be to reduce government saving and increase private saving by the same amount.
- If the funds would have been used to finance additional government consumption spending, then any increase in private saving due to the individual accounts would increase national saving.
- If the funds would have been used for a tax cut, then national saving will increase if the individual accounts generate more private saving than the tax cut.

The actual effect of any reform proposal with individual accounts on national saving—including Archer-Shaw—would depend on behavioral offsets. For example, if households are forgoing current consumption by saving for their retirement, they may reduce these savings in response to a potential increase in future retirement benefits from individual accounts. There is, however, no expert consensus on how Social Security reform proposals would affect the saving behavior of private households and businesses.

According to the analysis provided by SSA's Office of the Chief Actuary, the Archer-Shaw proposal would restore 75-year actuarial balance to the OASDI trust funds and produce a stable trust fund ratio.¹⁶ By the end of the projection period, the Office of the Actuary estimated the trust fund ratio to be over 200 percent and rising. Under the Actuary's estimates, the proposal would result in a sustainable system with or without reductions in the payroll tax rate. Without the payroll tax reduction, the OASDI trust fund ratio would be expected to rise to over 10 times annual outgo by the end of the long-range period due to the estimated magnitude of the transfers flowing from the individual accounts.

¹⁶The trust fund ratio is a measure of the adequacy of the trust fund level in the short term. The ratio represents the proportion of a year's outgo that could be paid with the funds available at the beginning of the year.

The analysis prepared by the Office of the Chief Actuary noted, however, that the proposal's effects on trust fund solvency depend greatly on the assumed yields of the individual account investments. SSA's analysis assumed an expected real portfolio yield of 5.35 percent, net of administrative expense.¹⁷ In a sensitivity analysis that assumed yields of 1 percentage point lower than expected and no payroll tax reductions, the Office of the Chief Actuary estimated that the OASDI trust funds would be exhausted by 2048 and the actuarial balance would be -0.08 percent of taxable payroll for the 75-year projection period, compared with -2.07 under current law. In a second sensitivity analysis that assumed account yields of 1 percentage point higher than expected, the Office of the Chief Actuary estimated that the payroll tax rate reductions would be larger and would start sooner and the actuarial deficit would be eliminated. The actuarial balance would be an estimated +0.07 percent of payroll, and the trust fund ratio would be stable at about 300 percent at the end of the 75-year period.

Should the assumptions used by the Office of the Chief Actuary about future account yields prove overly optimistic and account balances indeed fall below what is needed to fund promised benefits, the OASDI trust funds would bear the resulting liability. This means that payments could only be made from the OASDI trust funds, not the general fund.¹⁸ Further, descriptions of the proposal do not include a safety valve to control program growth or to limit federal liabilities that could result. Some descriptions of the proposal, however, could be interpreted to imply a link between future payroll tax reductions and the realization of assumed account yields.

¹⁷In its November 1999 report to the Social Security Advisory Board, the 1999 Technical Panel on Assumptions and Methods recommended that SSA lower its assumptions about expected yield for both equities and government securities. Applying the technical panel's recommendations to the Archer-Shaw proposal would lead to a 0.9 percentage point lower return on individual accounts than the return used in the estimates made by the Office of the Chief Actuary. The Technical Panel is composed of actuaries, economists, and demographers appointed by the Social Security Advisory Board to review the assumptions and methodology used to project the future financial status of the OASDI trust funds.

¹⁸This statement is based on analysis of proposal descriptions, not on the specific wording of the legislation, which is not yet available.

Balancing Adequacy and Equity

This criterion evaluates the balance struck between the twin goals of income adequacy and individual equity. Income adequacy refers to the level and certainty of benefits provided to retirees, the disabled, dependents, and survivors. It is particularly important for low-income workers who are most reliant on the program, and may be achieved, in part, through a progressive benefit formula. Individual equity refers to rates of return on individual contributions. That is, it concerns the relationship between the benefit individuals receive and the contributions they have made to the Social Security system. Individual equity would be affected by giving workers greater choice and control over their contributions, which in turn could give them the potential to earn higher rates of return by investing in higher yielding assets, though generally by taking on greater investment risk at the same time. The current Social Security system makes certain trade-offs between the degree of income adequacy and individual equity provided by its benefit structure. Redistributive transfers embedded in the current system create an implicit “safety net” for workers and their families. At the same time, linking benefits to contributions invokes the standard of individual equity.

Because the Archer-Shaw proposal makes no changes to the benefit structure of the current Social Security system, it would not adversely affect income adequacy as compared to current promised benefit levels. Specifically, the Archer-Shaw proposal maintains current-law benefits for current and future retirees, including low-income workers and others most reliant on Social Security.¹⁹ It makes no changes to disabled, dependent, or survivor benefits and thus, retains the existing safety net. The proposal makes no changes from the current Social Security structure in the way workers are covered, and it preserves the progressivity of the existing system. In addition, it retains the compulsory nature of the current payroll tax. According to SSA actuaries, higher earners, especially two-earner couples with high earnings levels, would be more likely than lower income workers or one-earner couples to receive higher benefits under the proposal than under current law.

¹⁹If account balances fall below what is needed to fund promised benefits, the OASDI trust funds would bear the resulting liability. To address this liability, benefit or revenue adjustments could be required.

Consequently the Archer-Shaw proposal's individual account structure does have implications for individual equity. The proposal could enhance individual equity to the extent that it results in higher rates of return on workers' contributions. At the same time, individuals bear no investment risk because the proposal guarantees current law benefits. The Archer-Shaw proposal would pay current law benefits out of the OASDI trust funds, with the trust funds recapturing an amount from the individual account to finance those benefits. In the short run, the effect on individual equity would be limited, as the SSA actuaries estimate that these transfers would almost always take the entire account balances, leaving workers with the equivalent of their current law benefit. The Archer-Shaw proposal also affects individual equity through its provision to reduce payroll tax rates.²⁰ According to SSA's projections, future workers would pay lower payroll tax rates that would take effect in 2050 and 2060 with no benefit reductions. These tax reductions would increase rates of return on contributions, enhancing individual equity.

Individual equity applies not only to comparisons made within a generation of workers, but across generations as well. The Archer-Shaw proposal's stable patterns of contributions and benefits could result in fairly level rates of return across generations. Benefit levels would be the same as under current law over the next 75 years for virtually all workers. The amounts credited to an individual's account are increased immediately by 2 percent, and then remain constant until proposed tax cuts take effect in 2050 and 2060.²¹ Future workers benefiting from these tax cuts would then receive higher rates of return.²²

²⁰As stated earlier, this tax cut provision is under review.

²¹In a technical sense, contribution rates in the form of higher payroll taxes are not increased, as Archer-Shaw relies on a refundable tax credit to finance its individual account feature. Under the proposal, Treasury will transfer an aggregate 2 percent of OASDI taxable earnings to Social Security for these accounts. However, since SSA then credits the individual account of each covered worker with this amount and provides periodic information on the performance of those contributions, they can be considered a *de facto* increase in workers' contribution rates.

²²By comparison, raising the payroll tax under the current system immediately by 2.15 percentage points would result in the same actuarial balance as the Archer-Shaw proposal. Such a tax increase would also pay current law benefits and result in a constant tax rate over the next 75 years. Therefore, these two approaches would have very similar effects on generations for the next several decades, though the Archer-Shaw proposal would improve rates of return for generations in the distant future.

Increasing workers' control over contributions and providing greater investment choice also potentially enhances individual equity.²³ The Archer-Shaw proposal would not give individuals as much control over their accounts as 401(k) accounts since individuals would not be able to borrow or otherwise use these funds for nonretirement purposes prior to death or retirement. However, in certain circumstances, workers could bequeath their account balances to their heirs. The Archer-Shaw proposal does provide investment choices to workers, subject to certain limitations. Account investments are constrained to mutual funds with a portfolio allocation of 60 percent equities and 40 percent fixed income securities. Within this overall constraint, investment choices will be limited largely to those bond and equity index funds approved by the proposal's Social Security Guarantee Board.

Implementing and Administering Reforms

This criterion evaluates how readily proposed changes could be implemented, administered, and explained to the public. Implementation and administration issues are important because they have the potential to delay—if not derail—reform if they are not considered early enough for planning purposes. Moreover, such issues can influence policy choices—feasibility and cost should be integral factors in ultimate decisions regarding the Social Security program. In addition, potential transparency and public education needs associated with various proposals should be considered. Reforms that are not well understood could face difficulties in achieving broad public acceptance and support.

As reform proposals are developed, two key design elements are often overlooked: timing and funding for implementation. The Archer-Shaw proposal does not explicitly provide funding for implementation of its changes to the Social Security system, nor does it provide a specific time frame for implementing those changes. However, the proposal would establish a Social Security Guarantee Board, which would have supervisory control over funds investment and could be responsible for establishing a time frame for implementation.²⁴ The Board's main role would be to

²³Increased choice and control over investments could also expose individuals to greater financial risk and could lead to lower rates of return.

²⁴SSA has expressed concerns about lead time for the Board to get established, including time for operational preparation, legislative interpretation, regulation development and publication, and systems development.

develop investment policies that provide prudent diversification of investments and low administrative costs. The Board also could have a role in implementing safeguards against politically motivated investing of the accounts.²⁵

The Archer-Shaw proposal estimates that administrative costs for the program would not exceed 25 basis points. This estimate may not be realistic, especially in the long term. The cost of administering a system that includes individual accounts would depend on decisions made about who would assume new administrative and recordkeeping responsibilities, how much choice or discretion individuals would have in selecting and changing their investment options, and how workers would receive their benefits when they retire.²⁶ While the Archer-Shaw proposal's reliance on index funds could reduce administrative expenses to some degree, its administrative costs would also depend, in large part, on the number of index funds ultimately offered to participants. In previous work we reported that, in general, administrative costs are higher for more decentralized systems and for those offering broader investment choices, more customer service options, or both.²⁷ In addition, the estimate of 25 basis points does not take into account other costs related to the establishment of individual accounts, such as the cost to SSA for modifying agency software to incorporate changes in payout calculations, the need for employee hiring and training, acquisition of equipment and facilities to support customer service, and promulgation of new regulations, policies and procedures. These categories represent primarily one-time costs.²⁸

Public understanding of both the financing and benefit structures is critical to any reform proposal. Public confidence is increased when the financing mechanism is readily understood by all, and broad-based support for the

²⁵While none of the proposals we have evaluated thus far have provided specific information about how they would be implemented, the Archer-Shaw proposal includes more detail than some others we reviewed. See *Social Security: Evaluating Reform Proposals* (GAO/AIMD/HEHS-00-29, November 4, 1999).

²⁶For more detail on implementation issues, see *Social Security Reform: Implementation Issues for Individual Accounts* (GAO/HEHS-99-122, June 18, 1999).

²⁷For more detail on administrative cost issues see *Social Security Reform: Administrative Costs for Individual Accounts Depend on System Design* (GAO/HEHS-99-131, June 18, 1999).

²⁸The proposal also does not clearly discuss the treatment of fees and commissions to the certified qualified professional asset managers who will manage the accounts.

program is more easily maintained. Various elements of the Archer-Shaw proposal may be particularly difficult to explain clearly and simply. Participants will need to understand that the tax credit financing structure of the proposal does not mean that individuals would actually file for this credit on their tax returns. Rather, it would be automatically credited to their individual accounts. Similarly, the complex “offset” feature of the benefit structure, which reduces Social Security benefits by the amount that is accumulated in the individual account, must also be clearly explained. Otherwise retirees may expect a larger return than the proposal actually provides, potentially creating an “expectations gap.” For example, some people may devote a significant amount of time to choosing between the different investment options, only to have their choices provide no more than an incremental increase in their retirement benefit. Their perception could then be that they have received a poor rate of return on their individual accounts. To avoid these perception problems an extensive education program will be necessary.

At the same time, investment education will be needed to give individuals information about financial planning and general investment strategies, as well as the specific choices made available to them and the risks associated with each. The need to provide these education programs could place an administrative burden, as well as extra costs, on SSA. The Archer-Shaw proposal does not directly provide for such a program or the resources necessary for SSA or other agencies to conduct such an effort.

Agency Comments and Our Evaluation

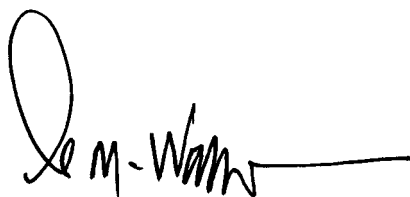
We requested comments on a draft of this report from SSA. SSA generally agreed with GAO’s treatment of the issues. SSA’s comments, which can be found in appendix III, reemphasized the point made by the Office of the Chief Actuary that the proposal’s success in reaching solvency is sensitive to assumptions about future account yields. SSA also provided a number of technical comments, which we incorporated as appropriate.

Unless you release the contents of this report earlier, we will not distribute it until 30 days from the date of this letter. At that time we will send copies of this report to the Honorable Bill Archer, Chairman, and the Honorable Charles B. Rangel, Ranking Member, House Ways and Means Committee; the Honorable Clay Shaw, Chairman, Subcommittee on Social Security, House Ways and Means Committee; other interested congressional committees; the Honorable Kenneth S. Apfel, Commissioner of Social

Security; and the Honorable Lawrence Summers, Secretary of the Treasury. Copies will be made available to others upon request.

If you or your staff have any questions about this report, please contact Cynthia M. Fagnoni, Director, Education, Workforce, and Income Security Issues, on (202) 512-7215 or Paul L. Posner, Director, Budget Issues, on (202) 512-9573.

Sincerely yours,

A handwritten signature in black ink, appearing to read "D. M. Walker", with a long horizontal line extending to the right.

David M. Walker
Comptroller General
of the United States

Criteria for Evaluating Social Security Reform Proposals

Financing Sustainable Solvency

This criterion evaluates the extent to which the proposal achieves sustainable solvency, including how the proposal would affect the economy and the federal budget.

To what extent does the proposal:

- Reduce future budgetary pressures?
- Reduce debt held by the public?
- Reduce the cost of the Social Security system as a percentage of GDP?
- Reduce the percentage of federal revenues consumed by the Social Security system?
- Increase national saving?
- Restore 75-year actuarial balance and create a stable system?
- Raise payroll taxes, draw on general revenues, and/or use Social Security trust fund surpluses to finance changes?
- Create contingent liabilities?
- Include “safety valves” to control future program growth?

Balancing Adequacy and Equity

This criterion evaluates the balance struck between the twin goals of income adequacy (level and certainty of benefits) and individual equity (rates of return on individual contributions).

To what extent does the proposal:

- Change current-law benefits for current and future retirees?
- Maintain benefits for low-income workers who are most reliant on Social Security?
- Maintain benefits for the disabled, dependents, and survivors?
- Ensure that those who contribute receive benefits?
- Provide higher replacement rates for lower income earners?
- Expand individual choice and control over program contributions?
- Increase returns on investment?
- Improve intergenerational equity?

Implementing and Administering Reforms

This criterion evaluates how readily such changes could be implemented, administered, and explained to the public.

To what extent does the proposal:

Appendix I
Criteria for Evaluating Social Security
Reform Proposals

- Provide reasonable timing and funds for implementation and result in reasonable administrative costs?
- Allow the general public to readily understand its financing structure and increase public confidence?
- Allow the general public to readily understand the benefit structure and avoid expectations gaps?
- Limit the potential for politically motivated investing?

The Economic Model and Assumptions

GAO's long-term economic model has been used since 1992 to assess the potential fiscal and economic impacts of alternative policy choices. Based on an economic growth model developed by economists at the Federal Reserve Bank of New York, the model simulates the interrelationships between the budget and the economy over a 75-year projection period. The key interaction between the budget and the economy in the model is the effect of the unified federal deficit/surplus on the amount of national saving available for investment, which influences long-term economic growth.

The long-term simulations generated by the model illustrate the relative fiscal and economic outcomes associated with alternative policy paths and thus provide a useful way to compare alternatives within a common economic framework. The simulations are not predictions of what would actually happen in the future. For example, in reality policymakers likely would take action before the occurrence of the negative out-year fiscal and economic consequences reflected in some simulated fiscal policy paths. In addition, the model reflects the interrelationships between the budget and the economy over the long term and does not capture their interaction during short-term business cycles. Assumptions underlying the model have been chosen to be conservative in recognition of the uncertainties inherent in long-term simulations,¹ but variation in these assumptions generally would not affect the *relative* outcomes of the alternative policies being compared.

In our November 1999 report, we compared several Social Security reform proposals to the following three fiscal policy paths developed as part of GAO's ongoing model work.

- **No Action/Save the Surplus** assumes no changes in current policies and thus results in saving the unified surpluses. This assumption implies no emergency spending and actual spending that falls within the existing discretionary caps. Thus, unified budget surpluses through 2029 are used to reduce debt held by the public. Thereafter, unified deficits are permitted to emerge. Discretionary spending follows CBO's 10-year projections, which assume compliance with the spending caps through 2002 and growth with inflation through 2008. Thereafter, we assume discretionary spending grows with the economy.
- **Eliminate non-Social Security surpluses** assumes that permanent unspecified policy actions (i.e., spending increases and/or tax cuts) are

¹For example, interest rates and total factor productivity growth are held constant.

taken through 2009 that eliminate the projected on-budget surpluses. Thereafter, these unspecified actions are projected through the end of the simulation period. On-budget deficits emerge in 2010, followed by unified deficits in 2017.

- **Long-term on-budget balance** assumes that the on-budget surplus is eliminated through 2009, as in the previous path. Thereafter, the on-budget portion is kept in balance by actions that cut spending and/or raise revenue to prevent on-budget deficits from emerging. This results in a unified surplus/deficit equal to the OASDI trust funds' annual surplus/deficit through 2034 and equal to the OASDI annual cash deficit thereafter.

All three paths assume payment in full of all currently promised OASDI benefits, including after the projected exhaustion of the OASDI trust funds in 2034.

Fiscal and economic assumptions underlying the No Action simulation generally reflect those of CBO's July 1999 baseline.² As shown in figure 5, the model uses the Trustees' 1999 intermediate estimates for Social Security and Medicare spending.

²For alternative fiscal policy simulations, certain assumptions are varied, which are noted in the discussion of the alternative policy paths. CBO will next update its baseline, including technical and economic assumptions, in January 2000.

Appendix II
The Economic Model and Assumptions

Figure 5: No Action Model Assumptions

Model Inputs	Assumptions
Unified surplus/deficit	CBO through 2008; GAO simulations thereafter
Social Security spending (OASDI)	1999 Social Security Trustees' Intermediate projections
Medicare spending (HI and SMI)	1999 Medicare Trustees' intermediate projections
Medicaid spending	CBO's projections
Other mandatory spending	CBO's assumed levels through 2008; thereafter, increases at the rate of economic growth (i.e., remains constant as a share of GDP)
Discretionary spending	CBO through 2008; thereafter, increases at the rate of economic growth
Receipts	CBO's assumed levels through 2008 ; in subsequent years, receipts held constant at 21.1% of GDP (CBO's projection in 2008)
Saving rate : gross saving of the private sector and state and local government sector	17.4%
Share of gross national saving that flows abroad	33.3%
Labor: growth in hours worked	1999 Social Security Trustees' intermediate projections
Total factor productivity growth	1.1%
Inflation (GDP price index)	CBO through 2009; 1.9% thereafter (CBO's projection in 2009)
Interest rate (average on the national debt)	Average rate implied by CBO's interest payment projections through 2008; 5.6% thereafter (CBO's implied rate in 2008)

Note: In all our work, all CBO budget projections were converted from a fiscal year to a calendar year basis. The last year of CBO's projection period is fiscal year 2009, permitting the calculations of calendar year values through 2008.

Some of the assumptions underlying No Action were not fully realized in the recently enacted fiscal year 2000 budget,³ and other assumptions may or may not prove realistic over time. For example, discretionary spending follows CBO's July 1999 10-year projections, which assume (1) no emergency spending and (2) actual spending that falls within the existing discretionary caps through 2002 and then grows with inflation through 2008. However, CBO reported in December that, including adjustments to the discretionary caps for fiscal year 2000 enacted emergency spending, discretionary spending enacted for fiscal year 2000 exceeded the caps.

In simulating the Archer-Shaw and other Social Security reform proposals, we relied on estimates of OASDI income and cost provided by the Office of the Chief Actuary at SSA. The OASDI cost estimates for each proposal

³In December 1999, CBO published re-estimates reflecting the effect of enacted budget legislation. See CBO's *Final Sequestration Report for Fiscal Year 2000* and also CBO's *The Budget for Fiscal Year 2000: An End-of-Session Summary*.

reflect all proposed reforms affecting benefits, and the OASDI income estimates reflect reforms affecting financing elements. For example, for the Archer-Shaw proposal the OASDI cost estimates reflect the estimated amounts of transfers from the individual accounts to the OASDI trust funds; the OASDI income estimates reflect proposed payroll tax reductions.

As with other reform proposal simulations, on-budget revenue and spending in the Archer-Shaw simulation reflect the assumptions underlying our base simulation—the “No Action” or “Save the Surplus” path—adjusted for reform proposal changes affecting on-budget totals. For example, in modeling Archer-Shaw, a reduction was made to federal revenues to reflect the refundable tax credit used to finance individual accounts; this reduction was also based on data provided by the Office of the Chief Actuary.

We did not audit or validate the projections of CBO or the Social Security and Medicare actuaries. We conducted this work from August through December 1999 in accordance with generally accepted government auditing standards.

Comments From the Social Security Administration



SOCIAL SECURITY

Office of the Commissioner

January 07, 2000

Cynthia Fagnoni
Director, Education, Workforce,
and Income Security Issues
United States General Accounting Office
Washington, DC 20548

Dear Ms. Fagnoni,

Enclosed are our comments on the General Accounting Office's (GAO) draft report Social Security Reform: Information on the Archer-Shaw Proposal (GAO/HEHS-00-XX). We appreciate the opportunity to review the report and hope these comments will prove useful.

We are pleased that this GAO report provides additional information on the Social Security Guarantee Plan proposed by Representatives Archer and Shaw. Improving the understanding of this proposal is important because of the unique nature of some of the financing provisions, such as individual accounts with a "recapture" or offset provision and a guarantee of current law benefit levels. The information in this report will no doubt increase the level of understanding of this proposal, and we commend you in this effort.

We would like to emphasize a point mentioned in the report that the success of the proposal in reaching solvency is sensitive to the assumptions about future account yields. For example, if account yields were one percentage point lower, the proposal would not restore long-term actuarial balance. We believe that additional discussion in the report regarding the sensitivity of future account yields to achieving solvency would be beneficial.

Additionally, the report's discussion of the proposal's effect on national saving includes a noteworthy comment about the uncertainty of predicting the behavioral response to individual accounts. Some have concluded that introducing these accounts

SOCIAL SECURITY ADMINISTRATION BALTIMORE MD 21235-0001

**Appendix III
Comments From the Social Security
Administration**

would increase national saving, but the report's discussion of this issue indicates that this area needs more examination. One area in particular that needs more exploration is the scenario where the public misunderstands the offset mechanism and has mistakenly high expectations about future benefit amounts, leading to lower personal savings.

Finally, the report states that transferring the 2 percent of covered earnings to Social Security via a refundable tax credit could be considered a de facto increase in worker contribution rates. We believe that this is an important point to consider.

Our specific comments are detailed in the attached document. Our comments are abbreviated due the limited time we were provided to comment, which fell over a holiday period. If you should have any questions concerning our comments, you may contact Jane L. Ross, the Social Security Administration's Deputy Commissioner for Policy, at (202) 358-6082 in Washington, or (410) 966-6756 in Baltimore. Again, we appreciate the opportunity to review the draft report and request an opportunity to review the revised report. We look forward to the GAO's continued involvement in this vital debate.

Sincerely,



Kenneth S. Apfel
Commissioner
of Social Security

Enclosure

Related GAO Products

Social Security: Evaluating Reform Proposals (GAO/AIMD/HEHS-00-29, November 4, 1999).

Social Security Reform: Implications of Raising the Retirement Age (GAO/HEHS-99-112, August 27, 1999).

Social Security: Issues in Comparing Rates of Return With Market Investments (GAO/HEHS-99-110, August 5, 1999).

Social Security: Implications of Private Annuities for Individual Accounts (GAO/HEHS-99-160, July 30, 1999).

Social Security: Capital Markets and Educational Issues Associated with Individual Accounts (GAO/GGD-99-115, June 28, 1999).

Social Security Reform: Administrative Costs for Individual Accounts Depend on System Design (GAO/HEHS-99-131, June 18, 1999).

Social Security Reform: Implementation Issues for Individual Accounts (GAO/HEHS-99-122, June 18, 1999).

Social Security: Criteria for Evaluating Social Security Reform Proposals (GAO/T-HEHS-99-94, March 25, 1999).

Social Security: Individual Accounts as an Element of Long-Term Financing Reform (GAO/T-HEHS-99-86, March 16, 1999).

Social Security and Surpluses: GAO's Perspective on the President's Proposals (GAO/T-AIMD/HEHS-99-96, February 23, 1999).

Social Security and Minorities: Current Benefits and Implications for Reform (GAO/T-HEHS-99-60, February 10, 1999).

Social Security: What the President's Proposal Does and Does Not Do (GAO/T-AIMD/HEHS-99-76, February 9, 1999).

Social Security Reform: Implications for Women (GAO/T-HEHS-99-52, February 3, 1999).

Budget Issues: Long-Term Fiscal Outlook (GAO/T-AIMD/OCE-98-83, February 25, 1998).

Ordering Information

The first copy of each GAO report and testimony is free. Additional copies are \$2 each. Orders should be sent to the following address, accompanied by a check or money order made out to the Superintendent of Documents, when necessary, VISA and MasterCard credit cards are accepted, also.

Orders for 100 or more copies to be mailed to a single address are discounted 25 percent.

Orders by mail:

**U.S. General Accounting Office
P.O. Box 37050
Washington, DC 20013**

or visit:

**Room 1100
700 4th St. NW (corner of 4th and G Sts. NW)
U.S. General Accounting Office
Washington, DC**

**Orders may also be placed by calling (202) 512-6000
or by using fax number (202) 512-6061, or TDD (202) 512-2537.**

Each day, GAO issues a list of newly available reports and testimony. To receive facsimile copies of the daily list or any list from the past 30 days, please call (202) 512-6000 using a touchtone phone. A recorded menu will provide information on how to obtain these lists.

For information on how to access GAO reports on the INTERNET, send an e-mail message with "info" in the body to:

info@www.gao.gov

or visit GAO's World Wide Web Home Page at:

<http://www.gao.gov>

**United States
General Accounting Office
Washington, D.C. 20548-0001**

**Official Business
Penalty for Private Use \$300**

Address Correction Requested

<p>Bulk Rate Postage & Fees Paid GAO Permit No. GI00</p>

