GAO
Accountability * Integrity * Reliability

Comptroller General
of the United States

United States General Accounting Office
Washington, DC 20548

B-284692

February 29, 2000

The Honorable Nick Smith
House of Representatives

Subject: Social Security Reform: Evaluation of the Nick Smith Proposal

Dear Mr. Smith:

This letter responds to your request that we extend our previous analysis of the potential budgetary and economic effects of various Social Security reform proposals[1] to include the proposal you have put forth. This letter follows the methodology and format of and uses the same economic assumptions as our previously issued reports. Our analysis of your proposal is based on cost estimates provided by the Office of the Chief Actuary, Social Security Administration (SSA);[2] the legislative language contained in H. R. 3206; and discussions with your staff. In summary, as agreed with your office, our assessment of your proposal is based on the analytic framework we provided to the Congress last March, which consists of three basic criteria:[3]

- the extent to which the proposal achieves sustainable solvency and how it would affect the economy and the federal budget (see pages 13 through 18);
- the balance struck between the twin goals of income adequacy (level and certainty of benefits) and individual equity (rates of return on individual contributions) (see pages 19 through 20), and

[1] *Social Security: Evaluating Reform Proposals* (GAO/AIMD/HEHS-00-29, Nov. 4, 1999) and *Social Security Reform: Evaluation of the Gramm Proposal* (GAO/AIMD/HEHS-00-71R, Feb. 1, 2000).

[2] As provided in the memo from the Office of the Chief Actuary, dated November 3, 1999.

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

- how readily such changes could be implemented, administered, and explained to the public (see page 21).[4]

In evaluating your proposal against the three basic criteria, we used a set of detailed questions, included on pages 6 through 8, to determine potential effects of reform proposals on important policy and operational aspects of public concern.

As you requested, we used our long-term economic model in evaluating the proposal against the first criterion, that of financing sustainable solvency.[5] Specifically, we used this model to simulate the potential fiscal and economic impacts of your proposal over a 75-year projection period. In simulating the reform proposal, we used the income and cost estimates prepared by the Office of the Actuary at SSA, and we adapted the model as appropriate to reflect specific reform proposal provisions. As you requested, our simulation results also compare the proposal with alternative fiscal policy paths developed in our prior model work. As agreed with your office, in order to permit comparison with other reform plans discussed in our issued work, the long-term simulations presented in this report are based on the economic and budget assumptions contained in the Congressional Budget Office's July 1999 baseline.

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 determining the impact of reforms on minorities and women.[6]

We provided a draft of this letter and the enclosure to SSA. We received oral comments from SSA's Office of Retirement Policy and Office of the Chief Actuary and have incorporated these as appropriate. We conducted our work from November 1999 through February 2000 in accordance with generally accepted government auditing standards.

---

[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).

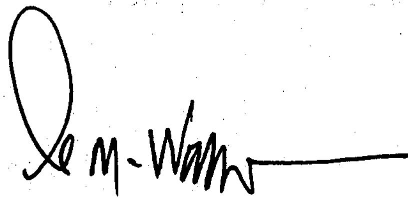
[5]For our analysis of the Smith proposal, we relied upon the economic and budget assumptions contained in the Congressional Budget Office's July 1999 baseline. These are the same assumptions we used in our earlier analysis of other Social Security reform proposals.

[6]See *Social Security: Individual Accounts as an Element of Long-Term Financing Reform* (GAO/T-HEHS-99-86, Mar. 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, Aug. 5, 1999); *Social Security Reform: Implications of Raising the Retirement Age* (GAO/HEHS-99-112, Aug. 27, 1999); *Social Security Reform: Implications for Women* (GAO/T-HEHS-99-52, Feb. 3, 1999); and *Social Security and Minorities: Current Benefits and Implications of Reform* (GAO/T-HEHS-99-60, Feb. 10, 1999).

We are sending copies of this report to the Honorable Kenneth S. Apfel, Commissioner of the Social Security Administration; the Honorable Lawrence Summers, Secretary of the Treasury; and other interested parties. Copies will be made available to others upon request.

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

Sincerely yours,



David M. Walker
Comptroller General
of the United States

Enclosure

Criteria for Evaluating Social Security Reform Proposals

The three basic criteria that provide policymakers with a framework for assessing reform plans:

- Financing Sustainable Solvency
- Balancing Adequacy and Equity in the Benefits Structure
- Implementing and Administering Reforms

Evaluating Social Security Reform Proposals

- Comprehensive proposals can be evaluated against three basic criteria.
- Reform proposals should be evaluated as packages that strike a balance among individual reform elements and important interactive effects.
- Some proposals will fare better or worse than other proposals under each criterion.
- Overall evaluation of each proposal depends on the weight individual policymakers place on each criterion.

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:

- 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 expectation gaps?
- Limit the potential for politically motivated investing?

Financing Sustainable Solvency: GAO's Long-term Economic Model

- GAO's long-term economic model is used to help assess the potential fiscal and economic impacts of Social Security reform proposals.
- The economic model was originally developed by economists at the Federal Reserve Bank of New York.
- 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.
- Long-term simulations provide illustrations--not precise forecasts--of the relative fiscal and economic outcomes associated with alternative policy paths.

Financing Sustainable Solvency: Alternative Fiscal Policy Simulations

Reform simulations are compared to several long-term simulations developed as part of GAO's ongoing model work. These simulations are based on the economic and budget assumptions contained in CBO's July 1999 baseline. All simulations assume payment of current-law Social Security benefits using general revenues to supplement payroll tax financing.

- **No action** assumes no changes in current policies and thus results in saving the unified surpluses. This assumption implies no emergency spending and that actual spending falls within the existing discretionary caps. Thus unified budget surpluses through 2029 are used to reduce debt held by the public. Thereafter, 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 taken through 2009 that eliminate the 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 2019.

- **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 Social Security annual cash deficit thereafter.

Smith, H.R. 3206

- Defined benefits are generally reduced from current law through changes to the benefit formula and increases in the normal retirement age. At retirement, an additional reduction to OASI benefits is made based on individual account contributions. Surviving aged spouses would receive the reduced benefit plus 10 percent.

- Individual "carve-out" accounts are equal to 2.5 percent of all taxable payroll for years 2001-2025 and 2.75 percent of all taxable payroll for years 2026-2038.[1] After 2038, carve-out amounts would be based on OASDI income in excess of the amount needed to cover annual program costs and a small contingency reserve. Fifty percent of a married individual's account contribution would be credited to the spouse's account. Additional voluntary contributions to individual accounts are allowed up to $2,000 annually. Individuals may choose among investment funds approved by the Secretary of the Treasury.

[1] In estimating the proposal, SSA's Office of the Chief Actuary assumed universal individual account participation. Mr. Smith's staff informed us that the intent of the legislation was that individual account participation would be voluntary.

Smith, H.R. 3206

- General revenue transfers to the OASDI trust funds in the years 2001-2009 equal to CBO's April 1999 estimates of the non-Social Security surplus for these years. Some additional general revenue would finance certain Disability Insurance benefits.
- At retirement the expected lifetime OASI defined benefit would be reduced by the amount of individual account contributions plus interest accumulated at a 3.7 percent real rate. This hypothetical accumulation would reflect contribution amounts plus interest as if the account had been invested at the special Treasury rate of 3 percent plus 0.7 percentage points. Account balance at death is transferred to worker's estate.

Smith, H.R. 3206
Financing Sustainable Solvency

As illustrated in the following graphs, compared to No Action, the Smith proposal:

- Reduces projected unified surpluses until 2027 but maintains unified surpluses that average about 0.5 percent of GDP through 2072. (Figure 1)
- Results in higher levels of debt held by the public in the near term but eliminates debt by 2017 and prevents debt from reemerging throughout the end of the simulation period. (Figure 2)
- Lowers the net government cost of Social Security as a share of GDP in 2030 by 2.2 percentage points--almost one-third. Compared to No Action, the proposal reduces the government's cost of the program by nearly 90 percent by 2074. Total revenue falls over this period by the amount of the carve-out. (Figure 3)
- Lowers net Social Security spending as a share of federal revenues in 2030 by 9.3 percentage points--about one-fourth. In 2074, program spending would consume about 6 percent of federal revenues--or about one-fourth of today's Social Security spending as a share of federal revenues. (Figure 4)

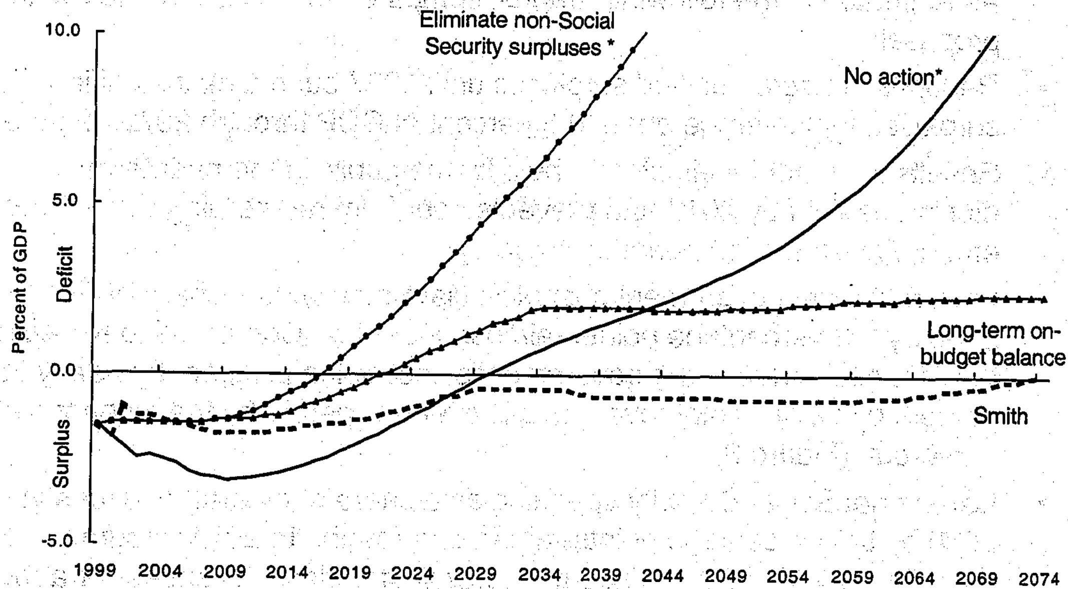
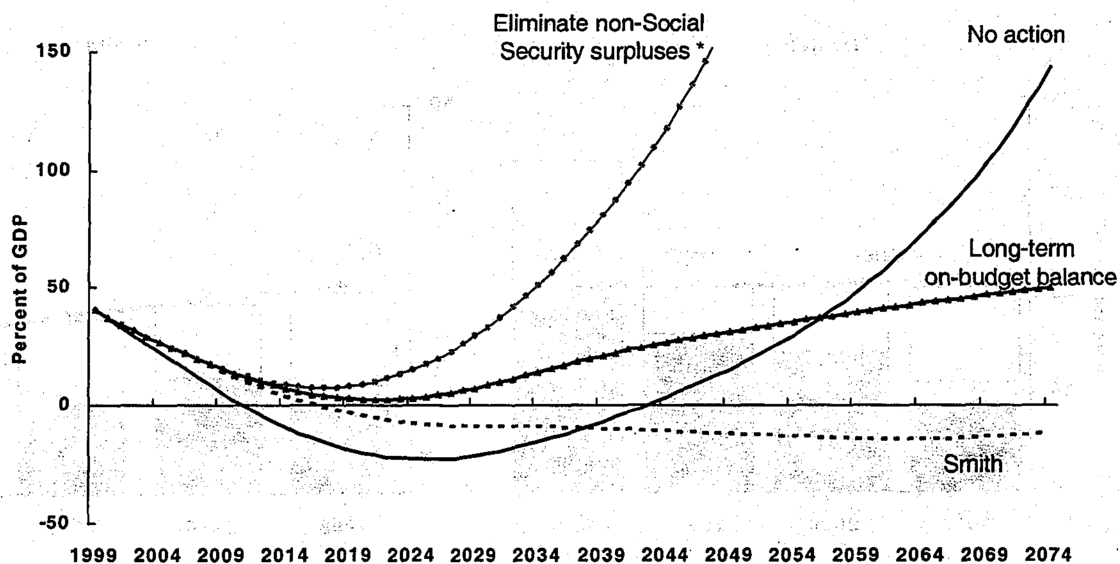


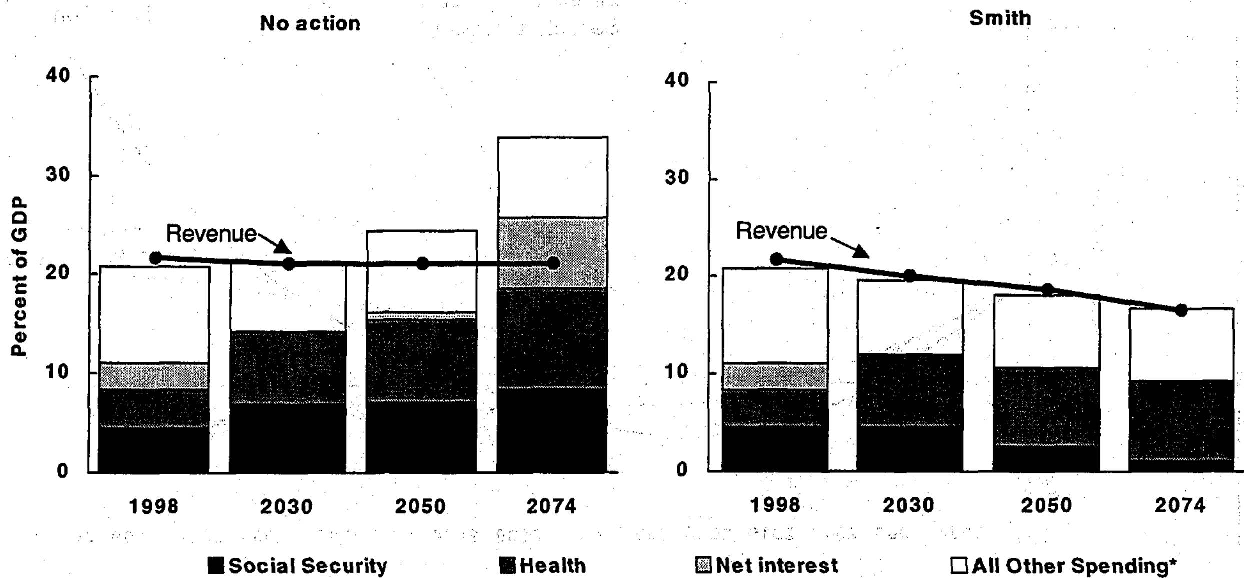
Figure 1: Smith, H.R. 3206
Unified Deficits/Surpluses as a Share of GDP
Eliminate non-Social Security surpluses *
No action*
Long-term on-budget balance
Smith
Percent of GDP
Deficit
Surplus
10.0
5.0
0.0
-5.0
1999
2004
2009
2014
2019
2024
2029
2034
2039
2044
2049
2054
2059
2064
2069
2074
*Data end when deficits reach 10 percent of GDP.

Figure 2: Smith, H.R. 3206
Debt Held by the Public as a Share of GDP



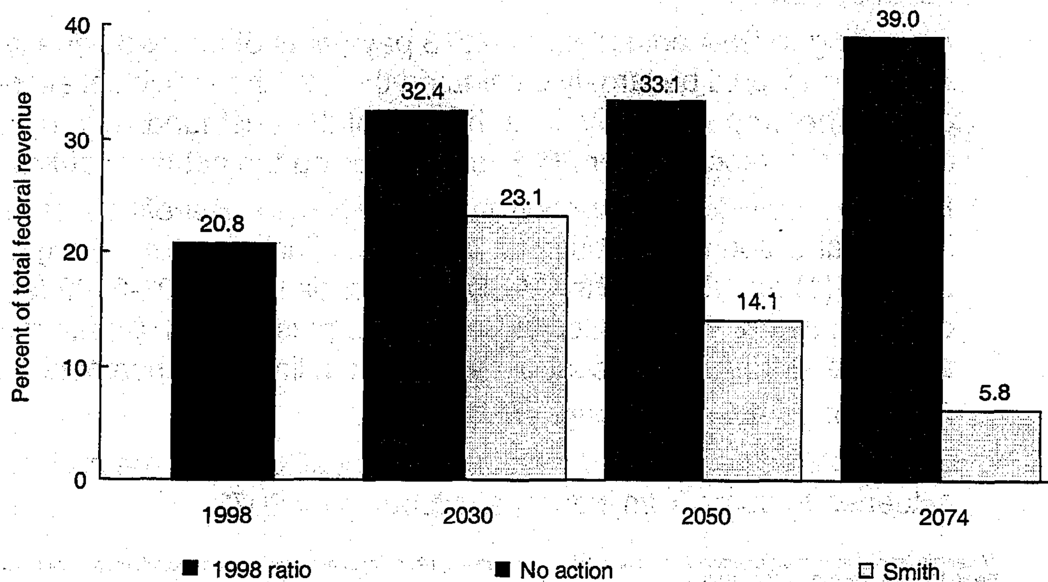
*Data end when debt reaches 150 percent of GDP.

Figure 3: Composition of Spending as a Share of GDP in 1998 and Under No Action and Smith, H.R. 3206



*All other spending includes offsetting interest receipts in 2030 under no action and in 2030, 2050, and 2074 under the Smith reform plan.
Note: Since a payroll tax carve-out reduces revenue, revenue under Smith is net of the carve-out amount.

Figure 4: Social Security Spending as a Share of Total Federal Revenue in 1998 and Under No Action and Smith, H.R. 3206



Note: Since a payroll tax carve-out reduces revenue, revenue under Smith is net of the carve-out amount.

Smith, H.R. 3206
Financing Sustainable Solvency

- National saving would increase due to the improved fiscal position of the government resulting from the proposed benefit reductions. The carve-out would increase private saving and decrease government saving with no net effect on national saving.[1]
- According to SSA actuaries, by 2073 payments of defined benefits from the OASI fund would be largely eliminated through the individual account benefit offset. The proposal would limit the size of the trust funds to a minimal contingency reserve after 2038, thus reducing the actuarial deficit to about zero.
- Finances individual accounts from payroll taxes.[2] Benefit offset based on individual account contributions. Additional financing from the general fund through (1) transfers to the OASDI trust funds from 2001-2009 (amounts based on estimates of the non-Social Security surpluses) and (2) reimbursements from the general fund for the cost of certain Disability Insurance benefits.
- Does not create new contingent liabilities.
- OASI defined benefits reduced until almost all benefits are projected by SSA actuaries to come from individual accounts by 2073.

[1]Analysis limited to first order effects on saving. Effects on saving behavior in response to specific reform provisions are not considered given the lack of expert consensus.

[2]According to Mr. Smith's staff, once individual account contributions reach 8 percent of taxable payroll, the intent of the legislation is to transfer to the general fund amounts in excess of a contingency reserve equal to 50 percent of the amount projected to be paid from the OASI trust fund for the fiscal year. For our analysis we relied on the estimates from the Office of the Chief Actuary, which assume contributions would reach 8 percent by 2062 and increase to 10.26 percent by 2074. While this difference may have an effect on individual accounts, the Office of the Chief Actuary informed us that this difference would have little effect on Trust Fund solvency.

Smith, H.R. 3206
Balancing Adequacy and Equity

- Reduces current-law benefits for new retirees, starting in 2001.
  - Phases in reductions to the benefit formula. Initial OASDI defined benefit level for average earners would decline by about 1 percent or less each year, i.e., by 2020 defined benefits would have been reduced by about 19 percent relative to current law. Reductions limited for workers over about age 55 in 2000.
  - OASI defined benefits are reduced (offset) based on individual account contributions. As OASI defined benefits fall and account balances get larger for later retirees, offset increases. According to SSA's actuaries, virtually all benefits would come from accounts by 2073.
  - Increases the normal retirement age at the rate of 2 months per year until it reaches 67 in 2011. Thereafter, retirement age would increase with longevity gains.
  - As an incentive to work longer, the proposal would increase the delayed retirement credit in 2000 and eliminate the earnings test for retirees by 2006.
- Maintains current OASDI defined benefits (before offset) only for those workers who retire at the normal retirement age and have average lifetime earnings under roughly $6,000 per year in 1999 dollars.

Smith, H.R. 3206
Balancing Adequacy and Equity

- Reduces OASDI defined benefits (before offset) for survivors, dependents, and some disabled workers[1] as a result of the benefit formula reductions; surviving aged spouses would receive reduced defined benefit plus 10 percent. Benefit adequacy may be improved for some individuals due to division between spouses of individual account contributions.
- All who contribute receive benefits. Would expand coverage to include newly hired state and local government workers.
- OASDI defined benefit structure maintains replacement rates for workers who retire at the normal retirement age and have annual earnings under roughly $6,000 in 1999 dollars.
- Workers have some investment choice, subject to certain limitations.
- There is the potential for higher returns on investment; the risk is borne by the individual. According to the SSA actuaries, whether workers realize an advantage from individual accounts will depend upon whether account yields are at least the level specified for the benefit offset (i.e., 3.7 percent real yield).
- The move to advanced funding of Social Security may improve intergenerational equity.

[1] Although not included in the estimates provided by the Office of the Chief Actuary, the legislation provides for general fund transfers to reimburse the OASDI trust funds for the benefits of disabled workers whose average indexed monthly earnings (AIME) does not exceed $1,667.

Smith, H.R. 3206
Implementing and Administering Reforms

- Funding for implementation is not explicitly discussed. The proposal provides no time frames for implementation.
- There is not enough information to estimate administrative costs.
- Financing structure of the system may be difficult to explain.
- The changes to the benefit structure may be difficult to explain. The "offset" feature of the proposal must be clearly explained; otherwise retirees may expect a larger return than the proposal actually provides, potentially creating an "expectations gap." An education program will be necessary to explain these points.
- The proposal would have SSA conduct a public education effort to assist individuals in making educated investment decisions.
- Participants may only choose among investment funds approved by the Secretary of the Treasury.

Appendix I: Interpreting Long-term Simulations

- Long-term simulations provide illustrations--not precise forecasts--of the relative fiscal and economic outcomes associated with alternative policy paths.

- Long-term simulations are useful for comparing the potential outcomes of alternative policies within a common economic framework over the long term.

  - Recognizing the inherent uncertainties of long-term simulations, we have generally chosen conservative assumptions such as holding interest rates and total factor productivity growth constant. Variations in these assumptions generally would not affect the relative outcomes of alternative policies.

  - The model simulates the interrelationships between the budget and the economy over the long term and does not reflect their interaction during short-term business cycles.

- Long-term simulations are not predictions of what will happen in the future. 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.

Appendix I: Social Security Reform Proposals in the Model

- Reform proposal cost and income estimates are from SSA's Office of the Actuary.
  - For each proposal, the OASDI cost estimate reflects all proposed reforms affecting benefits. These include increases in the retirement age, reduced COLAs, changes in the index used to adjust initial benefit levels, benefit reductions meant to offset individual accounts, and other proposed changes.
  - For each proposal, the OASDI income estimate reflects such elements as transfers from the general fund to the trust funds, the redirection of revenue from the taxation of benefits from the Hospital Insurance (HI) trust fund to the OASDI trust funds, and carve-outs from the payroll tax used to establish individual accounts.
- For all reform proposals, on-budget revenue and spending reflect the assumptions included in GAO's no action path,[1] adjusted for proposed reform proposal changes affecting on-budget totals.
  - Changes include transfers from the general fund to the OASDI trust funds, tax credits used to fund individual accounts, and other provisions that would affect on-budget totals.

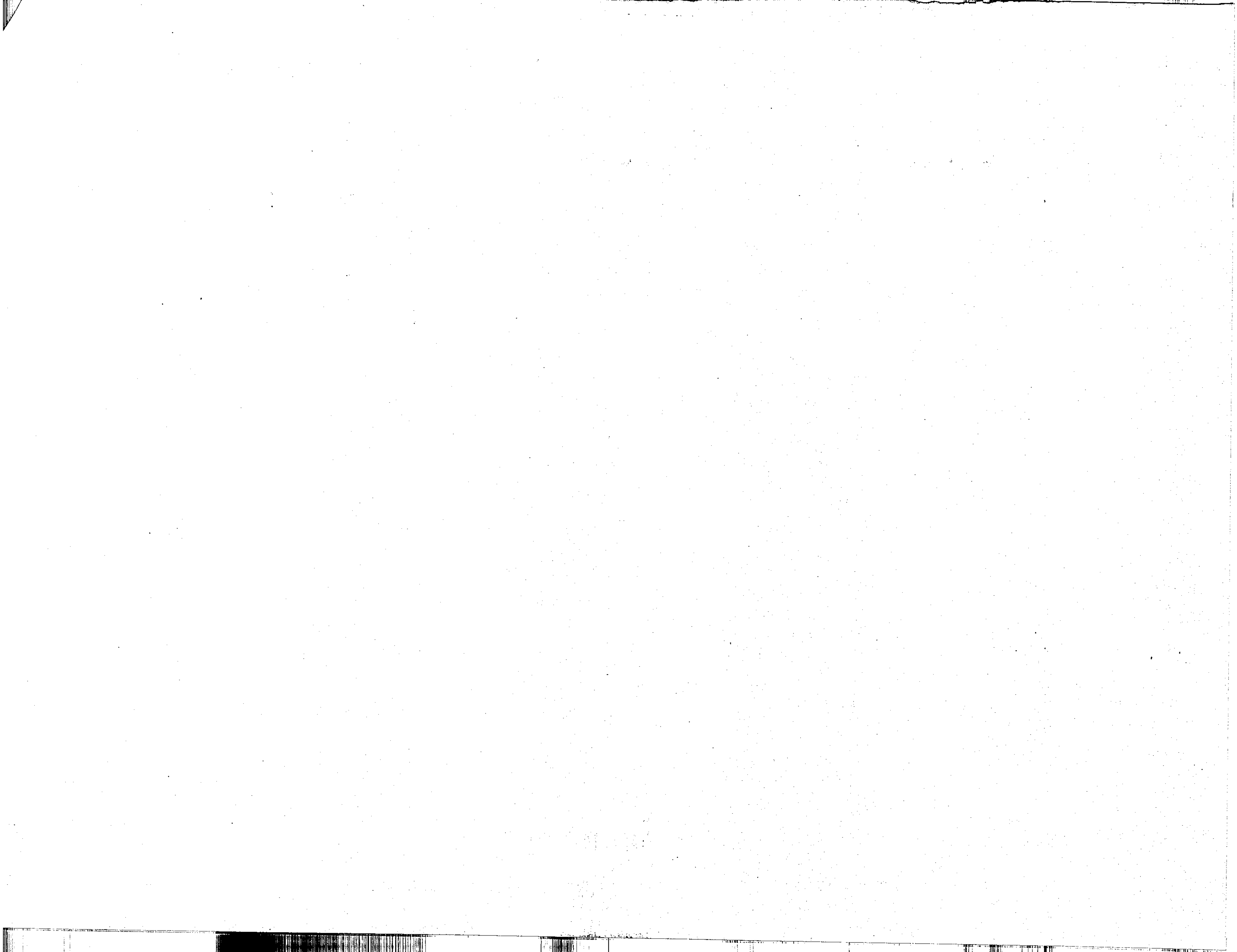
[1]Assumptions underlying the no action path are shown on the following slide.

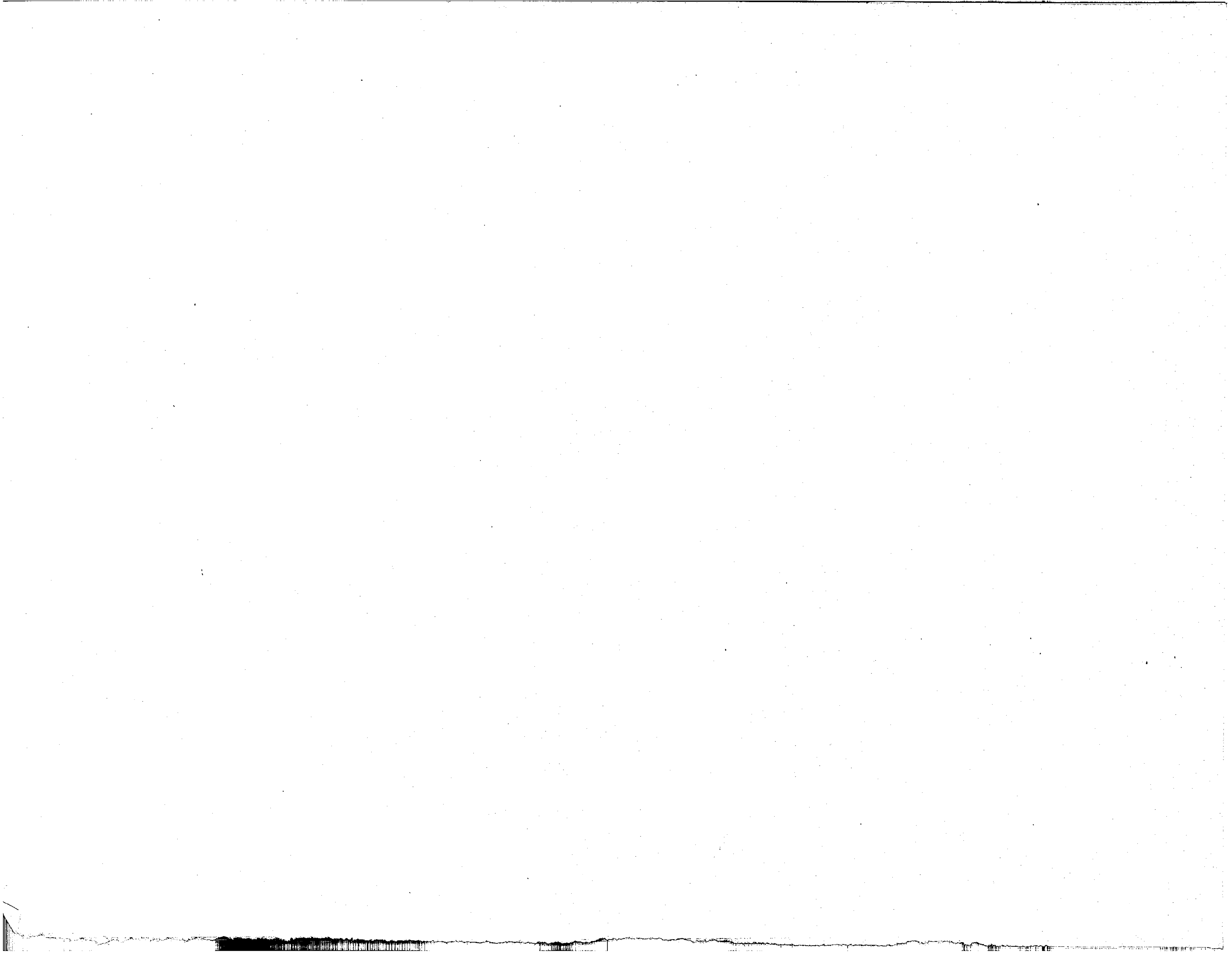
Appendix I: No Action Model Assumptions

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 1: These assumptions apply to our base simulation, no action. For alternative fiscal policy simulations, certain assumptions are varied, which are noted in the discussion of the alternative paths.
Note 2: In 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.

(935346/207089)





Ordering Information

The first copy of each GAO report is free. Additional copies of reports are $2 each. A check or money order should be made out to the Superintendent of Documents. 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

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

Orders by phone:
(202) 512-6000
fax: (202) 512-6061
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.

Orders by Internet:
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

To Report Fraud, Waste, or Abuse in Federal Programs

Contact one:

- Web site: http://www.gao.gov/fraudnet/fraudnet.htm
- e-mail: fraudnet@gao.gov
- 1-800-424-5454 (automated answering system)

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

Bulk Rate
Postage & Fees Paid
GAO
Permit No. G100

Official Business
Penalty for Private Use $300

Address Correction Requested