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SOCIAL SECURITY AND MINORITIES

Current Benefits and Implications of Reform

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Social Security and Minorities: Current Benefits and Implications of Reform

Mr. Chairman and Members of the Subcommittee:

Thank you for inviting me here today to speak about minorities and Social Security. Social Security has had a significant and positive effect on the nation's elderly. Since 1959, poverty rates for the elderly have fallen from 35 percent to 10.5 percent, thanks largely to this social insurance program. Nevertheless, elderly African-Americans and Hispanics are much more likely to be living below the poverty line, even with the program's important benefits. For example, 28 percent of African-Americans and 27 percent of Hispanics aged 65 and older have incomes below the poverty threshold, compared with 11 percent of similarly aged Caucasians.¹

My remarks today focus on (1) how minorities currently fare under Social Security, (2) how they might be affected by some of the proposed changes in benefits to restore the program's solvency, and (3) how minorities might fare under a system restructured to include individual accounts. The information I am providing today is based on preliminary findings from work we are currently doing for Representative Charles B. Rangel, Ranking Minority Member of the full Committee on Ways and Means.

In summary, while Social Security's benefit and contribution provisions are neutral with respect to race, ethnicity, and gender, we found that because of certain socioeconomic characteristics, minorities have benefited from the Social Security program. Because minorities are more likely than whites to have lower lifetime earnings, they are advantaged by Social Security's progressive benefit formula that provides larger relative benefits for lower-paid workers. Moreover, blacks in particular are more likely to receive other important Social Security benefits, such as disability, that help protect against lost earnings. Certain reforms that would reduce benefits to help restore solvency could have a disproportionate effect on low-wage earners, including blacks and Hispanics, depending on how they are structured. For example, raising the age of retirement would lower the average lifetime benefits of blacks relative to whites because of blacks' lower life expectancy.

Restructuring Social Security to include individual accounts would also likely have varying effects on different racial and ethnic groups. However, our analysis indicates that education and family income are better predictors of individuals' investment behavior than race. Individuals with

¹Most of the data sources we relied on used the terms blacks, whites, and Hispanics. Therefore, for the remainder of this testimony we use the same terms. Although we recognize that there are other minority groups, such as Asians and Native Americans, for the most part the data were not broken down finely enough for us to look at them separately.

less education and lower incomes tend to invest more conservatively than those with more education and higher incomes. Because blacks and Hispanics are more likely to have less education and lower incomes, they would likely earn smaller returns on their accounts, although they would bear less risk. These results suggest that if individual accounts were adopted as an element of comprehensive Social Security reform, investor information and education would be needed to help low-income individuals with their investment decisions.

Background

The Social Security program is the foundation of the nation's retirement income system. Since 1940, Social Security has been providing benefits to the nation's eligible retired workers and their dependents. In addition to retired worker benefits, Social Security protects covered workers who have severe disabilities and their dependents through the Disability Insurance (DI) program. Also, spouses and children of deceased workers may receive Social Security survivor benefits. As a social insurance program, Social Security allows workers to pool the risks they face from a loss of earnings that results from retirement, disability, or death.

Social Security's benefit formula redistributes income from high-wage earners to low-wage earners to help keep low-wage earners out of poverty. Benefits are based, in part, on an individual's earnings, but when calculating actual benefits, Social Security uses a progressive formula that replaces a relatively larger portion of lifetime earnings for people with low earnings than for people with high earnings. To calculate Social Security benefits, Social Security uses average indexed monthly earnings, defined as a worker's lifetime covered earnings over his or her 35 highest earnings years. A progressive benefit formula is applied to these lifetime earnings to determine the benefit that would be payable to the worker at age 65. The benefit is then adjusted for the age at which the worker first receives the benefit.

The Social Security system currently faces a long-term solvency problem. As you know, the Social Security trust funds are predicted to begin paying out more in annual benefits than they collect in taxes in 2013 and are expected to be depleted by 2032.² A number of proposals have emerged to resolve this financing problem, with a great deal of variety in terms of both how the Social Security program would be structured and who would be

²The relevant figures include both the Old Age and Survivors Insurance program and the Disability Insurance program.

eligible for benefits.³ Some of these proposals would restore solvency within the existing program structure, while others call for some form of restructuring to include individual accounts as an element of reform. Many major proposals would provide a significant defined benefit as a base with voluntary or mandatory individual accounts included as an element of the plan.⁴ In the current national debate over how best to restore Social Security's long-term solvency, some researchers have argued that minorities, particularly blacks, would fare better under a system that included some individual account element.⁵ They argue that certain minorities are more likely to have specific characteristics that result in their receiving lower benefits than others under the current system.

How Minorities Currently Fare Under Social Security

Although Social Security's benefit and contribution provisions are neutral with respect to race, ethnicity, and gender, some researchers have questioned how well some minorities, especially blacks, have fared under the existing Social Security system because they have lower life expectancies. Differences in life expectancy affect the length of time that individuals from different racial and ethnic groups can expect to pay into the Social Security system and collect retired worker benefits. For example, white males born in 1998 can expect to live for 74 years, black males for 64.3 years, and Hispanic males for 75 years. These differences become much less pronounced, but still exist, for individuals who survive to age 65. At age 65, in 1998, white men can expect to live 2.3 years longer than black men, and Hispanic men can expect to live 2.9 years longer than white men. The projections of life expectancy for white, black, and Hispanic women at age 65 are 19.5, 17.6, and 22.2 years, respectively.

However, life expectancy is only one of many factors that affect the level of benefits that people receive from Social Security, relative to what they contribute. Social Security's progressive benefit formula has particular importance for blacks and Hispanics because they tend to have lower lifetime taxable earnings than whites. The consensus among researchers is generally that the progressivity of the benefit formula outweighs the negative effect of lower life expectancy for blacks in terms of what they receive from Social Security relative to what they contribute. Hispanics' longer life expectancy, combined with the progressive benefit formula, indicates that they fare even better than blacks under Social Security.

³The President's recent Social Security reform proposal, for example, would extend Social Security solvency until 2055. It would not, however, fundamentally reform the Social Security benefit program.

⁴Defined benefit refers to a benefit based on a specific formula linked to a worker's earnings and years worked.

⁵W. Beach and G. Davis, "Social Security's Rate of Return," Heritage Center for Data Analysis, Heritage Foundation, Washington, D.C., 1998.

None of the currently available studies have included disability or survivors benefits in their assessments of the benefits minorities receive from Social Security.⁶ Blacks rely more heavily than others on these features of the program, which provide important protections against the loss of earnings caused by disability or death. While blacks currently make up 12 percent of the U.S. population, they are overrepresented in these beneficiary categories. For example, blacks make up 23 percent of child beneficiaries (as children of retired workers, disabled workers, or deceased workers), 18 percent of disabled workers, and 14 percent of survivors of deceased workers. Put another way, 47 percent of black beneficiaries are receiving either disabled or survivor benefits, while only 28 percent of whites are receiving benefits in these categories. In contrast, blacks make up only 8 percent of all retired worker beneficiaries, while whites make up 90 percent of this category.⁷

How Minorities Might Be Affected by Various Reform Proposals Within the Existing Program Structure

The changes contained in various Social Security reform proposals could have disproportionate effects on minorities but these would vary depending on the nature of the reforms. Many reform proposals include provisions that would reduce current benefit levels by, for example, increasing the number of years of taxable earnings used to calculate benefits from 35 years to 38 or 40 years. Even a proportional reduction in benefits such as this could have a more serious effect on minorities since their lower overall incomes put them much closer to or below the poverty line to begin with.

Many Social Security reform proposals include a provision to raise the normal age of retirement to age 70. Some proposals would also increase the early retirement age from 62 to 65. Any increase in the age at retirement would decrease the number of years during which individuals would collect benefits while increasing the number of years they would pay Social Security taxes. Because blacks, on average, already can expect to spend fewer years in retirement than whites as a result of their shorter life expectancy, they would experience a greater relative reduction in benefits, compared with whites, from an increase in the Social Security

⁶We are currently working with a special data set, provided by the Social Security Administration and the Bureau of the Census, that will allow us to make more complete estimates of minorities' total returns to Social Security, including disability and survivors benefits. This information will be forthcoming in a report to Representative Charles B. Rangel, Ranking Minority Member of the House Committee on Ways and Means, later this year.

⁷Hispanics were not reported separately and are included in the numbers for whites and blacks. The final 2 percent of retired worker beneficiaries includes Asians and Pacific Islanders, American Indians and Alaskan Natives, and a subset of the total number of beneficiaries of Spanish origin.

retirement age. Given Hispanics' longer life expectancy, the negative effect of raising the retirement age would be smaller in relative terms. At the same time, an increase in the ages of early and normal retirement would have implications for the DI program. Raising the early and normal retirement ages would create a financial incentive for individuals in poor health to apply to the DI program because the gap between disability benefits and retired worker benefits would increase. Moreover, as individuals stay longer in the labor force, more older workers will become disabled. Assuming that current disability trends continue, proportionately more of these disabled workers would be black.

How Minorities Might Fare Under a System Restructured to Include Individual Accounts

Many reform proposals would fundamentally restructure Social Security by creating retirement accounts that individuals would own and manage. Many proposals would provide a defined benefit but would also include an individual account feature. For example, the plan put forth by the National Commission on Retirement Policy includes a minimum benefit provision that is set at the poverty line for individuals who have worked for 40 years and directs 2 percentage points of the payroll tax into individual savings accounts. Because no research has previously been done on minorities' investment patterns, we have estimated the effect of race on individual investment behavior. Using national survey data, we estimated the probability that people with Individual Retirement Accounts (IRA) would invest their accounts in stocks and mutual fund shares.⁸ Our preliminary results indicate that individuals with higher family income and more years of education are more likely to invest in more volatile but potentially higher-yielding assets such as stocks and mutual funds. On average, blacks and Hispanics have lower family incomes and fewer years of education than do whites. We found that controlling for these and other characteristics, black IRA holders are still somewhat less likely to invest in stocks and mutual fund shares than whites.⁹ We also found that Hispanic IRA holders are neither more nor less likely than whites to invest their accounts in stocks or mutual fund shares, once we controlled for the other demographic characteristics.

⁸We used a cross-section of people from Census' 1992-93 Survey of Income and Program Participation. Because of data limitations, we were able to look only at the investment decisions of people with IRAs. In the full sample, blacks and Hispanics were less likely to have an IRA account than whites. In general, respondents with IRAs had higher family income, had completed more years of education, were older, were more likely to be married, and had fewer children than those without IRAs.

⁹This result was significant at the 90-percent confidence level. The analysis did not control for differences in levels of wealth, which would also explain some of the differences in investment behavior.

Individuals who chose a relatively low-risk investment strategy for their retirement income accounts would be likely to earn lower rates of return over longer periods of time but would not be as exposed to large losses from riskier assets. While it is true that in the past U.S. stocks have almost always posted higher returns over time than less risky assets, there is no guarantee that they will always do so, especially for shorter investment horizons.

Our analysis also revealed that blacks and Hispanics are much less likely to have interest earnings from any other type of savings vehicles such as savings accounts, money market funds, certificates of deposit, or mutual fund accounts. Individuals unfamiliar with making investment choices may need assistance in understanding and managing their individual account investments. Providing low-income and less well-educated individuals who have limited investing experience—including some blacks and Hispanics—with appropriate information may be particularly challenging. Nevertheless, information that covers general investment principles and financial planning advice would be essential in helping all investors to better manage their accounts. It is not clear who would provide such information to workers under a restructured Social Security system that included mandatory individual accounts. Within the private pension system, there are mechanisms for people to learn more about investing. For example, some employer-sponsored pension plans provide written material or contract with a financial planning service to give employees information about investing. It might be possible to draw from these experiences in structuring an investor education program for Social Security. The nature and extent of these information and education efforts, when combined with the design of related investment options, would be especially important to helping maximize the effectiveness of, and minimize the risk associated with, individual accounts under the Social Security system.

Conclusions

The Social Security system has benefited minorities through a benefit formula that favors lower-paid workers and through important social insurance features, including disability benefits. Because blacks and Hispanics are more likely to have lower overall incomes than whites, certain reforms, such as increasing years of covered earnings, would have a more serious effect on them, because they are already closer to the poverty line. Because blacks and Hispanics on average have lower incomes and are less well educated than whites, the creation of mandatory individual accounts could also decrease their benefits relative to those of

whites if they invested more conservatively. Our work suggests that providing information and education would be essential, especially to low-income individuals who would be making investment decisions for the first time. Investor education that covers general investment principles and financial planning advice might help all new investors to better manage such accounts.

This concludes my prepared statement. I would be happy to answer any questions you or other Members of the Committee may have.

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