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SOCIAL SECURITY AND SURPLUSES

GAO's Perspective on the President's Proposals

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Mr. Chairman and Members of the Committee:

It is a pleasure to be here today to discuss the President's recent proposal for addressing Social Security and use of the budget surplus. These proposals address some of the most important issues facing the nation, both now and over the longer term. As you know, both GAO as an institution and I as an individual have a long-standing interest in these issues.

The President's proposal is complex, which makes it all the more important for us to focus our attention on what it does—and what it does not do—for our long-term future. In summary, the President's proposal:

- Reduces debt held by the public from current levels, thereby also reducing net interest costs, raising national saving, and contributing to future economic growth.
- Fundamentally changes Social Security financing in two ways:
  - It promises general funds in the future by, in effect, trading publicly held debt for debt held by the Social Security Trust Fund (SSTF).
  - It invests some of the trust fund in equities with the goal of capturing higher returns over the long term.
- Does not have any effect on the projected cash flow imbalance in the Social Security program's taxes and benefits, which begins in 2013.
- Does not represent a Social Security reform plan and does not come close to "saving Social Security."

Context: Long-Term Outlook Is Important

It is important to look at the President's proposal in the context of the fiscal situation in which we find ourselves. After nearly 30 years of unified budget deficits, we look ahead to projections for "surpluses as far as the eye can see." At the same time, we know that we face a demographic tsunami in the future that poses significant challenges for the Social Security system, Medicare, and our economy as a whole. In this context, we should recognize that the President uses a longer-term framework for resource allocation than has been customary in federal budgeting.

Although all projections are uncertain—and they get more uncertain the farther out they go—we have long held that a long-term perspective is important in formulating fiscal policy for the nation. Each generation is in part the custodian for the economy it hands the next and the nation's long-term economic future depends in large part on today's budget decisions.

This perspective is particularly important because our model and that of the Congressional Budget Office (CBO) continue to show that absent a change in policy, the changing demographics to which I referred above will lead to renewed deficits. This longer-term problem provides the critical backdrop for making decisions about today's surpluses.

Surpluses are the result of a good economy and difficult policy decisions. They also provide a unique opportunity to put our nation on a more sustainable path for the long term, both for fiscal policy and the Social Security program itself. Current decisions can help in several important respects: (1) current fiscal policy decisions can help expand the future capacity of our economy by increasing national savings and investment, (2) engaging in substantive reforms of retirement and health programs can reduce future claims, (3) by acting now, we have the opportunity of phasing in changes to Social Security and health programs over a sufficient period of time to enable our citizens to adjust, and (4) failure to achieve needed reforms in the Social Security and Medicare programs will drive future spending to unsustainable levels and eventually "squeeze out" most or all discretionary spending. If we let the achievement of a budget surplus lull us into complacency about the budget, then in the middle of the 21st century, we could face daunting demographic challenges without having built the economic capacity or program/policy reforms to handle them.

The Proposal

Before turning to the context for and analysis of the President's proposal, let me briefly describe it. The President proposes to use approximately 15 years to reduce debt held by the public and to address Social Security's financing problem. His approach to this, however, is extremely complex and confusing. The President proposes to "transfer" an amount equal to a portion of the projected surplus to the Social Security and Medicare trust funds.[1] This transfer is projected to extend the solvency of Social Security from 2032 to 2049. His proposal to permit the trust fund to invest in equities is expected to further extend trust fund solvency to 2055. He calls on the Congress to work with him on program changes to get to 2075.

To understand and evaluate this proposal, it is important to understand the nature of the federal budget, how trust funds fit into that budget, and the challenges of "saving" within the federal budget.

[1] In this testimony, I will address only the Social Security portion of this transfer. The issues are similar but not identical for the Medicare trust fund transfer.

Can We Save for the Future in the Federal Budget?

The federal budget is a vehicle for making choices about the allocation of scarce resources. It is different from state budgets in ways important to this discussion. Most states use "fund budgeting" in which pension funds that are separate and distinct legal entities, build up surpluses that are routinely invested in assets outside the government (e.g., readily marketable securities held in separate funds). In contrast, the federal government's unified budget shows all governmental transactions and all funds are available for current activities, including current-year activities of all trust funds. We cannot park our surplus in a cookie jar. The only way to save in the federal budget is to run a surplus or purchase a financial asset. When there is a cash surplus it is used to reduce debt held by the public. Therefore, to the extent that there is an actual cash surplus, debt held by the public falls.

This presents a problem for any attempt to "advance fund" all or part of future Social Security benefits. Advance funding within the current program would mean increasing the flows to the SSTF. Although it is officially "off budget," the fact remains that the SSTF is a governmental fund. In the federal budget, trust funds are not like private trust funds. They are simply budget accounts used to record receipts and expenditures earmarked for specific purposes. A private trust fund can set aside money for the future by increasing its assets. However, under current law, when the SSTF's receipts exceed costs, they are invested in Treasury securities and used to meet current cash needs of the government. These securities are an asset to the trust fund, but they are a claim on the Treasury. Any increase in assets to the SSTF is an equal increase in claims on the Treasury. One government fund is lending to another. The transactions net out on the government's books. Given this investment policy, any increase in the trust fund balances would only become an increase in saving if this increment were to add to the unified budget surplus (or decrease the unified budget deficit) and thereby reduce the debt held by the public. This is also the only way in which an increase in the SSTF balance could be a form of advance funding.

How do these transactions affect the government's debt? Gross federal debt is the sum of debt held by the public and debt held by governmental accounts—largely trust funds. This means that increases in the trust fund surplus will increase gross debt unless debt held by the public declines by at least the same amount. Any reform of Social Security that increases the annual SSTF surplus would increase debt held by government accounts since, under current law, any excess of revenues over benefit payments is loaned to Treasury for current needs. As a result, total government debt

would go up unless these surpluses were used to reduce debt held by the public by an equivalent amount.

For most people, the different types of "debt" in the federal budget may be confusing—especially since what is "good news" for a trust fund may be "bad news" for total debt and vice versa. This is so because total debt (or gross debt) is the sum of two very different types of debt—debt owed to the public and debt owed by one part of the government (general fund) to another part of the government (trust funds). Therefore, if a trust fund surplus grows faster than debt held by the public falls, total debt grows—even if the trust fund surplus is created as an attempt to "save" or to "pre-fund" some of the future benefit payments. These contradictory movements emphasize the need to differentiate between different types of debt and what they mean. Both debt held by the public and debt held by trust funds are important--but for different reasons. Analytically, therefore, what is most important is not whether total debt increases but rather the reasons behind the increase--does it represent an attempt to "advance fund" through substantive reform or merely the promise of future resources?

Debt held by the public and debt held by trust funds represent very different concepts. Debt held by the public approximates the federal government's competition with other sectors in the credit markets. This affects interest rates and private capital accumulation. Further, interest on debt held by the public is a current burden on taxpayers. Reducing this burden frees up capacity to meet future needs.

In contrast, debt held by trust funds performs an accounting function and currently represents the cumulative annual surpluses of these funds (i.e., excess of receipts over disbursements plus accrued interest). Importantly, debt held by the SSTF does not represent the actuarial present value of expected future benefits for either current or future participants. Nor does this debt have any of the economic effects of borrowing from the public. It is not a current transaction of the government with the public; it does not compete with the private sector for available funds in the credit market. It reduces the need to borrow from the public and so may hold down interest rates. Unlike debt held by the public, debt held by trust funds does not represent an immediate burden on current taxpayers. Rather, it is a claim on future resources. The surplus is held in Treasury securities that give the SSTF a claim on the Treasury equal to the value of those securities. When the securities have to be redeemed, the Treasury must come up with the

cash. At that time, taxpayers will see some combination of a lower surplus, lower spending, higher taxes, and/or greater borrowing from the public.

If borrowing from the public is increased to cover this cash need, there could be upward pressure on interest rates. In addition, because debt held by the trust fund is not equal to future benefit payments--it is not a measure of the unfunded liability of the current system--it cannot be seen as a measure of this future burden. Nevertheless, it provides an important signal of the existence of this burden. Whether the debt constitutes a new economic burden for the future or merely recognizes an existing one depends on whether these currently promised benefits would be paid even in the absence of the securities.

How Does the President's Proposal Work?

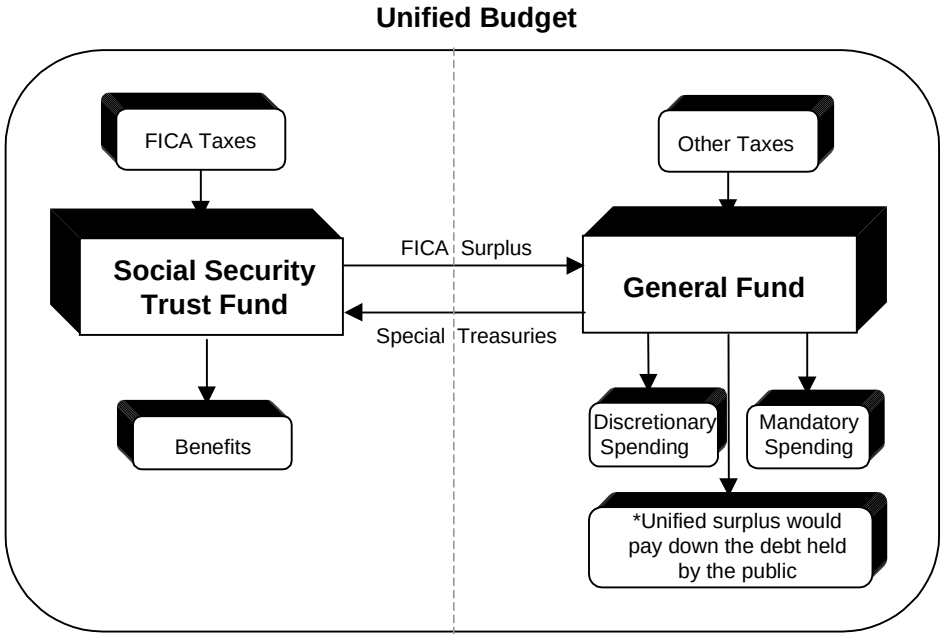
This information is important to understand the President's proposal because, in large part, he proposes a set of transactions that, in effect, trade debt held by the public for debt held by the SSTF.[2] By running a cash surplus over the next 15 years, debt held by the public falls. To "save" this surplus, the President proposes to "transfer" it to the trust fund in the form of increased Treasury securities. Under his proposal, debt held by the public falls, but debt held by the trust funds increases. Because he shows the transfer as a subtraction from the surplus—a new budgetary concept—he shows no surplus. As a result, he attempts to save some of the projected surplus by hiding it.

The mechanics of the proposed transfer of surpluses to the SSTF are complex and difficult to follow. Few details have been made available, and there is conflicting information on exactly how it would work. Figures 1 and 2 are flowcharts representing our best understanding of the Social Security portion of this transfer. Since it is impossible to understand the changes proposed by the President without understanding the present system, figure 1 shows the flows under the current system. Under current law, annual cash flow surpluses (largely attributable to excess payroll taxes over benefits payments and program expenses) are invested in Treasury

[2]Paying down publicly held debt and issuing new special securities to the SSTF are two different transactions. Nevertheless, the effect is as if the securities are exchanged.

securities.[3] This excess "cash" is commingled with other revenues and used to finance other governmental activities. In this way, SSTF surpluses have helped and continue to help finance the rest of the government. This year, the SSTF surplus is expected to exceed the general fund deficit so there is also a surplus in the unified budget. Over the entire 15-year period, more than half of the projected unified surplus is composed of Social Security surpluses. Absent any change in policy, these unified surpluses will be used to reduce the debt held by the public.

Figure 1: Current Social Security Flows



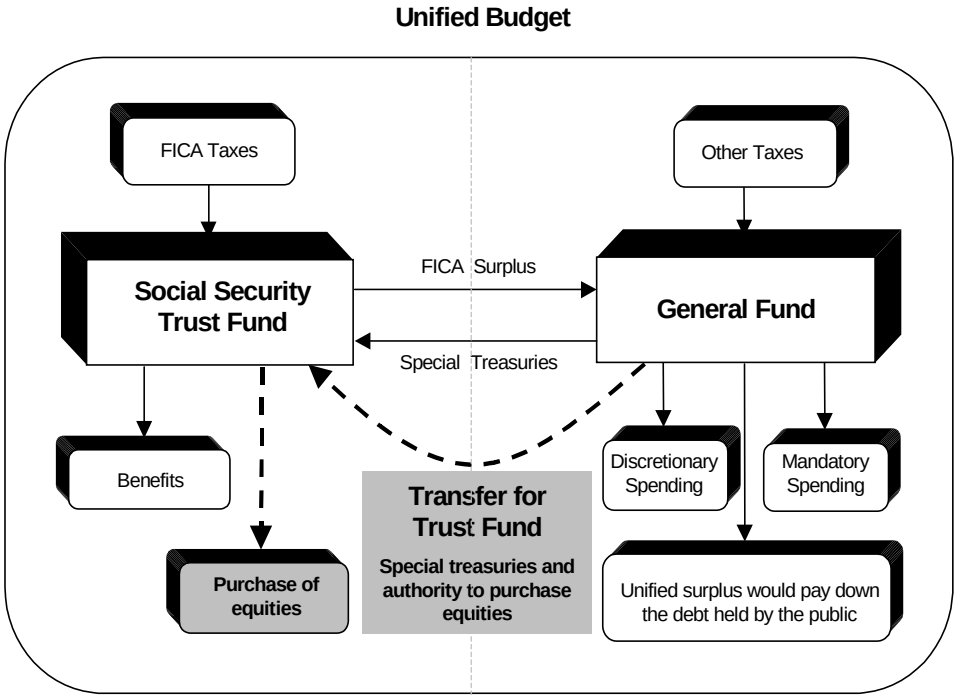
*Unified surplus = FICA surplus + general fund surplus

Source: GAO Analysis.

[3]This presentation is somewhat simplified. In reality, FICA taxes are collected with income and corporate taxes by the Treasury and then allocated by the Treasury to Social Security, Medicare, or the general fund. In addition, a portion of income taxes paid on Social Security benefits flow into the SSTF. The expenditure side of the SSTF transactions is also simplified since administrative expenses also flow from the trust fund. These elements are unchanged by the President's proposal and do not change the flows critical to understanding it.

Under the President's proposal, this would continue. However, as shown in figure 2, at the point where total tax receipts are allocated to pay for government activities, a new financing step would be added to "transfer" a portion of the unified budget surpluses to the Social Security and Medicare trust funds. The unified budget would do this by providing a new set of securities for these trust funds. However, the excess cash would still be used to reduce the debt held by the public.

Figure 2: Social Security Flows Under President's Proposal



Source: GAO Analysis.

In essence, this exchanges debt held by the public for debt held by the trust funds. While there are many benefits to reducing publicly held debt, it is important to recognize that under the current law baseline—i.e., with no changes in tax or spending policy—this would happen without crediting additional securities to the trust funds.

The administration has defended this approach as a way of assuring both a reduction in debt held by the public and giving Social Security first claim on what they call the "debt-reduction dividend" to pay future benefits.

However, issuing these additional securities to the SSTF is a discretionary act with major legal and economic consequences for the future. Some could view this as double counting—or double-crediting. Importantly, to the extent it appears that way to the public, it could undermine confidence in a system that is already difficult to explain. However, the debate over double counting focuses on the form of the proposal rather than its substance. Although form is important when it interferes with our ability to understand the substance—and I think this proposal falls into that trap—the important debate must be on the substance of the proposal.

This proposal represents a fundamental shift in the way the Social Security program is financed. It moves it away from payroll financing toward a formal commitment of future general fund resources for the program. This is unprecedented. Later in my statement, I will discuss the implications of this proposal for overall fiscal policy and for the Social Security program.

Government Financing and Debt

The President's proposals would have the effect of reducing debt held by the public from the current level of 44 percent of Gross Domestic Product (GDP) to 7 percent over the 15-year period. The President notes that this would be the lowest level since 1917. Nearly two-thirds of the projected unified budget surplus would be used to reduce debt held by the public. Because the surplus is also to be used for other governmental activities, the amount of debt reduction achieved would be less than the baseline (i.e., a situation in which none of the surplus was used), but nonetheless the outcome would confer significant benefits to the budget and the economy.

Our previous work on the long-term effects of federal fiscal policy has shown the substantial benefits of debt reduction.[4] One is lowering the burden of interest payments in the budget. Today, net interest represents the third-largest "program" in the budget, after Social Security and Defense. Interest payments, of course, are a function of both the amount of debt on which interest is charged and the interest rate . At any given interest rate, reducing publicly held debt reduces net interest payments within the

[4] Budget Issues: Analysis of Long-Term Fiscal Outlook (GAO/AIMD/OCE-98-19, October 22, 1997).

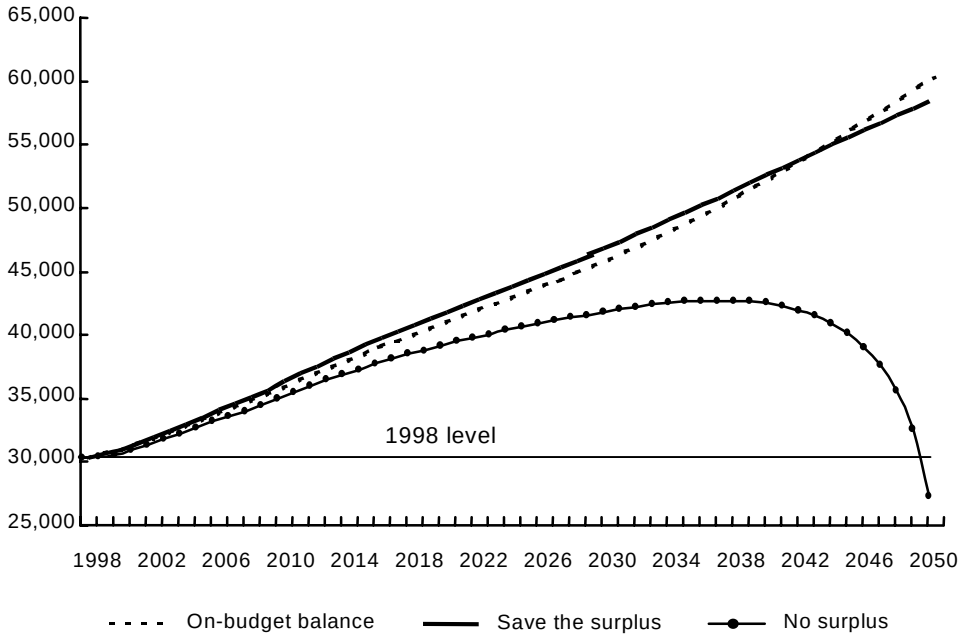
budget. For example, CBO estimates that the difference between spending the surplus and saving the surplus is $123 billion in annual interest payments by 2009--or almost $500 billion cumulatively between now and then. Compared to spending the entire surplus, the President's proposal would also substantially reduce projected interest payments . Lower interest payments lead to larger surpluses; these in turn lead to lower debt which leads to lower interest payments and so on: the miracle of compound interest produces a "virtuous circle." The result would be to provide increased budgetary flexibility for future decisionmakers who will be faced with enormous and growing spending pressures from the aging population.

For the economy, lowering debt levels increases national saving and frees up resources for private investment. This in turn leads to increased productivity and stronger economic growth over the long term. Over the last several years, we and CBO have both simulated the long-term economic results from various fiscal policy paths. These projections consistently show that reducing debt held by the public increases national income over the next 50 years, thereby making it easier for the nation to meet future needs and commitments. Our latest simulations done for the Senate Budget Committee, as shown in figure 3, illustrate that any path that saves all or a significant share of the surplus in the near term would produce demonstrable gains in per capita GDP over the long run.[5] This higher GDP in turn would increase the nation's economic capacity to handle all its commitments in the future.

[5]The "on-budget balance" path assumes that any surplus in the non-Social Security part of the budget is "spent" on either a tax cut or spending increases or some combination but assumes the current law path for the Social Security trust fund. Thus, the surplus in the Social Security trust fund remains untouched until it disappears in 2013 after which the unified budget runs a deficit equal to the SSTF deficit. The "Save the Surplus" path assumes no changes in current policies and that budget surpluses through 2024 are used to reduce debt held by the public. The "No Surplus" path assumes that permanent increases in discretionary spending and tax cuts deplete the surpluses but keep the budget in balance through 2009. Thereafter, deficits reemerge as spending pressures grow.

Figure 3: GDP Per Capita Under Alternate Fiscal Policy Simulations

Per capita 1998 dollars

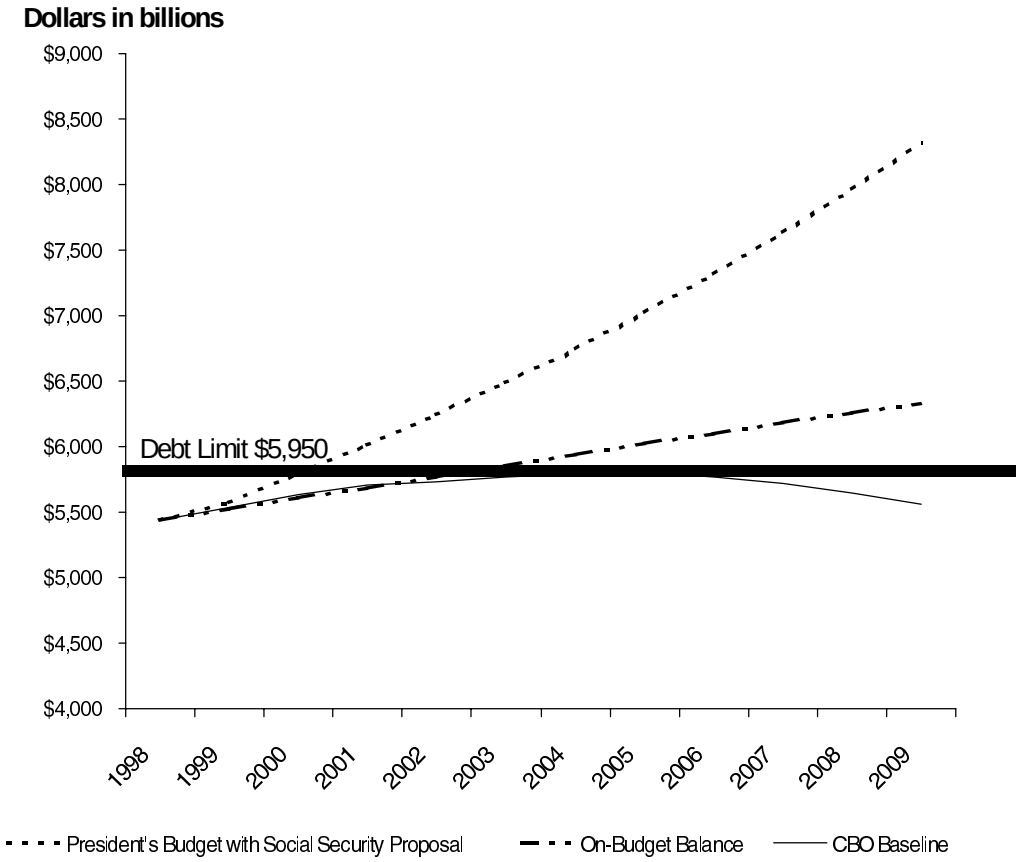


Source: GAO Analysis.

Under the President's proposal, debt held by trust funds goes up more rapidly than debt held by the public falls, largely due to these additional securities transferred to the trust funds. Gross debt, therefore, increases. It is gross debt—with minor exceptions—that is the measure that is subject to the debt limit. The current limit is $5.95 trillion. Under the President's plan, the limit would need to be raised sometime during 2001. Under either the CBO or the Office of Management and Budget baseline (i.e., save the entire surplus), the limit would not need to be raised during at least the next 10 years. Since other proposals to use the surplus would also bring forward the time when the debt limit would have to be raised, the impact of the President's proposal on debt is in part a "compared to what?" question. In figure 4, we show the debt subject to limit under the baseline, the

President's proposal, and a hypothetical path we have labeled "on-budget balance."[6]

Figure 4: Debt Subject to Limit Under Baseline and President's Proposal



Source: OMB, CBO, Senate Budget Committee, and GAO Analysis.

[6]The baseline is the CBO baseline. It assumes that none of the surplus is used for tax cuts or spending increases. "On-budget balance" assumes that any surplus in the non-Social Security part of the budget is "spent" on either a tax cut or spending increases or some combination but that the surplus in the Social Security trust fund remains untouched. There is no "on-budget" surplus until 2001.

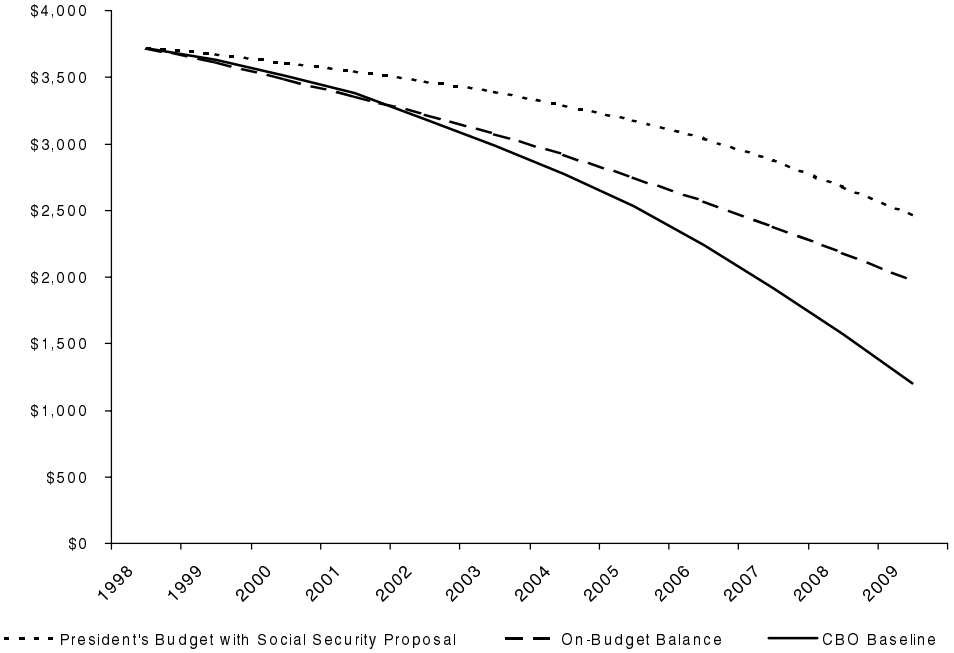
Figures 5 and 6 below compare the composition of debt under the same three paths: the baseline (save the entire surplus), the President's proposal (including both the Social Security proposal and the other spending), and "on-budget balance." Figure 5 shows debt held by the public under all three scenarios, and figure 6 shows debt held by governmental accounts.

As figure 5 shows, debt held by the public falls under all three scenarios. Since the baseline assumes the entire surplus is devoted to reducing debt held by the public, it shows the greatest drop. Under the "on-budget balance" path there are no tax cuts or spending increases until there is an on-budget balance in 2001 while under the President's proposal spending increases and tax cuts are front-loaded. As a result, the President's proposal is projected to reduce debt held by the public less than the "on-budget balance" path during these 10 years.

Figure 6 shows the impact of the President's proposal to transfer securities to the SSTF. The projections for debt held by government accounts are the same for the baseline and the "on-budget balance" paths since neither changes current law. Under the President's proposal, however, debt held by the SSTF increases as securities are transferred to it. This leads to the increase shown in figure 6.

Figure 5: Composition of Federal Debt: Debt Held by the Public

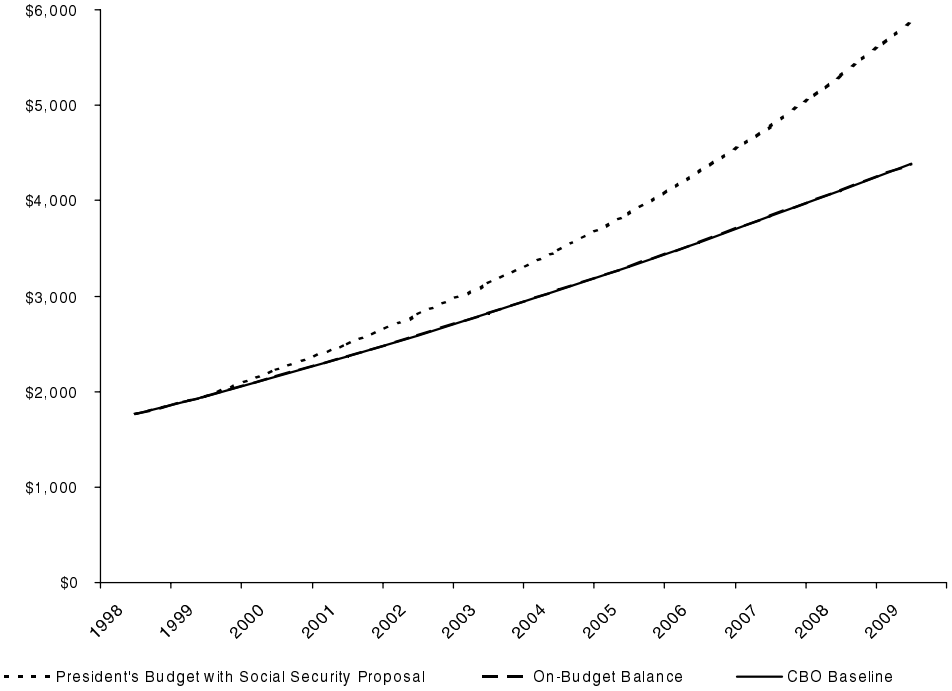
Dollars in billions



Source: OMB, CBO, Senate Budget Committee, and GAO Analysis.

Figure 6: Composition of Debt: Debt Held by Government Accounts

Dollars in billions



Note: Debt held by government accounts is the same under CBO baseline and the on-budget balance path.

Source: OMB, CBO, Senate Budget, and GAO Analysis.

While reducing debt held by the public appears to be a centerpiece of the proposal—and has significant benefits—as I noted above, the transfer of unified surpluses to Social Security is a separate issue. The transfer is not technically necessary: whenever revenue exceeds outlays and the cash needs of the Treasury—whenever there is an actual surplus—debt held by the public falls. The President's proposal appears to be premised on the belief that the only the way to sustain surpluses is to tie them to Social Security. He has merged two separate questions: (1) how much of the surplus should be devoted to reducing debt held by the public and (2) how should the nation finance the Social Security program in the future.

Let me turn now to the question of Social Security financing.

Social Security Financing

The President proposes two changes in the financing of Social Security: a pledge of general funds in the future and a modest amount of investment in equities. Both of these represent major shifts in approach to financing the program.

General Fund Financing

By, in effect, trading debt held by the public for debt held by the trust funds, the President is committing future general revenues to the Social Security program. This is true because the newly transferred securities would be in addition to any buildup of payroll tax surpluses. Securities held by the SSTF have always represented annual cash flows in excess of benefits and expenses, plus interest.[7] Under the President's proposal, this would no longer continue to be true. The value of the securities held by the SSTF would be greater than the amount by which annual revenues plus interest exceed annual benefits and expenditures.

This means that for the first time there is an explicit general fund subsidy. This is a major change in the underlying theoretical design of this program. Whether you believe it is a major change in reality depends on what you assume about the likely future use of general revenues under the current circumstances. For example, current projections are that in 2032 the fund will lack sufficient resources to pay the full promised benefits. If you believe that this shortfall would—when the time came—be made up with general fund moneys, then the shift embedded in the President's proposal merely makes that explicit. If, however, you believe that there would be changes in the benefit or tax structure of the fund instead, then the President's proposal represents a very big change. In either case, the question of bringing significant general revenues into the financing of Social Security is a question that deserves full and open debate. The debate should not be overshadowed by the accounting complexity and budgetary confusion of the proposal.

One disconcerting aspect of the President's proposal is that it appears that the transfers to the trust fund would be made regardless of whether the expected budget surpluses are actually realized. The amounts to be

[7]Cash flow into the SSTF is composed of payroll taxes and a portion of the income taxes paid on Social Security benefits. Income taxes make up a relatively small component of the surplus. Interest paid to Social Security is analogous to interest paid on publicly held debt. Both come from the general fund. Interest on publicly held debt is paid in cash while interest to the trust fund is credited in the form of additional Treasury securities.

transferred to Social Security apparently would be written into law as either a fixed dollar amount or as a percentage of taxable payroll rather than as a percentage of the actual unified surplus in any given year. These transfers would have a claim on the general fund even if the actual surplus fell below the amount specified for transfer to Social Security—and that does present a risk.[8] However, it is important to emphasize that any proposal to allocate surpluses is vulnerable to the risk that those projected surpluses may not materialize. Proposals making permanent changes to use the surplus over a long period of time are especially vulnerable to this risk.

The history of budget forecasts should remind us not to be complacent about the certainty of these large projected surpluses. In its most recent outlook book, CBO compared the actual deficits or surpluses for 1988-1998 with the first projection it produced 5 years before the start of each fiscal year. Excluding the estimated impact of legislation, CBO says its errors averaged about 13 percent of actual outlays. Such a shift in 2004 would mean a surplus $250 billion higher or lower; in 2009, the swing would be about $300 billion. Accordingly, we should consider carefully any permanent commitments that are dependent on the realization of a long-term forecast.

Investment in Equities

Under current law, the SSTF is required to invest only in securities that are issued or backed by the Treasury. The President proposes changing current law to allow the SSTF to invest a portion of its assets in equities. His proposal calls for the fund to gradually invest 15 percent of its total assets in the equity market. According to the administration's estimates, the SSTF's equity holdings would represent only a small portion—about 4 percent—of the total equity market. To insulate investment decisions from political considerations, the administration proposes investing passively in a broad-based stock index and creating an independent board to oversee the portfolio.

[8] It is worth noting that something like this happens now. Treasury does not track how much of the revenues it collects are for Social Security and how much for income taxes. It credits the SSTF with funds equal to the appropriate tax rate applied to the taxable wage base—whether or not those FICA taxes were actually paid.

Last year, we reported on the implications of allowing the SSTF to invest in equities.[9] In that report, we concluded that stock investing offers the prospect of higher returns in exchange for greater risk. We found that, by itself, stock investing was unlikely to solve Social Security's long-term financing imbalance but that it could reduce the size of other reforms needed to restore the program's solvency. We also concluded that investing in a broad-based index would help reduce, but not eliminate, the possibility of political influence over stock selections. However, the issue of how to handle stock voting rights could prove more difficult to resolve. If the government voted its shares, it would raise concerns about potential federal involvement in corporate affairs. If the government chose not to vote, it would affect corporate decision-making by enhancing the voting power of other shareholders or investment managers. The model applicable to passive private sector investment managers under the Employee Retirement Income Security Act may be relevant to the resolution of this issue.

Stock investing would have approximately the same impact on national saving as using the same amount of money to reduce debt held by the public. Both approaches would add about the same amount of funds to private capital markets, meaning that national saving would essentially be unchanged. From a budget accounting standpoint, they are not the same. Under current scoring rules the purchase of equities would be counted as an outlay, even though it is a financial transaction, because it is a transfer of funds from a governmental entity to a nongovernmental entity. The proposal apparently would change that. The administration proposes to show the entire transfer to the SSTF as a reduction in the surplus and the equity purchases would be part of that. The purchase of equities has another financial impact: since part of the surplus would be used to purchase equities, debt held by the public would be reduced less in the near term than if that amount went to reduce publicly held debt. However, in the future, claims on the Treasury would be lower because the program would rely in part on stock sales to pay benefits.

[9] Social Security Financing: Implications of Government Stock Investing for the Trust Fund, the Federal Budget, and the Economy (GAO/AIMD/HEHS-98-74, April 22, 1998).

Have Other Countries Tackled These Problems?

Although the dilemma we are facing of whether and how to save for the future is a very difficult one, it is not unique. A look at other democracies shows that surpluses are difficult to sustain. However, several nations have succeeded in sustaining surpluses. In those nations, political leaders were able to articulate a compelling rationale to justify the need to set aside current resources for future needs.

For example, those countries that have come to the conclusion that the debt burden matters make it an explicit part of their fiscal decision-making process. Australia, New Zealand, and the United Kingdom all attempt to define prudent debt levels as a national goal to strive for. These debt goals can prove important in times of surplus. New Zealand, for example, used its debt goals as justification for maintaining spending restraint and attempting to run sustained surpluses. They promised that once they met their initial debt target they would give a tax cut. Importantly, when they hit that specified debt target, they delivered on their promise of tax cuts.

Other countries have saved for the future by separating their pension or Social Security-related assets from the rest of the government's budget. For example, the Canadian Pension Plan is completely separate from both federal and provincial budgets. When the fund earns surplus cash, it is invested in provincial debt securities and, starting this year, in the stock market. Sweden also maintains a pension fund outside the government's budget and invests assets in stocks and bonds.

Norway may be the most dramatic example of setting aside current surpluses to address long-term fiscal and economic concerns. Norway faces the two-edged problem of a rapidly aging population and declining oil revenues—a significant source of current government revenue. To address these long-term concerns, Norway started setting aside year-end budget surpluses in 1996 to be invested in foreign stocks and bonds. Their express intention is to draw down these assets to pay for the retirement costs for their baby boomers.

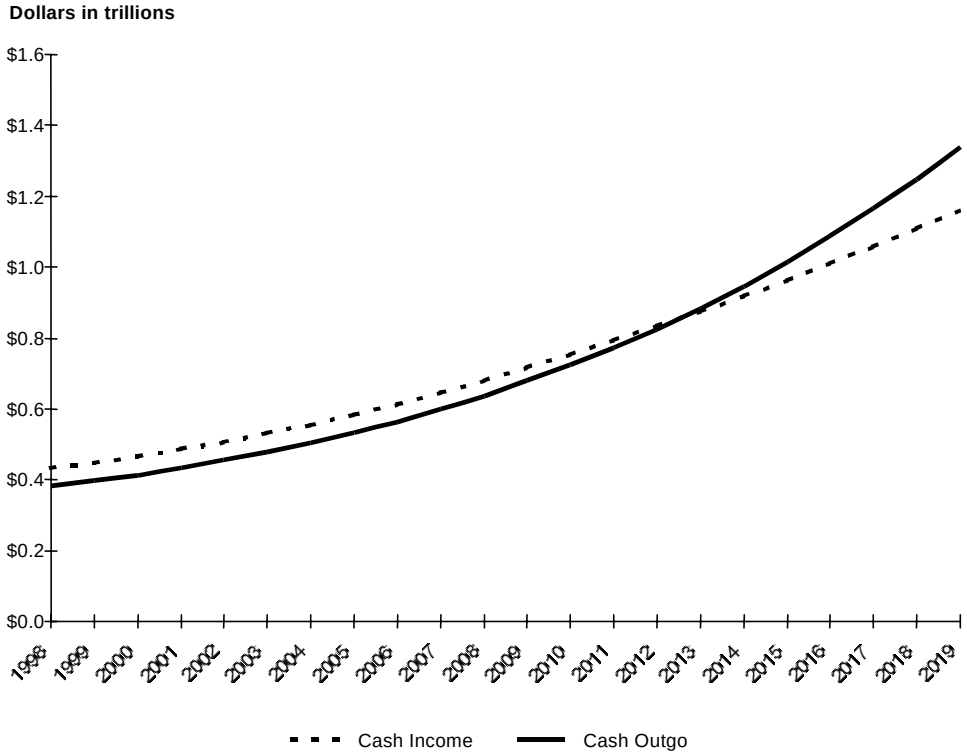
It should be noted that other nations that have attempted to directly address their debt and pension problems have usually done so during or shortly after a fiscal or economic crisis. Fortunately, we do not have that problem. Instead, we have a unique opportunity to use our current good fortune to meet the challenges of the future.

Social Security Reform Is Still Needed

Finally, it is important to note that the President's proposal does not alter the projected payroll tax and benefit imbalances in the Social Security program. In addition, it does not come close to "saving Social Security." Benefit costs and revenues currently associated with the program will not be affected by even 1 cent. Figure 7, which shows Social Security's payroll tax receipts and benefit payments, illustrates this point. Without the President's proposal, payroll tax receipts will fall short of benefit payments in 2013[10]; *with* the President's proposal, payroll tax receipts also fall short of benefit payments in 2013—the graph doesn't change at all. Under the President's proposal, expected stock market returns would be used to fill part of this gap, but from 2013 on the trust funds will need cash from redeemed Treasury securities, whether or not the President's proposal is adopted.

[10]Cash inflows actually consist of payroll taxes plus the income taxes paid on Social Security benefits. Cash outflows are almost entirely made up of benefit payments, but they also include the fund's administrative expenses.

Figure 7: SSTF Projected Cash Income and Outflow Through 2019



Source: Social Security Trustees 1998 Report, Intermediate Assumptions.

What does this mean? In 2013, inflows to the SSTF from payroll taxes and income taxes on Social Security benefits will no longer exceed outflows for benefits and administrative expenses. As a result, the year 2013 is the key date from a government financing perspective. At this point, the SSTF will have to begin drawing on its other income sources—the transfers from the general fund proposed by the President and the returns on its existing assets. Beginning in 2015, the SSTF will obtain some of the additional cash it needs from its equity holdings. However, most of the cash needed in the years that follow would come from tapping the SSTF's Treasury securities. When the SSTF begins drawing on the Treasury, it means that the rest of the government will have to come up with the cash. If there is a unified budget surplus, it will shrink. If, however, there is no surplus, there are only three choices: cut spending, raise taxes, and/or increase borrowing from the public. The amount needed from the rest of the government to help cover the SSTF's cash deficit will escalate rapidly, exceeding $100 billion annually by 2019. This has already happened to Medicare's Hospital

Insurance Trust Fund--it has been drawing on its special treasuries for several years.

Under the President's proposal, the changes to the Social Security program will be more perceived than real: although the trust funds will appear to have more resources as a result of the proposal, in reality, nothing about the program has changed. The proposal does not represent Social Security program reform, but rather a different means to finance the current program. Although the President has called for bipartisan cooperation to make programmatic changes, one of the risks of his proposal is that the additional years of financing it provides could very well diminish the urgency to achieve meaningful changes in the program. This would not be in the overall best interests of the nation.

To achieve long-term solvency and sustainability, the Social Security program itself must be reformed. The demographic trends that are driving the program's financial problems affect the program well into the future. The impending retirement of the baby boom generation is the best known of these trends, but is not the only challenge the system faces. If this were so, perhaps a one-time financing strategy could be sufficient. But people are retiring earlier, birth rates have fallen, and life expectancies are increasing—all these factors suggest that Social Security's financial problems will outlive the baby boom generation and continue far into the future. These problems cannot be addressed without changes to the Social Security program itself.

Changes to the Social Security system should be made sooner rather than later. The longer meaningful action is delayed, the more severe such actions will have to be in the future. Changes made today would be relatively minor compared to what could be necessary years from now, with less time for the fiscal effects of those changes to build. Moreover, acting now would allow any benefit changes to be phased in gradually so that participants would have time to adjust their saving or retirement goals accordingly. It would be tragic indeed if this proposal, through its budgetary accounting complexity, masked the urgency of the Social Security solvency problem and served to delay much-needed action.

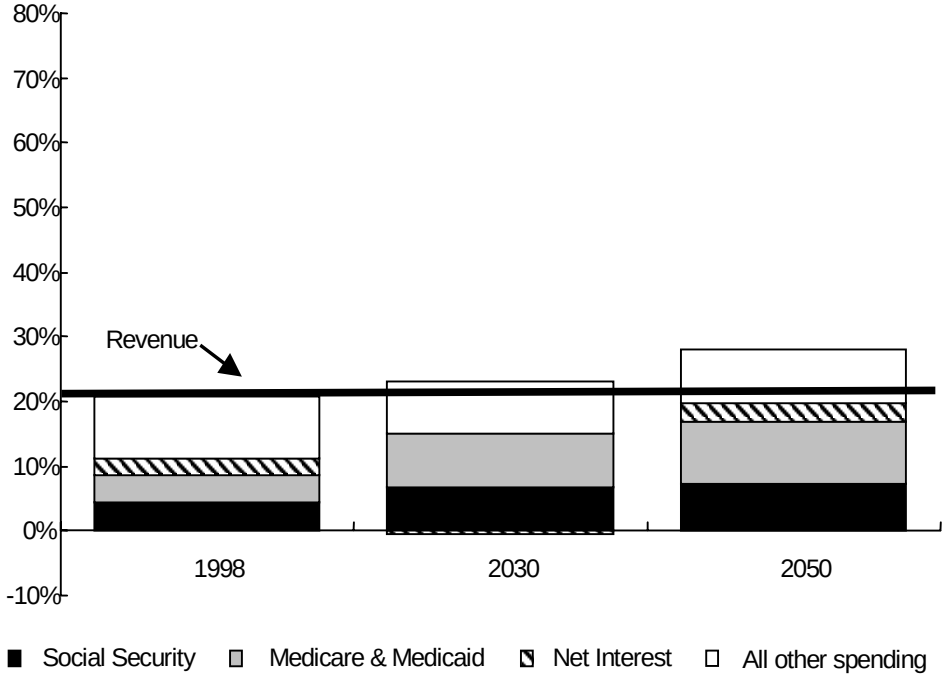
There is another reason to take action on Social Security now. Social Security is not the only entitlement program needing urgent attention. In fact, the issues surrounding the Medicare program are much more urgent and complex. Furthermore, the many variables associated with health care

consumption and Medicare costs and the personal emotions associated with health decisions make reform in this program particularly difficult.

To move into the future without changes in Social Security or health programs is to envision a very different role for the federal government. Assuming no financing or benefit changes, our long-term model (and that of CBO) shows a world in 2050 in which Social Security and health care absorb an increasing share of the federal budget. (See figure 8.) Budgetary flexibility declines drastically and there is increasingly less room for programs for national defense, the young, infrastructure, and law enforcement—i.e., essentially no discretionary programs at all. Eventually, again assuming no program or financing changes, Social Security, health, and interest take nearly all the revenue the federal government takes in by 2050. This is true even if we assume that the entire surplus is saved and these continued surpluses reduce interest from current levels. As shown in figure 9, the picture below is even more dramatic if we assume the entire surplus is used.[11] In that scenario, lower GDP and higher interest payments lead to a world in which revenues cover only Social Security, health, and interest in 2030. And in 2050 revenues don't even cover Social Security and health!

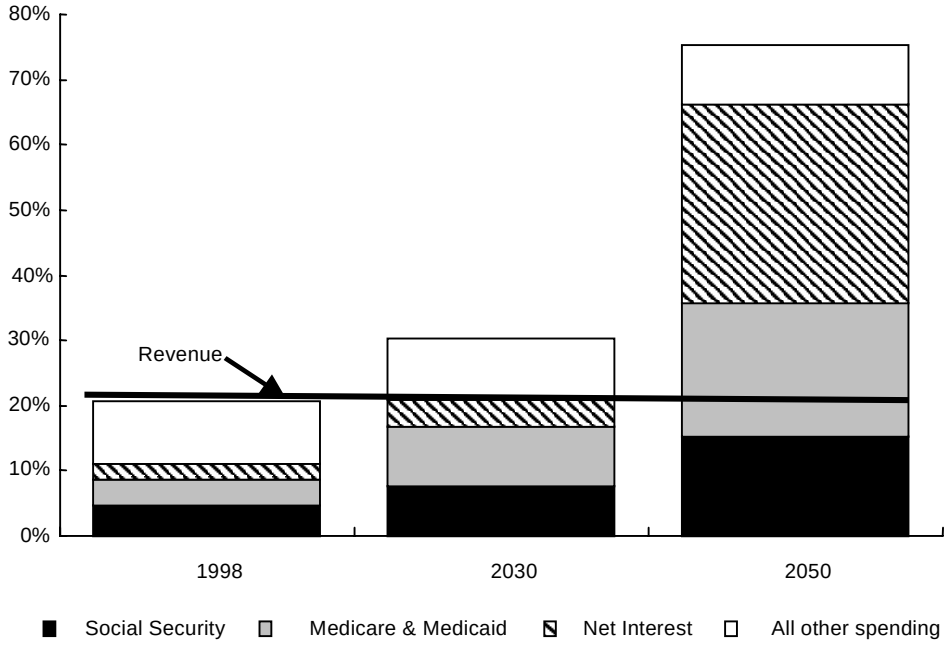
[11] Our "No Surplus" simulation is not a forecast but rather an illustration of the implications of enacting permanent tax cuts and/or spending increases that eliminate projected surpluses and the fiscal pressures posed by the aging of the baby boom generation. This simulation shows ever-increasing deficits that result in declining investment, a diminishing capital stock, and a collapsing economy. In reality, these economic consequences would inevitably force policy changes to avert such a catastrophic outcome.

Figure 8: Composition of Spending as a Share of GDP Under "Save the Surplus" Simulation



Source: GAO Analysis.

Figure 9: Composition of Spending as a Share of GDP Under "No Surplus" Simulation



Source: GAO Analysis.

Although views about the role of government differ, it seems unlikely that many would advocate a government devoted solely to sending checks and health care reimbursements to the elderly.

Let us address Social Security for the long term today so that the nation can turn its attention to these other more pressing and difficult issues early in the new millenium. Look again at figures 8 and 9: Social Security is not the fastest growing portion of those bars—health grows faster.

Much remains to be done in reforming entitlement programs, and engaging in meaningful Social Security reform would represent an important and significant first step. The Congress and the administration, working together, can find a comprehensive and sustainable solution to this important challenge.

I recognize, though, that restoring Social Security solvency is not easy. However, it is easy lifting compared to what faces us in connection with the Medicare program. Ultimately, any reforms to Social Security will address

not only the relatively narrow question of how to restore solvency and assure sustainability but will also go to the larger question of what role Social Security and the federal government should play in providing retirement income. There are many proposals being made to address these questions; choosing among them will involve difficult and complex choices, choices that will be critically important to nearly every American's retirement income.

In my view, progress is likely to be greatest if we see these choices not as "either/or" decisions but rather as an array of possibilities along a continuum. Combining elements of different approaches may offer the best chance to produce a package that addresses the problem comprehensively for the long term in a way that is meaningful and acceptable to the American people. For example, such a continuum may identify individual accounts that could serve as a voluntary or mandatory supplement to a financially sound and sustainable base defined benefit structure. In addition, master trust principles can be used to provide for collective investment of base defined benefit and individual account funds in ways that would serve to prevent political manipulation of investments.

In order to help structure these choices, I would suggest five criteria for evaluating possible Social Security proposals.

Sustainable solvency: A proposal should eliminate the gap between trust fund resources and expenditures over 75 years, and have the ability to sustain a stable system beyond that time period.

Equity: A proposal should create no "big winners" or "big losers." Those who are most reliant on Social Security for retirement and disability income should continue to receive adequate support; those who contribute the most would also benefit from participation in the system, and intergenerational equity would improve.

Adequacy: Consistent with Social Security's social insurance feature, a proposal should provide for a certain and secure defined benefit promise that is geared to providing higher replacement rates for lower-income workers and reasonable minimum benefits to minimize poverty among the elderly.

Feasibility: A proposal should be structured so that it could be implemented within a reasonable time period, it could be readily

administered, and the administrative costs associated with it would be reasonable.

Transparency: A proposal should be readily understandable to the general public and, as a result, generate broad support.

Applying such criteria will require a detailed understanding of the possible outcomes and issues associated with the various elements of proposals. We are working to provide the data, information, and analysis needed to help policymakers evaluate the relative merits of various proposals and move toward agreement on a comprehensive Social Security reform proposal.

Conclusions

Budget surpluses provide a valuable opportunity to capture significant long-term gains to both improve the nation's capacity to address the looming fiscal challenges arising from demographic change and aid in the transition to a more sustainable Social Security program. The President's proposal may prompt a discussion and decision on both how much of our current resources we want to save for the future and how we can best do so. The President's proposal is both wide ranging and complex, and it behooves us to clarify the consequences for both our national economy and the Social Security program.

A substantial share of the surpluses would be used to reduce publicly held debt, providing demonstrable gains for our economic capacity to afford our future commitments. In this way, the proposal would help us, in effect, prefund these commitments by using today's wealth earned by current workers to enhance the resources for the next generations.

Saving a good portion of today's surpluses can help future generations of workers better afford the billowing costs of these commitments, but this is only one side of the equation. We must also reform the programs themselves to make these commitments more affordable. Even if we save the entire surplus over the next 50 years Social Security and health programs will double as a share of the economy and consume nearly all federal revenues--essentially crowding out all other spending programs. Thus, it is vital that any proposal to expand economic growth be accompanied by real entitlement reform.

The transfer of surplus resources to the trust fund, which the administration argues is necessary to lock in surpluses for the future,

would nonetheless constitute a major shift in financing for the Social Security program, but it would not constitute real Social Security reform because it does not modify the program's underlying commitments for the future. Moreover, the proposed transfer may very well make it more difficult for the public to understand and support the savings goals articulated. Several other nations have shown how debt reduction itself can be made to be publicly compelling, but only you can decide whether such an approach will work here.

I am very concerned that enhancing the financial condition of the trust fund alone without any comprehensive and substantive program reforms may, in fact, undermine the case for fundamental program changes. In addition, explicitly pledging federal general revenues to Social Security will limit the options for dealing with other national issues.

The time has come for meaningful Social Security reform. Delay will only serve to make the necessary changes more painful down the road. We must be straight with the American people; achieving the goal of "saving Social Security" will require real options to increase program revenues and/or decrease program expenses. There is no "free lunch." After all, we have much larger and more complex challenges to tackle like the Medicare program.

As you consider various proposals, you should consider the following questions.

- How much of the unified budget surplus should go to debt reduction versus other priorities?
- If we are to use some portion of the surplus to reduce publicly held debt, is the President's proposed approach the way to do this?
- Should Social Security be financed in part by general revenues?
- Should the SSTF invest in the stock market?
- How can we best assure the solvency, sustainability, equity, and integrity of the Social Security program for current and future generations of Americans?
- How can we best increase real savings for our future?
- How can we best assure the public's understanding of and support for any comprehensive Social Security reform proposal?

We at GAO stand ready to help you address both Social Security reform and other critical national challenges. Working together, we can make a positive and lasting difference for our country and the American people.

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