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SOCIAL SECURITY

Analysis of Issues and Selected Reform Proposals

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GAO-03-376T

Mr. Chairman and Members of the Committee:

Thank you for inviting me here to talk about our nation's Social Security program and how to address the challenges presented in ensuring the long-term viability of this system. Social Security not only represents the foundation of our retirement income system; it also provides millions of Americans with disability insurance and survivors' benefits. As a result, Social Security provides benefits that are critical to the current and future well-being of tens of millions of Americans. However, as I have said in congressional testimonies over the past several years,[1] the system faces both solvency and sustainability challenges in the longer term. In their 2002 report, the Trustees emphasized that while the program's near-term financial condition has improved slightly, Social Security faces a substantial financial challenge in the not-too-distant future that needs to be addressed soon. In essence, the program's long-term outlook remains unchanged. Without reform, Social Security, Medicare, and Medicaid are unsustainable, and the long-term impact of these entitlement programs on the federal budget and the economy will be dramatic.

Over the past few years, a wide array of proposals has been put forth to restore Social Security's long-term solvency, and a commission established by the President has presented three models for modifying the current program. The Commission's final report[2] called for a period of discussion lasting at least a year before legislative action is taken to strengthen and restore sustainability to Social Security. Today we are issuing the GAO report you requested on the Commission's options.[3] At your request, we have also done a qualitative review of three other proposals introduced in the 107th Congress. In my testimony today I will discuss not only our report but also the broader issue of Social Security. I hope my testimony will help clarify some of the key issues in the debate about how to restructure this critically important program.

[1]U. S. General Accounting Office, *Social Security: Criteria for Evaluating Social Security Reform Proposals*, GAO/T-HEHS-99-94 (Washington, D.C.: Mar. 25, 1999); *Social Security: The President's Proposal*, GAO/T-HEHS/AIMD-00-43 (Washington, D.C.: Nov. 9, 1999); *Budget Issues: Long-Term Fiscal Challenges*, GAO-02-467T (Washington, D.C.: Feb. 27, 2002); *Social Security: Long-Term Financing Shortfall Drives Need for Reform* GAO-02-845T (Washington, D.C.: June 19, 2002).

[2]*Strengthening Social Security and Creating Personal Wealth for All Americans* (Dec. 21, 2001; rev. Mar. 19, 2002).

[3]*Social Security: Analysis of the Commission to Strengthen Social Security* (GAO-03-310, Jan. 15, 2003).

First, let me highlight a number of important points in connection with the Social Security challenge.

- **Social Security reform is part of a broader fiscal and economic challenge**. If you look ahead in the federal budget, the combined Social Security or Old-Age and Survivors Insurance and Disability Insurance (OASDI) program together with the rapidly growing health programs (Medicare and Medicaid) will dominate the federal government's future fiscal outlook. Under our long-term simulations, it continues to be the case that these programs increasingly constrain federal budgetary flexibility over the next few decades. Absent reform, the nation will ultimately have to choose between persistent, escalating federal deficits, significant tax increases, and/or dramatic budget cuts.

- **Focusing on trust fund solvency alone is not sufficient. We need to put the program on a path toward sustainable solvency**. Trust fund solvency is an important concept, but focusing on trust fund solvency alone can lead to a false sense of security about the overall condition of the Social Security program. The size of the trust fund does not tell us whether the program is sustainable—that is, whether the government will have the capacity to pay future claims or what else will have to be squeezed to pay those claims. Aiming for sustainable solvency would increase the chance that future policymakers would not have to face these difficult questions on a recurring basis. Estimates of what it would take to achieve 75-year trust fund solvency understate the extent of the problem because the program's financial imbalance gets worse in the 76th and subsequent years.

- **Solving Social Security's long-term financing problem is more important and complex than simply making the numbers add up**. Social Security is an important and successful social program that affects virtually every American family. It currently pays benefits to more than 45 million people, including retired workers, disabled workers, the spouses and children of retired and disabled workers, and the survivors of deceased workers. The number of individuals receiving benefits is expected to grow to almost 69 million by 2020. The program has been highly effective at reducing the incidence of poverty among the elderly, and the disability and survivor benefits have been critical to the financial well-being of millions of others.

- **Given the current projected financial shortfall of the program, it is important to compare proposals to at least two funded benchmarks—one that funds currently scheduled benefits and one that adjusts to current tax financing**. Comparing the beneficiary

impact of reform proposals solely to currently scheduled Social Security benefits is inappropriate since all current scheduled benefits are not funded over the longer term. As a result, comparisons to currently scheduled benefits after the point of trust fund insolvency assume a payroll tax increase or general revenue infusion that have not been enacted and may not occur. Likewise, comparisons of reform proposals solely to funded benefits after the point of trust fund insolvency are inappropriate since that assumes a future sudden and sharp reduction in benefits that is not likely to occur. The key point is that there is a significant gap between scheduled benefits and projected revenues. In fact, a primary purpose of most Social Security reform proposals is to close or eliminate this gap.

- **Reform proposals should be evaluated as packages**. The elements of any package interact; every package will have pluses and minuses, and no plan will satisfy everyone on all dimensions. If we focus on the pros and cons of each element of reform, it may prove impossible to build the bridges necessary to achieve consensus.

- **Acting sooner rather than later helps to ease the difficulty of change**. As I noted previously, the challenge of facing the imminent and daunting budget pressure from Medicare, Medicaid, and OASDI increases over time. Social Security will begin to constrain the budget long before the trust funds[4] are exhausted in 2041. The program's annual cash flow is projected to be negative beginning in 2017. Social Security's annual cash deficit will place increasing pressure on the rest of the budget to raise the resources necessary to meet the program's costs. Waiting until Social Security faces an immediate solvency crisis will limit the scope of feasible solutions and could reduce the options to only those choices that are the most difficult. It could also contribute to further delay the really tough decisions on health programs (e.g., Medicare and Medicaid). Acting sooner rather than later would allow changes to be phased in so that future and near retirees have time to adjust their retirement planning. It would also help to ensure that the "miracle of compounding" works for us rather than against us.

Our Social Security challenge is more urgent than it may appear. Failure to take remedial action will, in combination with other entitlement spending, lead to a situation unsustainable both for the federal government and,

[4]In this testimony, the term "Trust Funds" refers to the Old-Age and Survivors Insurance and Disability Insurance Trust Funds.

ultimately, the economy. This problem is about more than finances. It is also about maintaining an adequate safety net for American workers against loss of income from retirement, disability, or death; Social Security provides a foundation of retirement income for millions of Americans and has prevented many former workers and their families from living their retirement years in poverty. As the Congress considers proposals to restore the long-term financial stability and viability of the Social Security system, it also needs to consider the impact of the potential changes on different types of beneficiaries. Moreover, while addressing Social Security reform is important and will not be easy, Medicare presents a much greater, more complex, and even more urgent fiscal challenge.

To assist the Congress in its deliberations, we have developed criteria for evaluating Social Security reform proposals. These criteria aim to balance financial and economic considerations with benefit adequacy and equity issues and the administrative challenges associated with various proposals. The use of these criteria can help facilitate fair consideration and informed debate of Social Security reform proposals.

Social Security's Long-Term Financing Problem Is More Urgent Than It May Appear

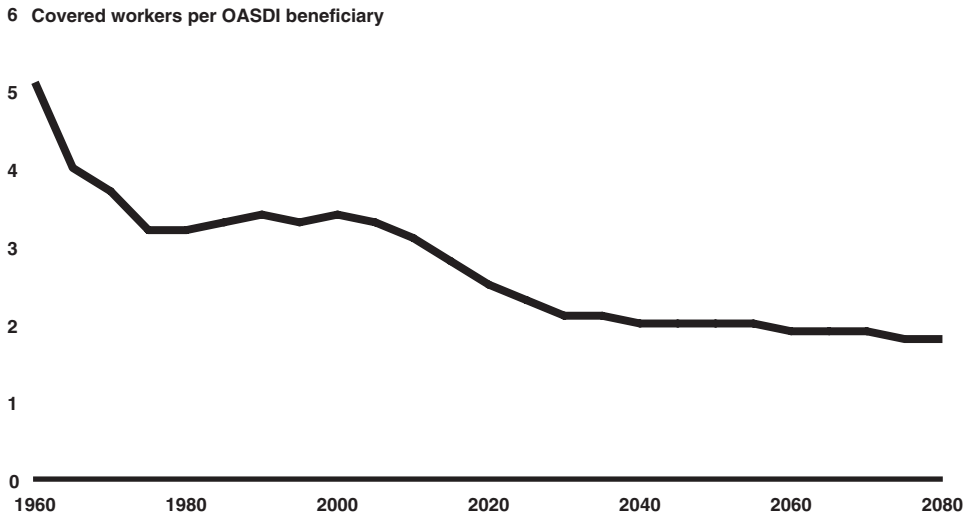
Today the Social Security program faces not an immediate crisis but rather a long-range and more fundamental financing problem driven largely by known demographic trends. The lack of an immediate solvency crisis affects the nature of the challenge, but it does not eliminate the need for action. Acting soon reduces the likelihood that the Congress will have to choose between imposing severe benefit cuts and unfairly burdening future generations with the program's rising costs. Acting soon would allow changes to be phased in so the individuals who are most likely to be affected, namely younger and future workers, will have time to adjust their retirement planning while helping to avoid related "expectation gaps." Since there is a great deal of confusion about Social Security's current financing arrangements and the nature of its long-term financing problem, I would like to spend some time describing the nature, timing, and extent of the financing problem.

Demographic Trends Drive Social Security's Long-Term Financing Problem

As you all know, Social Security has always been largely a pay-as-you-go system. This means that current workers' taxes pay current retirees' benefits. As a result, the relative numbers of workers and beneficiaries has a major impact on the program's financial condition. This ratio, however, is changing. In 1950, before the Social Security system was mature, the ratio was 16.5. In the 1960s, the ratio averaged 4.2:1. Today it is 3.4:1 and it is expected to drop to around 2:1 by 2030. The retirement of the baby

boom generation is not the only demographic challenge facing the system. People are retiring early and living longer. A falling fertility rate is the other principal factor underlying the growth in the elderly's share of the population. In the 1960s, the fertility rate was an average of 3 children per woman. Today it is a little over 2, and by 2030 it is expected to fall to 1.95—a rate that is below replacement. Taken together, these trends threaten the financial solvency and sustainability of this important program. (See fig. 1.)

Figure 1: Social Security Workers per Beneficiary

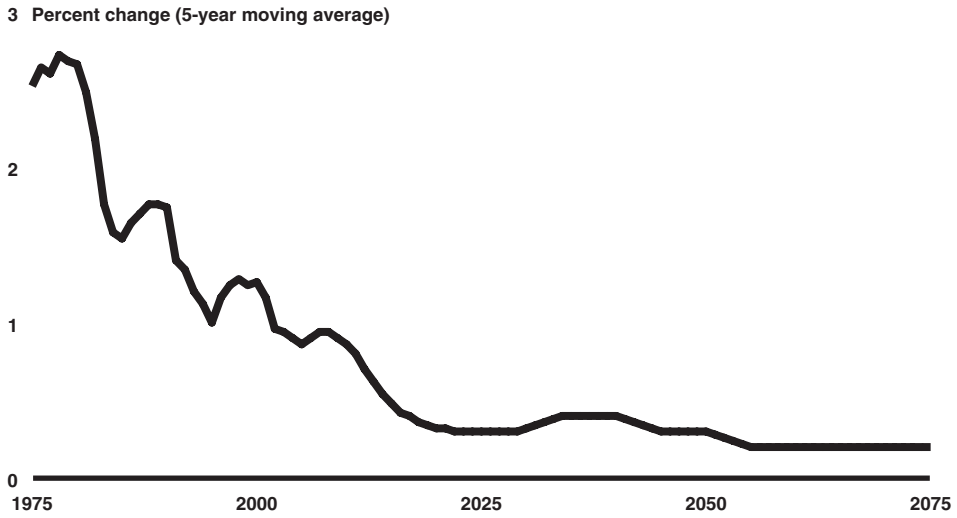


Source: *The 2002 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds*.

Note: Projections based on intermediate assumptions of the 2002 Trustees' Report.

The combination of these trends means that labor force growth will begin to slow after 2010 and by 2025 is expected to be less than a third of what it is today. (See fig. 2.) Relatively fewer workers will be available to produce the goods and services that all will consume. Without a major increase in productivity, low labor force growth will lead to slower growth in the economy and to slower growth of federal revenues. This in turn will only accentuate the overall pressure on the federal budget.

Figure 2: Labor Force Growth Is Expected to be Negligible by 2050



Source: GAO analysis of data from the Office of the Chief Actuary, Social Security Administration.

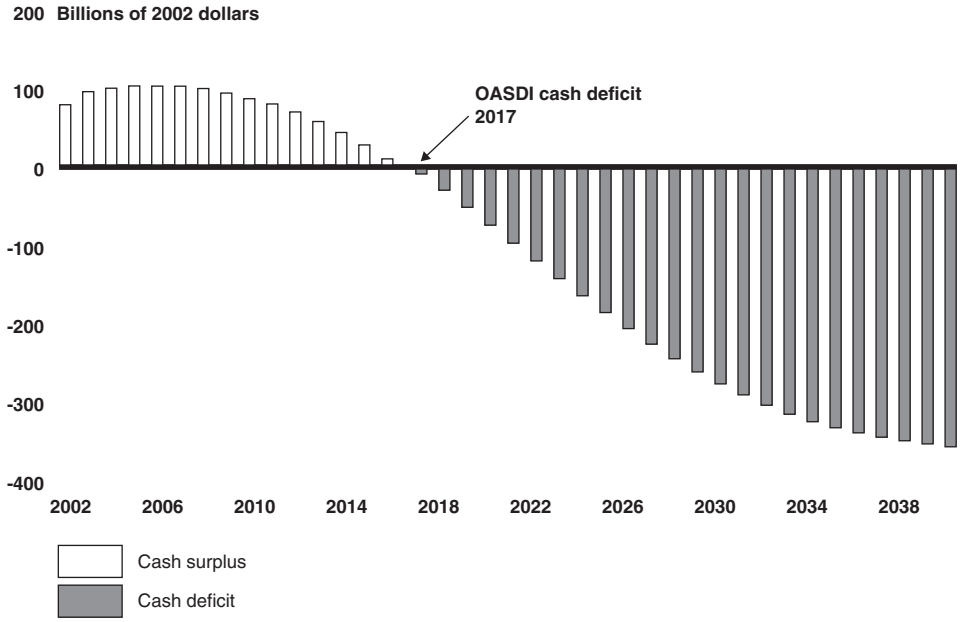
Note: Projections based on intermediate assumptions of the 2002 Trustees' Report.

This slowing labor force growth is not always recognized as part of the Social Security debate. Social Security's retirement eligibility dates are often the subject of discussion and debate and can have a direct effect on both labor force growth and the condition of the Social Security retirement program. However, it is also appropriate to consider whether and how changes in pension and/or other government policies could encourage longer workforce participation. To the extent that people choose to work longer as they live longer, the increase in the share of life spent in retirement would be slowed. This could improve the finances of Social Security and mitigate the expected slowdown in labor force growth.

Social Security's Cash Flow Is Expected to Turn Negative in 2017

Today, the Social Security Trust Funds take in more in taxes than they spend. Largely because of the known demographic trends I have described, this situation will change. Under the Trustees' intermediate assumptions, combined program outlays begin to exceed dedicated tax receipts in 2017 (see fig. 3), a year after Medicare's Hospital Insurance (HI) Trust Fund outlays are first expected to exceed program tax revenues. At that time, both programs will become net claimants on the rest of the federal budget.

Figure 3: Social Security's Trust Funds Face Cash Deficits as Baby Boomers Retire



Source: GAO analysis of data from the Office of the Chief Actuary, Social Security Administration, based on the intermediate assumptions of the 2002 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds.

Although the Trustees' intermediate estimates show that the combined Social Security Trust Funds will be solvent until 2041,[5] program spending will constitute a rapidly growing share of the budget and the economy well before that date. Ultimately, the critical question is not how much a trust fund has in assets, but whether the government as a whole can afford the benefits in the future and at what cost to other claims on scarce resources.

[5]Separately, the Disability Insurance Fund is projected to be exhausted in 2028 and the Old-Age and Survivors Insurance Fund in 2043.

As I have said before, the future sustainability of programs is the key issue policymakers should address—i.e., the capacity of the economy and budget to afford the commitment. Fund solvency can help, but only if promoting solvency improves the future sustainability of the program.

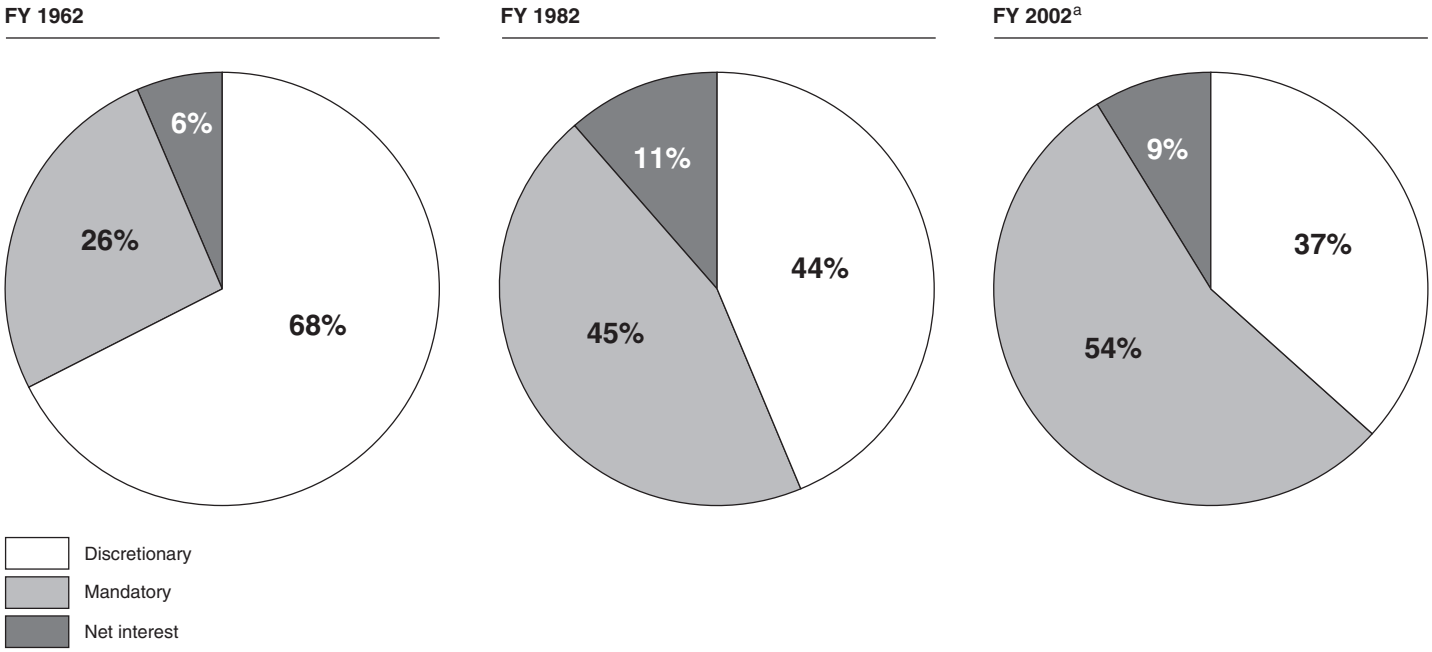
Beginning in 2017, the Trust Funds will begin drawing on the Treasury to cover the cash shortfall, first relying on interest income and eventually drawing down accumulated trust fund assets. The Treasury will need to obtain cash for those redeemed securities either through increased taxes, spending cuts, increased borrowing from the public, or correspondingly less debt reduction than would have been the case had Social Security's cash flow remained positive.[6] Neither the decline in the cash surpluses nor the cash deficit will affect the payment of benefits. The shift will, however, affect the rest of the budget. The negative cash flow will place increased pressure on the federal budget to raise the resources necessary to meet the program's ongoing costs.

Decline in Budgetary Flexibility Disappears Absent Entitlement Reform

From the perspective of the federal budget and the economy, the challenge posed by the growth in Social Security spending becomes even more significant in combination with the more rapid expected growth in Medicare and Medicaid spending. This growth in spending on federal entitlements for retirees will become increasingly unsustainable over the longer term, compounding an ongoing decline in budgetary flexibility. Over the past few decades, spending on mandatory programs has consumed an ever-increasing share of the federal budget. In 1962, prior to the creation of the Medicare and Medicaid programs, spending for mandatory programs plus net interest accounted for about 32 percent of total federal spending. By 2002, this share had almost doubled to approximately 63 percent of the budget. (See fig. 4.)

[6]If the unified budget is in surplus at this point, then financing the excess benefits will require less debt redemption rather than increased borrowing.

Figure 4: Federal Spending for Mandatory and Discretionary Programs, Fiscal Years 1962, 1982, and 2002



Source: GAO analysis of data from the Office of Management and Budget.

[a]Office of Management and Budget current services estimate.

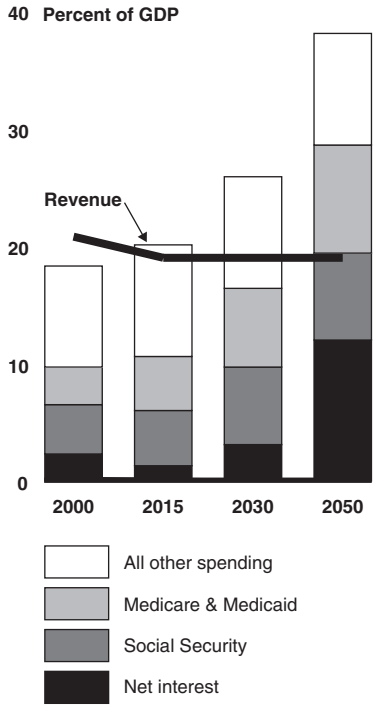
In much of the last decade, reductions in defense spending helped accommodate the growth in these entitlement programs. Even before the events of September 11, 2001, however, this ceased to be a viable option. Indeed, spending on defense and homeland security will grow as we seek to combat new threats to our nation's security.

We prepared long-term budget simulations that seek to illustrate the likely fiscal consequences of the coming demographic tidal wave and rising health care costs. These simulations continue to show that to move into the future with no changes in federal retirement and health programs is to envision a very different role for the federal government. Assuming, for example, that the tax reductions enacted in 2001 do not sunset and discretionary spending keeps pace with the economy, by mid-century federal revenues may only be adequate to pay Social Security and interest on the federal debt. [7] Spending for the current Medicare program—without

[7]This simulation assumes that all currently scheduled benefits would be paid in full throughout the 75-year projection period.

the addition of a drug benefit—is projected to account for more than one-quarter of all federal revenues. To obtain balance, massive spending cuts, tax increases, or some combination of the two would be necessary. (See fig. 5.) Neither slowing the growth of discretionary spending nor allowing the tax reductions to sunset eliminates the imbalance.

Figure 5: Composition of Spending as a Share of Gross Domestic Product Assuming Discretionary Spending Grows with GDP, the Tax Cuts Do Not Sunset, and Currently Scheduled Social Security Benefits



Source: GAO's August 2002 analysis.

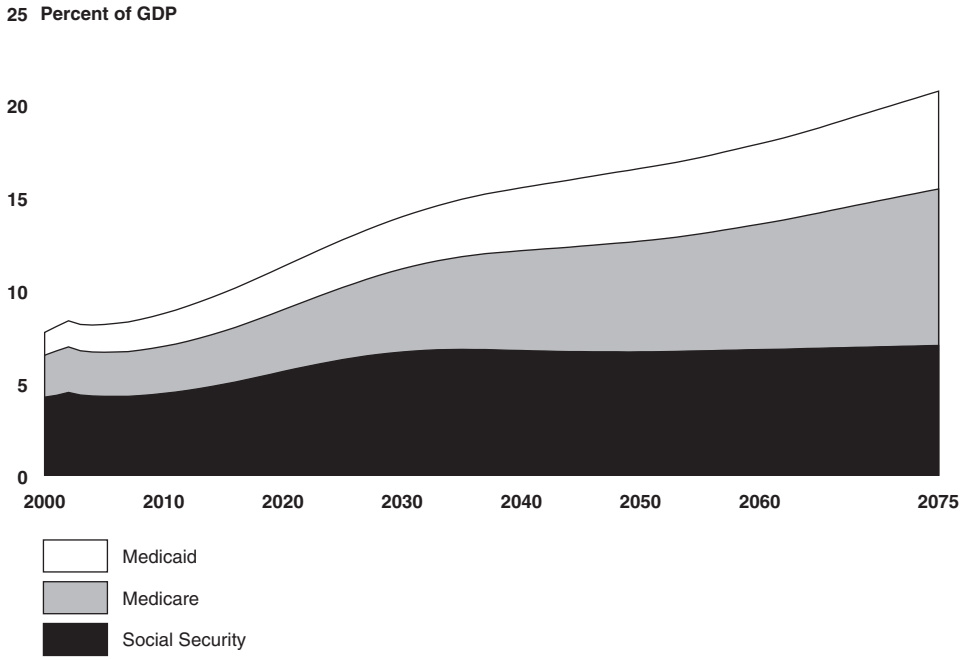
Although this figure assumes payment of currently scheduled Social Security benefits, the long-term fiscal imbalance would not be eliminated even if Social Security benefits were to be limited to currently projected trust fund revenues. This is because Medicare (and Medicaid)—spending for which is driven by both demographics and rising health care costs—present an even greater problem. Absent a change in design, these two health programs together are projected to nearly triple as a share of gross domestic product (GDP) over the next half-century.

This testimony is not about the complexities of Medicare, but it is important to note that Medicare presents a much greater, more complex, and more urgent fiscal challenge than does Social Security. Unlike Social Security, Medicare growth rates reflect not only a burgeoning beneficiary population, but also the escalation of health care costs at rates well exceeding general rates of inflation. Increases in the number and quality of health care services have been fueled by the explosive growth of medical technology. Moreover, the actual costs of health care consumption are not transparent. Third-party payers generally insulate consumers from the cost of health care decisions. These factors and others contribute to making Medicare a much greater and more complex fiscal challenge than even Social Security. We are developing a health care framework to help focus additional attention on this important area and to help educate key policymakers on the current system and related challenges.

Indeed, long-term budget flexibility is about more than Social Security and Medicare. While these programs dominate the long-term outlook, they are not the only federal programs or activities that bind the future. The federal government undertakes a wide range of programs, responsibilities, and activities that obligate it to future spending or create an expectation for spending. We have work underway regarding how to describe the range and measurement of such fiscal exposures—from explicit liabilities such as environmental cleanup requirements to the more implicit obligations presented by life-cycle costs of capital acquisition or disaster assistance. Making government fit the challenges of the future will require not only dealing with the drivers—entitlements for the elderly—but also looking at the range of federal activities. A fundamental review of what the federal government does and how it does it will be needed.

At the same time it is important to look beyond the federal budget to the economy as a whole. Figure 6 shows the total future draw on the economy represented by Social Security, Medicare, and Medicaid. Under the 2002 Trustees' intermediate estimates and the Congressional Budget Office's most recent long-term Medicaid estimates, spending for these entitlement programs combined will grow to 13.9 percent of GDP in 2030 from today's 8.3 percent. Taken together, Social Security, Medicare, and Medicaid represent an unsustainable burden on future generations.

Figure 6: Social Security, Medicare, and Medicaid Spending as a Percent of GDP



Source: Office of the Chief Actuary, Social Security Administration; Office of the Actuary, Centers for Medicare and Medicaid Services; and CBO.

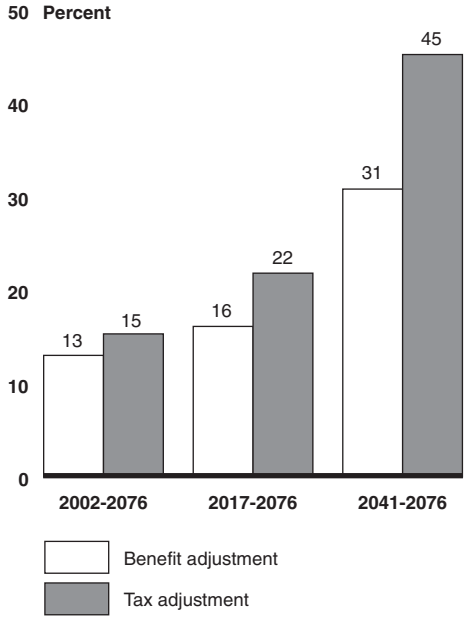
Note: Projections based on intermediate assumptions of the 2002 Trustees' Reports and CBO's June 2002 long-term projections under mid-range assumptions.

When Social Security redeems assets to pay benefits, the program will constitute a claim on real resources in the future. As a result, taking action now to increase the future pool of resources is important. To echo Federal Reserve Chairman Alan Greenspan, the crucial issue of saving in our economy relates to our ability to build an adequate capital stock to produce enough goods and services in the future to accommodate both retirees and workers in the future.[8] The most direct way the federal government can raise national saving is by increasing government saving, that is, as the economy returns to a higher growth path, a balanced fiscal policy that recognizes our long-term challenges can help provide a strong foundation for future economic growth and can enhance future budgetary flexibility.

[8]Testimony before the Senate Committee on Banking, Housing, and Urban Affairs, July 24, 2001.

Taking action now on Social Security would not only promote increased budgetary flexibility in the future and stronger economic growth but would also make less dramatic action necessary than if we wait. Some of the benefits of early action—and the costs of delay—can be seen in figure 7. This compares what it would take to achieve actuarial balance at different points in time by either raising payroll taxes or reducing benefits.[9] Figure 7 shows this. If we did nothing until 2041—the year the Trust Funds are estimated to be exhausted—achieving actuarial balance would require changes in benefits of 31 percent or changes in taxes of 45 percent. As figure 7 shows, earlier action shrinks the size of the necessary adjustment.

Figure 7: Size of Action Needed to Achieve Social Security Solvency



Source: GAO analysis of data from the Office of the Chief Actuary, Social Security Administration.

Note: The benefit adjustments in this graph represent a one-time, permanent change to all existing and future benefits beginning in the first year indicated.

[9]Solvency could also be achieved through a combination of tax and benefit actions. This would reduce the magnitude of the required change in taxes or benefits compared with making changes exclusively to taxes or benefits as shown in figure 7.

Thus, both sustainability concerns and solvency considerations drive us to act sooner rather than later. Trust Fund exhaustion may be nearly 40 years away, but the squeeze on the federal budget will begin as the baby boom generation starts to retire. Actions taken today can ease both these pressures and the pain of future actions. Acting sooner rather than later also provides a more reasonable planning horizon for future retirees.

Evaluating Social Security Reform Proposals

As important as financial stability may be for Social Security, it cannot be the only consideration. As a former public trustee of Social Security and Medicare, I am well aware of the central role these programs play in the lives of millions of Americans. Social Security remains the foundation of the nation's retirement system. Social Security is also much more than just a retirement program; it also pays benefits to disabled workers and their dependents, spouses and children of retired workers, and survivors of deceased workers. Last year, Social Security paid almost $408 billion in benefits to more than 45 million people. Since its inception, the program has successfully reduced poverty among the elderly. In 1959, 35 percent of the elderly were poor. In 2000, about 8 percent of beneficiaries aged 65 or older were poor, and 48 percent would have been poor without Social Security. It is precisely because the program is so deeply woven into the fabric of our nation that any proposed reform must consider the program in its entirety, rather than one aspect alone. Thus, we have developed a broad framework for evaluating reform proposals that considers not only solvency but other aspects of the program as well.

The analytic framework we have developed to assess proposals comprises three basic criteria:

- the extent to which a proposal achieves sustainable solvency and how it would affect the economy and the federal budget;
- the relative balance struck between the goals of individual equity and income adequacy; and
- how readily a proposal could be implemented, administered, and explained to the public.

The weight that different policymakers may place on different criteria will vary, depending on how they value different attributes. For example, if offering individual choice and control is less important than maintaining replacement rates for low-income workers, then a reform proposal emphasizing adequacy considerations might be preferred. As they fashion

a comprehensive proposal, however, policymakers will ultimately have to balance the relative importance they place on each of these criteria.

Financing Sustainable Solvency

Our sustainable solvency standard encompasses several different ways of looking at the Social Security program's financing needs. While 75-year actuarial balance is generally used in evaluating the long-term financial outlook of the Social Security program and reform proposals, it is not sufficient in gauging the program's solvency after the 75th year. For example, under the Trustees' intermediate assumptions, each year the 75-year actuarial period changes, and a year with a surplus is replaced by a new 75th year that has a significant deficit. As a result, changes made to restore trust fund solvency only for the 75-year period can result in future actuarial imbalances almost immediately. Reform plans that lead to sustainable solvency would be those that consider the broader issues of fiscal sustainability and affordability over the long term. Specifically, a standard of sustainable solvency also involves looking at (1) the balance between program income and cost beyond the 75th year and (2) the share of the budget and economy consumed by Social Security spending.

As I have already discussed, reducing the relative future burdens of Social Security and health programs is essential to a sustainable budget policy for the longer term. It is also critical if we are to avoid putting unsupportable financial pressures on future workers. Reforming Social Security and federal health programs is essential to reclaiming our future fiscal flexibility to address other national priorities.

Balancing Adequacy and Equity

The current Social Security system's benefit structure strikes a balance between the goals of retirement income adequacy and individual equity. From the beginning, benefits were set in a way that focused especially on replacing some portion of workers' pre-retirement earnings. Over time other changes were made that were intended to enhance the program's role in helping ensure adequate incomes. Retirement income adequacy, therefore, is addressed in part through the program's progressive benefit structure, providing proportionately larger benefits to lower earners and certain household types, such as those with dependents. Individual equity refers to the relationship between contributions made and benefits received. This can be thought of as the rate of return on individual contributions. Balancing these seemingly conflicting objectives through the political process has resulted in the design of the current Social Security program and should still be taken into account in any proposed reforms.

Policymakers could assess income adequacy, for example, by considering the extent to which proposals ensure benefit levels that are adequate to protect beneficiaries from poverty and ensure higher replacement rates for low-income workers. In addition, policymakers could consider the impact of proposed changes on various subpopulations, such as low-income workers, women, minorities, and people with disabilities. Policymakers could assess equity by considering the extent to which there are reasonable returns on contributions at a reasonable level of risk to the individual, improved intergenerational equity, and increased individual choice and control. Differences in how various proposals balance each of these goals will help determine which proposals will be acceptable to policymakers and the public.

Implementing and Administering Proposed Reforms

Program complexity makes implementation and administration both more difficult and harder to explain to the public. Some degree of implementation and administrative complexity arises in virtually all proposed changes to Social Security, even those that make incremental changes in the already existing structure. However, the greatest potential implementation and administrative challenges are associated with proposals that would create individual accounts. These include, for example, issues concerning the management of the information and money flow needed to maintain such a system, the degree of choice and flexibility individuals would have over investment options and access to their accounts, investment education and transitional efforts, and the mechanisms that would be used to pay out benefits upon retirement. Harmonizing a system that includes individual accounts with the regulatory framework that governs our nation's private pension system would also be a complicated endeavor. However, the complexity of meshing these systems should be weighed against the potential benefits of extending participation in individual accounts to millions of workers who currently lack private pension coverage.

Continued public acceptance and confidence in the Social Security program require that any reforms and their implications for benefits be well understood. This means that the American people must understand why change is necessary, what the reforms are, why they are needed, how they are to be implemented and administered, and how they will affect their own retirement income. All reform proposals will require some additional outreach to the public so that future beneficiaries can adjust their retirement planning accordingly. Yet the more transparent the implementation and administration of reform, and the more carefully such

reform is phased in, the more likely it will be understood and accepted by the American people.

Range of Proposals Illustrates Options for Reform and Choices to be Made

Over the course of the last several years, various reform proposals have been crafted. Many proposals involve restructuring the Social Security program to include individual retirement accounts. These individual accounts are similar to defined contribution pension plans in that benefits are based on contributions to and investment returns (gains and losses) on the accounts. This approach offers the potential for increased investment returns, but, depending on the design of the reform, may expose retirees and/or the government to investment risk. Increasing rates of return through investment in private securities, whether through individual accounts or collective government investment, cannot achieve sustainable solvency without additional changes to the current system.

There has been considerable variation in the individual account proposals introduced in the past couple of years. For example, some earlier proposals required that individuals participate in the accounts while more recent proposals provide individuals with the choice of whether or not to participate. As you know, Mr. Chairman, we are currently working on a report to be released next month that examines the unique issues surrounding voluntary individual accounts. Individual account proposals also differ in other areas, such as the manner in which accounts are financed, how the accounts interact with the existing Social Security program, the extent of choice and flexibility concerning investment options, and the way in which benefits are paid from the account balances.

A number of Social Security reform proposals were introduced in the 107th Congress. At your request, we have done a qualitative review of the proposals introduced last year by Representatives Shaw, De Mint, and DeFazio. These three proposals illustrate different approaches to reform. Representative Shaw introduced a new reform proposal last week—which we have not had a chance to look at—and we realize that other proposals may undergo some revisions as well. Like the Commission models, the proposals by Representatives DeMint and Shaw included voluntary individual accounts. All three proposals included significant revenue enhancements, and two of them (Rep. DeMint and Rep. Shaw) included a guarantee of future benefits at least as large as currently scheduled levels. Some of these plans include general revenue transfers, collective investment of some portion of trust fund assets in private securities, and eliminating the cap on the maximum amount of earnings subject to the payroll tax. In addition, some include provisions that would reduce future

expenditures, such as an individual account offset against Social Security retirement and aged survivor benefits and an increase in the number of benefit computation years in the benefit formula.

As I noted previously, last year the President's Commission to Strengthen Social Security issued a report containing three reform models. At your request, we looked at the Commission's proposals and is today issuing a report on our findings. Each of the Commission's three reform models represents a different approach to including a voluntary individual account option to Social Security. Model 1 adds individual accounts to the current system but does not restore solvency. Models 2 and 3 restore solvency to the Old-Age and Survivors Insurance and Disability Insurance Trust Funds through a combination of changes in the initial benefit calculation, general revenue transfers, and/or benefit offsets for those who choose to participate in the individual account option. Model 3 also requires an additional contribution equal to 1 percent of taxable payroll under the voluntary individual account option. All models share a common framework for administering individual accounts.

Examining the Effects of Reform Using the Commission's Proposals

Applying our criteria to the Commission models highlights trade-offs between efforts to achieve sustainable solvency and maintain adequate retirement income for current and future beneficiaries. The models illustrate some of the options and trade-offs that will need to be considered as the nation debates how to reform Social Security.

We used our long-term economic model in assessing the Commission reform models against the first criterion, that of financing sustainable solvency.[10] Over the past few years, we have been developing a capacity to estimate the quantitative effects of Social Security reform on individuals. Such estimates are useful in applying our adequacy/equity criterion to reform proposals. To examine how the Commission reform models balance adequacy and equity concerns, we used the GEMINI model, a dynamic microsimulation model for analyzing the lifetime implications of Social Security policies for a large sample of people born in the same year. Our analysis examined the effects of the reform models for the 1955, 1970, and 1985 birth cohorts. To show the range of possible outcomes given the

[10]For this analysis, consistent with SSA's scoring of the Commission reform models, our long-term economic model incorporates the 2001 Trustees' intermediate assumptions.

voluntary nature of individual accounts in the Commission models,[11] we simulated each model assuming (1) no participation in the individual account option and (2) universal participation in the account option.

Our analysis of the Commission reform models included comparison with three benchmarks:[12]

- The "benefit reduction benchmark" assumes a gradual reduction in the currently scheduled Social Security defined benefit beginning with those newly eligible for retirement in 2005. Current tax rates are maintained.
- The "tax increase benchmark" assumes an increase in the OASDI payroll tax beginning in 2002 sufficient to achieve an actuarial balance over the 75-year period. Currently scheduled benefits are maintained. [13]
- The "baseline extended" benchmark is a fiscal policy path developed in our earlier long-term model work that assumes payment in full of currently scheduled Social Security benefits and no other changes in current spending or tax policies.

Financing Sustainable Solvency

The use of these criteria to evaluate approaches to Social Security reform highlights the trade-offs that exist between efforts to achieve solvency for the OASDI trust funds and efforts to maintain adequate retirement income for current and future beneficiaries.

Overall, Model 2 would provide for sustainable solvency and reduce the shares of the federal budget and the economy devoted to Social Security compared to currently scheduled benefits (tax increase benchmark) regardless of how many individuals selected accounts. With universal account participation, general revenue funding would be needed for about

[11]In this testimony, the term "individual account" is used for the voluntary accounts, consistent with published GAO work. The Commission used the term "personal account" in its final report.

[12]From the perspective of analyzing benefit adequacy, the tax increase and baseline extended benchmarks are identical because both assume payment in full of scheduled Social Security benefits over the 75-year simulation period.

[13]Our benchmarks are solvent for the 75-year projection period commonly used by SSA's Office of the Chief Actuary, but they do not achieve sustainable solvency. Both the benefit reduction and tax increase benchmarks are explicitly fully funded and we worked closely with Social Security's Office of the Chief Actuary in their design.

3 decades. Specifically, our analysis of sustainable solvency under Model 2 showed that:

- As estimated by the actuaries, Model 2, with either universal or zero participation in voluntary individual accounts, is solvent over the 75-year projection period, and the ratio of annual income to benefit payments at the end of the simulation period is increasing. However, in Model 2 with universal account participation, over 3 decades of general revenue transfers are needed to achieve trust fund solvency. Model 2 with zero account participation achieves solvency with no general revenue transfers.

- Model 2 with universal account participation would ultimately reduce the budgetary pressures of Social Security on the unified budget relative to the baseline extended benchmark. However, this would not begin until the middle of this century. Relative to both our benefit reduction benchmark and tax increase benchmark, unified surpluses would be lower and unified deficits higher throughout the simulation period under Model 2 with universal account participation. Model 2 with zero account participation would reduce budgetary pressures due to Social Security beginning around 2015 relative to the baseline extended benchmark. This fiscal outlook under Model 2 with zero account participation is very similar to the fiscal outlook under our benefit reduction benchmark.

- Under Model 2 with universal account participation, the government's cash requirement (as a share of GDP) to fund the individual accounts and the reduced defined benefit would be about 20 percent higher initially than under both the baseline extended and tax increase benchmarks. This differential gradually narrows until the 2030s, after which less cash would be required under Model 2 with universal account participation. By 2075, Model 2 with universal account participation would require about 40 percent less cash than the baseline extended and tax increase benchmarks.

- Viewed from the perspective of the economy, total payments (Social Security defined benefits plus income from individual accounts) as a share of GDP would gradually fall under Model 2 with universal account participation relative to the baseline extended and tax increase benchmarks. In 2075, the share of the economy absorbed by payments to retirees from the Social Security system as a whole under Model 2 with universal account participation would be roughly 20 percent lower than the baseline extended or tax increase benchmark and roughly the same as under the benefit reduction benchmark.

- With regard to national saving, Model 2 increases net national saving on a first order basis primarily due to the proposed benefit reductions. The individual account provision does not increase national saving on a first order basis; the redirection of the payroll taxes to finance the accounts reduces government saving by the same amount that the individual accounts increase private saving.

  Beyond these first order effects, the actual net effect of a proposal on national saving is difficult to estimate due to uncertainties in predicting changes in future spending and revenue policies of the government as well as changes in the saving behavior of private households and individuals. For example, the lower surpluses and higher deficits that result from redirecting payroll taxes to individual accounts could lead to changes in federal fiscal policy that would increase national saving. However, households may respond by reducing their other saving in response to the creation of individual accounts.[14]

  Because the benefit reductions in Model 3 are smaller than in Model 2, long-term unified deficits are larger under Model 3. Model 3 requires an additional contribution equal to 1 percent of taxable payroll for those choosing individual accounts. Assuming universal account participation in both models, Model 3 would result in a larger share of the economy being absorbed by total benefit payments to retirees—about the same share as would be the case under the baseline extended and tax increase benchmarks.

Balancing Adequacy and Equity

The Commission's proposals also illustrate the trade-offs reform proposals face generally in balancing adequacy and equity considerations. Both of the models protect benefits for current and near retirees, and the shift to advance funding could improve intergenerational equity. However, under each of the models, some future retirees also could face potentially significant benefit reductions in comparison to either the tax increase or the benefit reduction benchmarks. This is because primary insurance amount formula factors are reduced by real wage growth, uncertainty in rates of return earned on accounts, changes in benefit status over time, and annuity pricing.

Our analysis of Model 2 shows that:

[14]No expert consensus exists on how Social Security reform proposals would affect the saving behavior of private households and businesses.

- Median monthly benefits (the individual account annuity plus the defined benefit reduced by an offset) for those choosing individual accounts are always higher than for those who do not choose the account, and this gap grows over time. In addition, median monthly benefits under universal participation in the accounts are also higher than the median benefits received under the benefit reduction benchmark. However, median monthly benefits received by those without accounts fall below those provided by the benefit reduction benchmark over time.

- For the lowest quintile of beneficiaries, median monthly benefits with universal participation in the accounts tend to be higher than the benefits received under the benefit reduction benchmark, likely due to the enhanced benefit for full-time "minimum wage" workers. This pattern becomes more pronounced over time.

- Regardless of whether an account is chosen, under Model 2 many people could receive monthly benefits that are higher than the benefit reduction benchmark. However, a minority could fare worse. Some people could also receive a benefit greater than under the tax increase benchmark although a majority could fare worse. Monthly benefits for those choosing individual accounts will be sensitive to the actual rates of return earned by those accounts.

The cohort results for Model 3 are generally similar to Model 2. However, median monthly benefits for those choosing individual accounts are higher than the benefit level under the tax increase benchmark for the 1970 and 1985 cohorts. This result is likely because of Model 3's feature of a mandatory extra 1 percent contribution into the individual accounts for those who choose to participate.

Implementing and Administering Reforms

Each of the models would establish a governing board to administer the individual accounts, including the choice of available funds and providing financial information to individuals. While the Commission had the benefit of prior thinking on these issues, many implementation issues remain, particularly in ensuring the transparency of the new system and educating the public to avoid any gaps in expectations. For example, an education program would be necessary to explain the changes in the benefit structure, model features like the benefit offset and how accounts would be split in the event of divorce. Education and investor information is also important as the system expands and increases the range of investment selection. Questions about the harmonization of such features with state laws regarding divorce and annuities also remain an issue.

Conclusion: Choices and Trade-Offs Will Be Part of Any Social Security Reform—Acting Soon Would Help

It is likely that the structural changes required to restore Social Security's long-term viability generally will require some combination of reductions from currently scheduled benefits, revenue increases, and may include the use of some general revenues. The proposals we have examined, both in 2002 and earlier, generally reflect this. Proposals employ possible benefit reductions within the current program structure, including modifying the benefit formula, raising the retirement age, and reducing cost-of-living adjustments. Revenue increases might take the form of increases in the payroll tax rate, expanding coverage to include the relatively few workers who are still not covered under Social Security, or allowing the trust funds to be invested in potentially higher-yielding securities such as stocks.[15] Similarly, some proposals rely on general revenue transfers to increase the amount of money going towards the Social Security program. Reforms that include individual accounts would also involve Social Security benefit reductions and/or revenue increases, and the use of general revenues.

The Commission report highlights the trade-offs and challenges in reform. Model 2 uses a combination of benefit reductions and revenue increases to restore long-term solvency. For example, we found that the model reduces Social Security's defined benefit from currently scheduled levels through formula changes, provides enhanced benefits for low-wage workers and spousal survivors, and adds a voluntary individual account option. Model 2 would both restore trust fund solvency and reduce the shares of the federal budget and the economy devoted to Social Security compared with currently scheduled benefits regardless of how many individuals selected accounts. With universal account participation, general revenues would be needed for about 3 decades. The other three proposals we examined take somewhat different approaches, relying heavily on additional sources of revenue. For example, Representative DeFazio's proposal would restore solvency primarily on the revenue side, allowing a portion of trust fund assets to be invested in marketable securities and eliminating the cap on taxable payroll earnings.

In evaluating Social Security reform proposals, the choice among various benefit reductions and revenue increases will affect the balance between income adequacy and individual equity. Benefit reductions could pose the risk of diminishing adequacy, especially for specific subpopulations. Both benefit reductions and tax increases that have been proposed could

[15]About 4 percent of the workforce remains uncovered, which mostly includes some state and local government employees and federal employees hired before 1984.

diminish individual equity by reducing the implicit rates of return the workers earn on their contributions to the system. In contrast, increasing revenues by investing retirement funds in the stock market could improve rates of return but potentially expose individuals to investment risk and losses.

Similarly, the choice among various benefit reductions and revenue increases—for example, raising the retirement age—will ultimately determine not just how much income retirees will have but also how long they will be expected to continue working and how long their retirements will be. Reforms will determine how much consumption workers will give up during their working years to provide for more consumption during retirement.

Early action to change these programs would yield the highest fiscal dividends for the federal budget and would provide a longer period for prospective beneficiaries to make adjustments in their own planning. Waiting to build economic resources and reform future claims entails risks. First, we lose an important window where today's relatively large workforce can increase saving and enhance productivity, two elements critical to growing the future economy. We lose the opportunity to reduce the burden of interest payments, thereby creating a legacy of higher debt as well as elderly entitlement spending for the relatively smaller workforce of the future. Most critically, we risk losing the opportunity to phase in changes gradually so that all can make the adjustments needed in private and public plans to accommodate this historic shift. Unfortunately, the long-range challenge has become more difficult, and the window of opportunity to address the entitlement challenge is narrowing. As the baby boom generation retires and the numbers of those entitled to these retirement benefits grow, the difficulties of reform will be compounded. Accordingly, it remains more important than ever to deal with these issues over the next several years.

Today, many retirees and near-retirees fear cuts that will affect them while young people believe they will get little or no Social Security benefits. As I have said before, I believe it is possible to structure a Social Security reform proposal that will exceed the expectations of all generations of Americans. In my view, there is a window of opportunity to craft a solution that will protect Social Security benefits for the nation's current and near-term retirees, while ensuring that the system will be there for future generations. However, this window of opportunity will close as the baby boom generation begins to retire. As a result, we must move forward to address Social Security because we have other major challenges

confronting us. The fact is, compared to addressing our long-range health care financing problem, reforming Social Security will be easy lifting.

It is my hope that we will think about the unprecedented challenge facing future generations in our aging society. Relieving them of some of the burden of today's financing commitments would help fulfill this generation's stewardship responsibility to future generations. It would also preserve some capacity for them to make their own choices by strengthening both the budget and the economy they inherit. We need to act now to address the structural imbalances in Social Security, Medicare, and other entitlement programs before the approaching demographic tidal wave makes the imbalances more difficult, dramatic, and disruptive.

We at GAO look forward to continuing to work with this Committee and the Congress in addressing this and other important issues facing our nation.

Mr. Chairman, Mr. Craig, members of the Committee, that concludes my statement. I'd be happy to answer any questions you may have.