

United States Government Accountability Office



RETIREMENT CHALLENGES IN THE 21ST Century

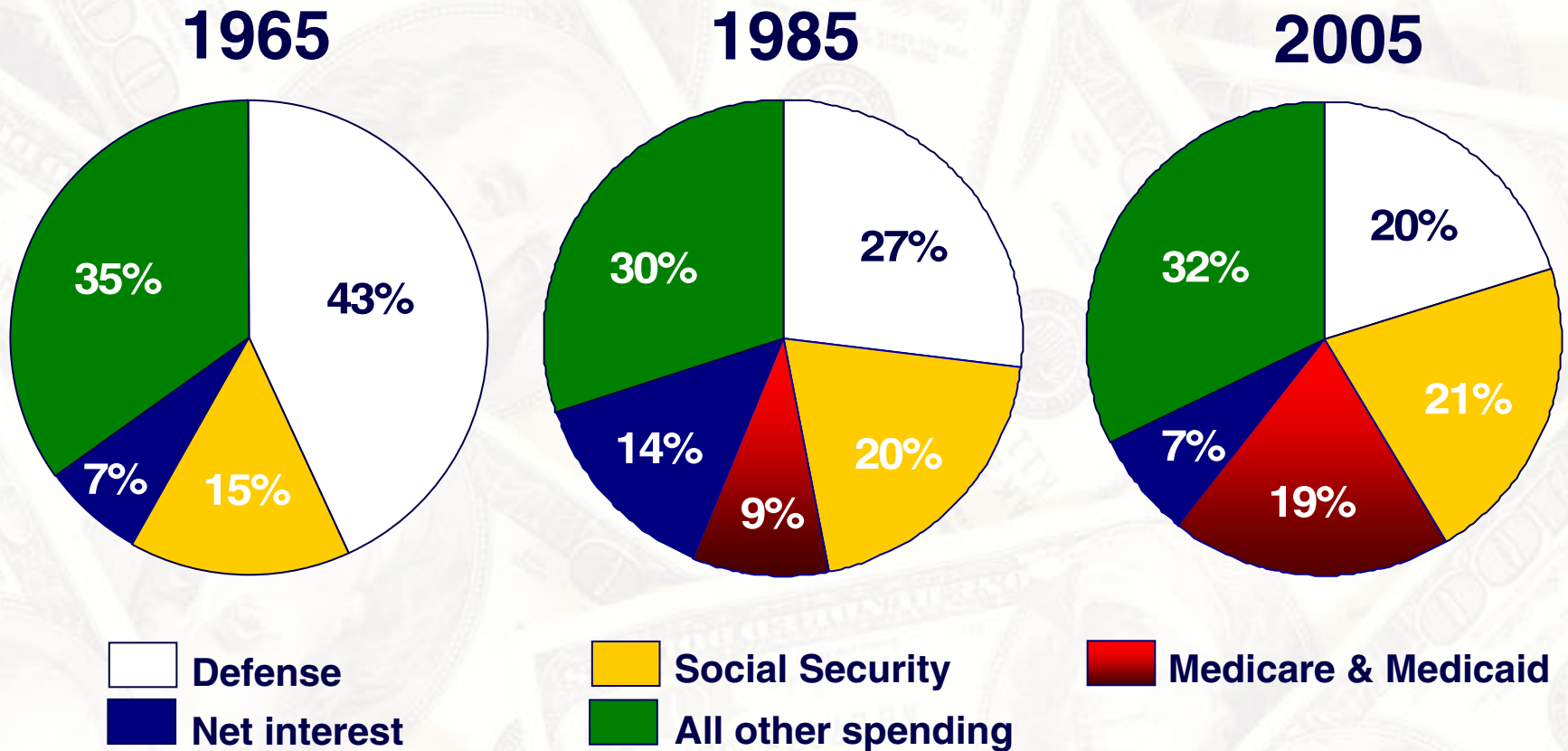
**International Foundation of Employee Benefit Plans
Annual Employee Benefits Conference
Las Vegas, NV
October 10, 2006**

The Honorable David M. Walker
Comptroller General of the United States

GAO revised this document on November 28, 2006, to clarify points related to "Provisions Affecting DB Plan Funding and Design" (page 31), "PBGC Premiums" (page 32), and "Financial Advice" (page 33).

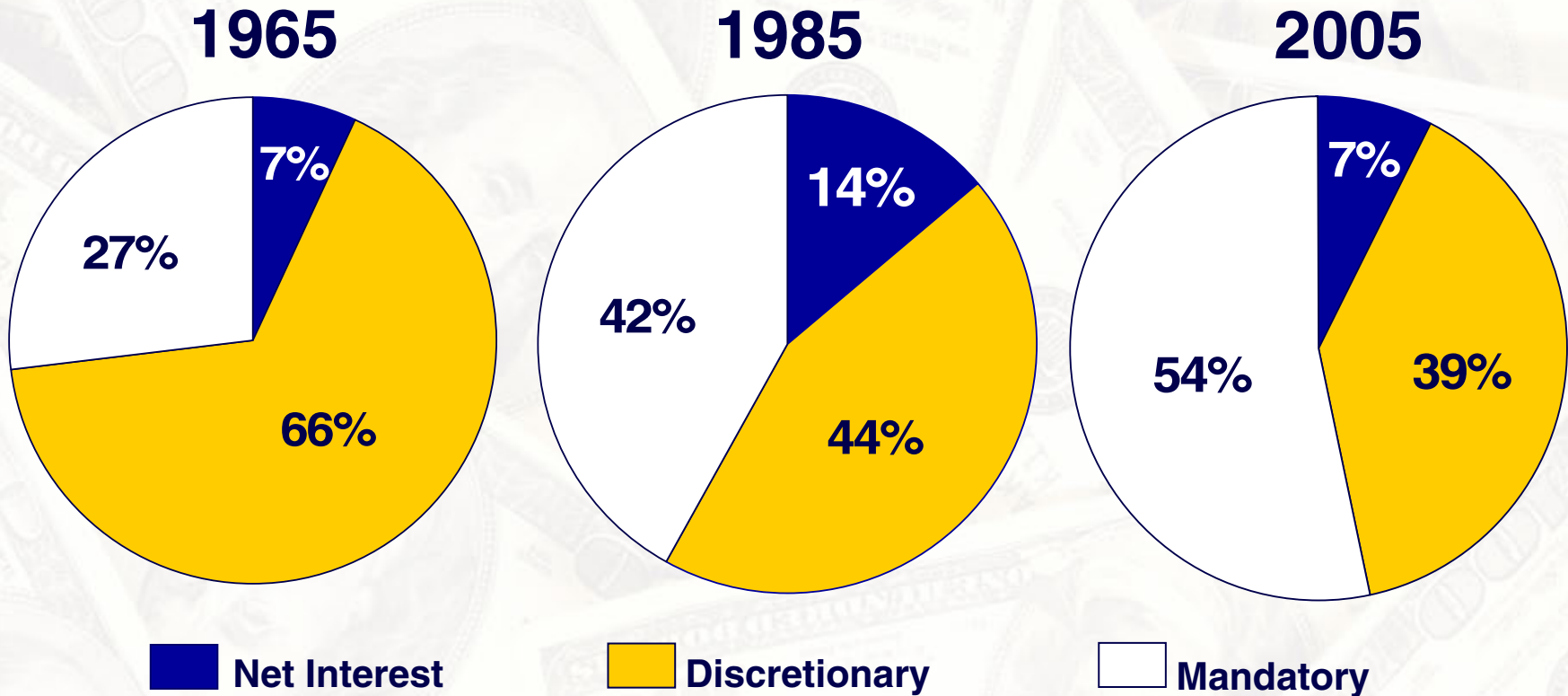


Composition of Federal Spending



Source: Office of Management and Budget.

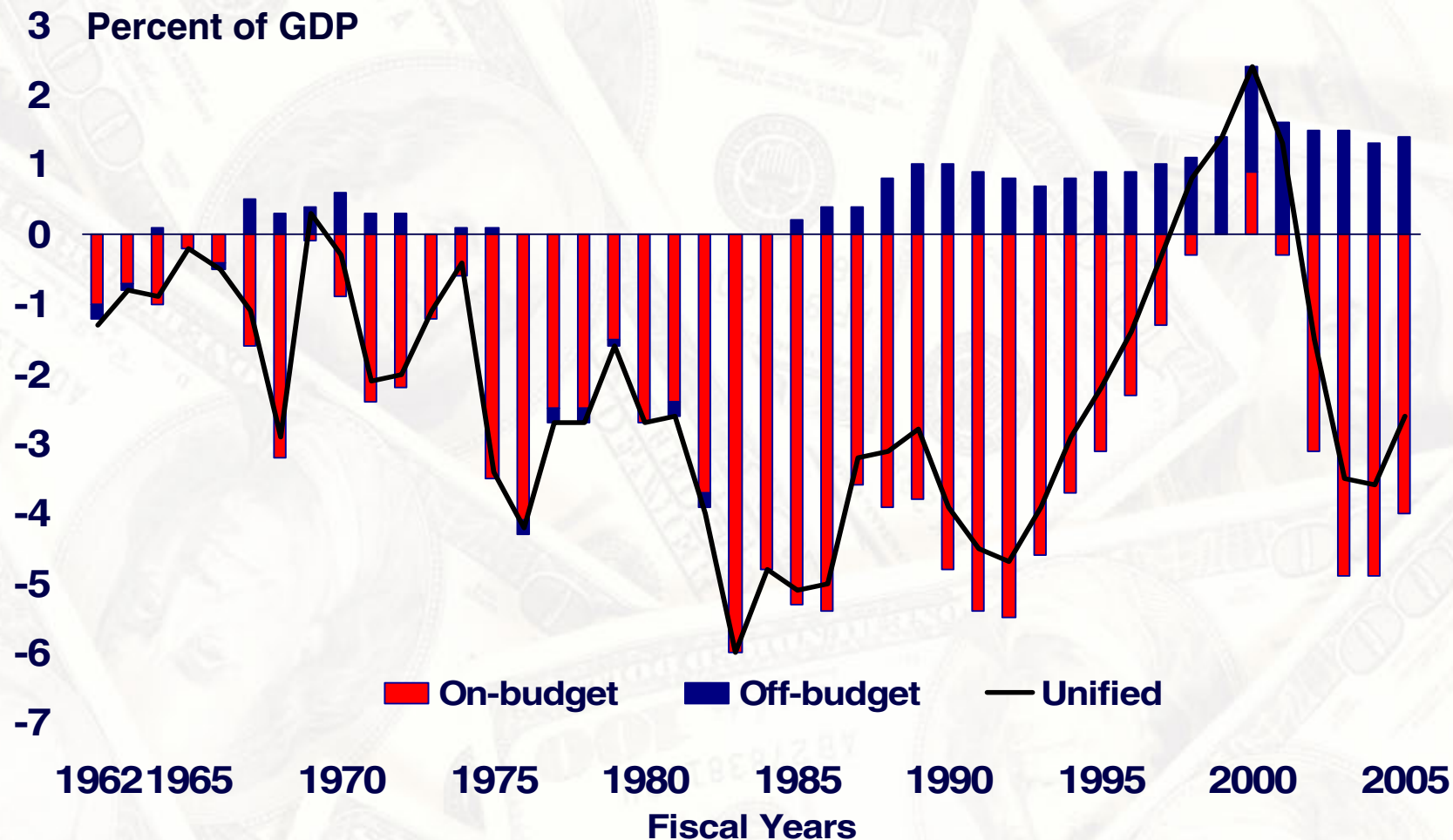
Federal Spending for Mandatory and Discretionary Programs



Source: Office of Management and Budget.

Surplus or Deficit as a Share of GDP

Fiscal Years 1962-2005



Source: Office of Management and Budget

Fiscal Year 2004 and 2005 Deficits and Net Operating Costs

	Fiscal Year 2004	Fiscal Year 2005
	(\$ Billion)	
On-Budget Deficit	(568)	(494)
Off-Budget Surplus*	155	175
Unified Deficit	(413)	(318)
Net Operating Cost	(616)	(760)

*Includes \$151 billion in fiscal year 2004 and \$173 billion in fiscal year 2005 in Social Security surpluses and \$4 billion in fiscal year 2004 and \$2 billion in fiscal year 2005 in Postal Service surpluses.

Sources: The Office of Management and Budget and the Department of the Treasury.

Estimated Fiscal Exposures

(\$ trillions)

	2000	2005
• Explicit liabilities	\$6.9	\$9.9
<ul style="list-style-type: none"> • Publicly held debt • Military & civilian pensions & retiree health • Other 		
• Commitments & contingencies	0.5	0.9
<ul style="list-style-type: none"> • E.g., PBGC, undelivered orders 		
• Implicit exposures	13.0	35.6
<ul style="list-style-type: none"> • Future Social Security benefits 	3.8	5.7
<ul style="list-style-type: none"> • Future Medicare Part A benefits 	2.7	8.8
<ul style="list-style-type: none"> • Future Medicare Part B benefits 	6.5	12.4
<ul style="list-style-type: none"> • Future Medicare Part D benefits 	--	8.7
Total	\$20.4	\$46.4

Source: U.S. government's consolidated financial statements (CFS).

Note: Estimates for Social Security and Medicare are at present value as of January 1 of each year as reported in the CFS and all other data are as of September 30.

How Big is Our Growing Fiscal Burden?

Our total fiscal burden can be translated and compared as follows:

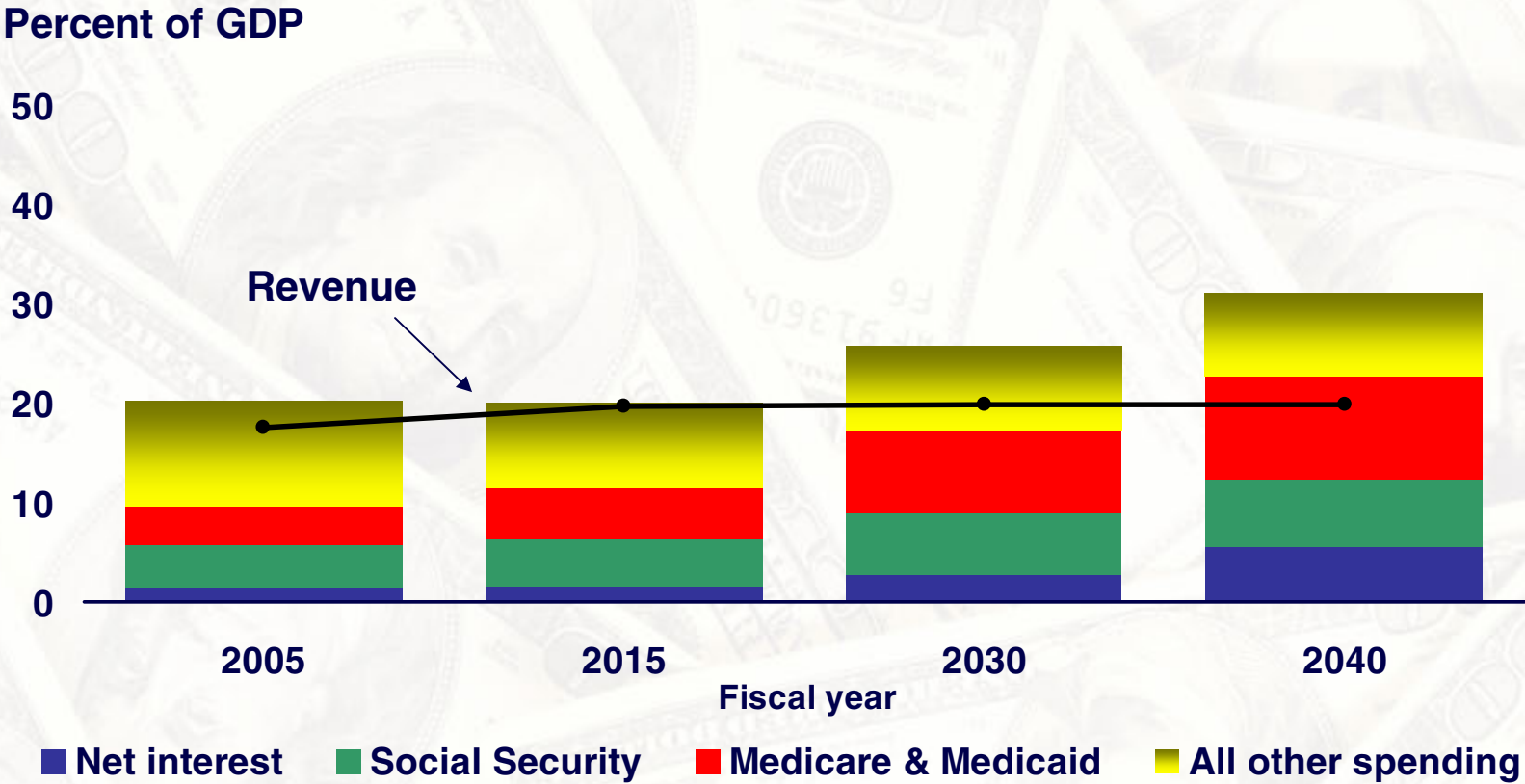
Total fiscal exposures	\$46.4 trillion
Total household net worth¹	\$51.1 trillion
Burden/Net worth ratio	91 percent
Burden²	
Per person	\$156,000
Per full-time worker	\$375,000
Per household	\$411,000
Income	
Median household income³	\$44,389
Disposable personal income per capita⁴	\$30,431

Notes: (1) Federal Reserve Board, Flow of Funds Accounts, Table B.100, 2005:Q3 (Dec. 8, 2005); (2) Burdens are calculated using total U.S. population as of 9/30/05, from the *U.S. Census Bureau*, full-time workers for 2004, reported by the Bureau of Economic Analysis, in NIPA table 6.5D (Aug. 4, 2005); and households for 2004, reported by the U.S. Census Bureau, in *Income Poverty & Health Insurance Coverage in the US: 2004* (Aug. 2005); (3) U.S. Census Bureau, *Income Poverty & Health Insurance Coverage in the US: 2004* (Aug. 2005); and (4) Bureau of Economic Analysis, *Personal Income and Outlays: October 2005*, table 2, 2005:Q3, (Dec. 1, 2005).

Sources: GAO analysis.

Composition of Spending as a Share of GDP

Under Baseline Extended



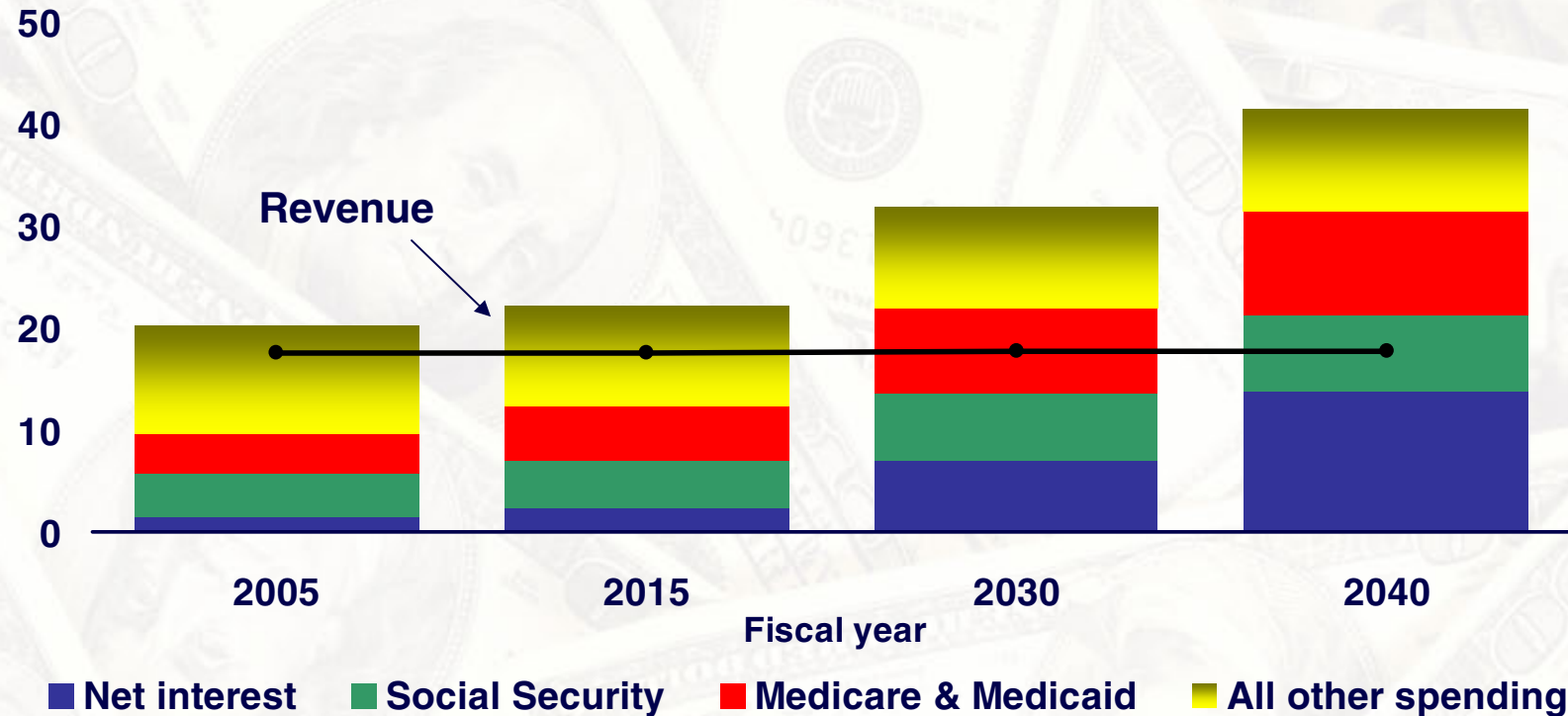
Notes: In addition to the expiration of tax cuts, revenue as a share of GDP increases through 2016 due to (1) real bracket creep, (2) more taxpayers becoming subject to the AMT, and (3) increased revenue from tax-deferred retirement accounts. After 2016, revenue as a share of GDP is held constant.

Source: GAO's August 2006 analysis.

Composition of Spending as a Share of GDP

Assuming Discretionary Spending Grows with GDP After 2006
and All Expiring Tax Provisions are Extended

Percent of GDP



Source: GAO's August 2006 analysis.

Current Fiscal Policy Is Unsustainable

- **The “Status Quo” is Not an Option**

- We face large and growing structural deficits largely due to known demographic trends and rising health care costs.
- GAO’s simulations show that balancing the budget in 2040 could require actions as large as
 - Cutting total federal spending by 60 percent or
 - Raising federal taxes to 2 times today's level

- **Faster Economic Growth Can Help, but It Cannot Solve the Problem**

- Closing the current long-term fiscal gap based on reasonable assumptions would require real average annual economic growth in the double digit range every year for the next 75 years.
- During the 1990s, the economy grew at an average 3.2 percent per year.
- As a result, we cannot simply grow our way out of this problem. Tough choices will be required.

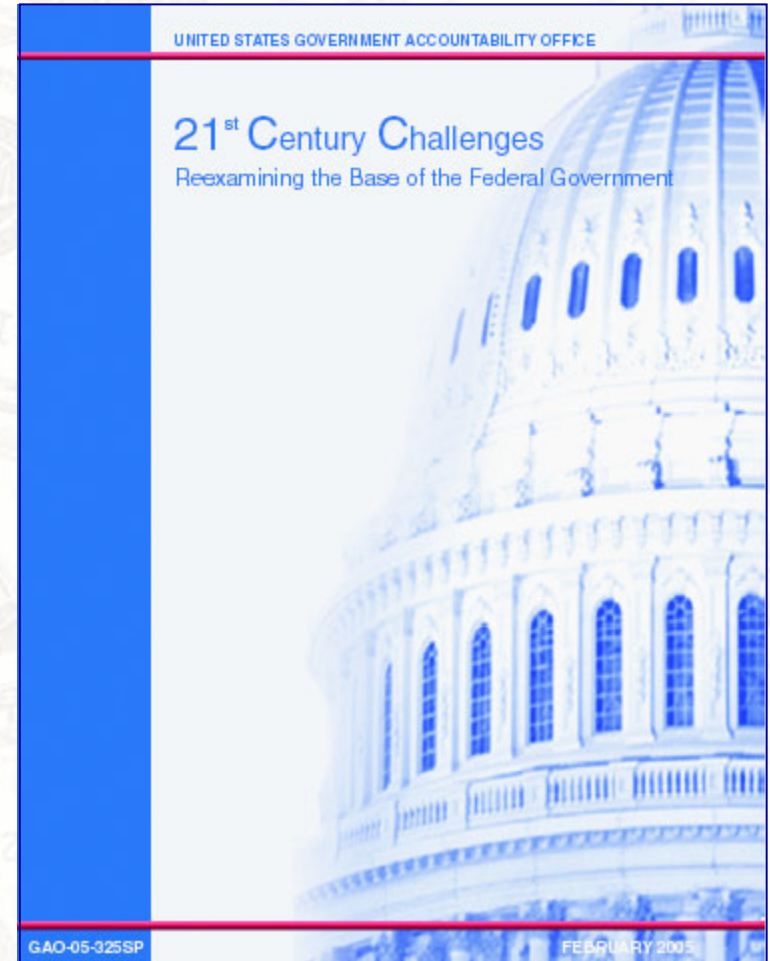
The Way Forward: A Three-Pronged Approach

1. Strengthen Budget and Legislative Processes and Controls
2. Improve Financial Reporting and Performance Metrics
3. Fundamental Reexamination & Transformation for the 21st Century

Solutions Require Active Involvement from both the Executive and Legislative Branches

21st Century Challenges Report

- Provides background, framework, and questions to assist in reexamining the base
- Covers entitlements & other mandatory spending, discretionary spending, and tax policies and programs
- Based on GAO's work for the Congress
- Issued February 16, 2005



Twelve Reexamination Areas

MISSION AREAS

- Defense
- Education & Employment
- Financial Regulation & Housing
- Health Care
- Homeland Security
- International Affairs
- Natural Resources, Energy & Environment
- Retirement & Disability
- Science & Technology
- Transportation

CROSSCUTTING AREAS

- Improving Governance
- Reexamining the Tax System

Illustrative 21st Century Questions: Retirement and Disability Policy

- How should **Social Security** be reformed to provide for long-term program solvency and sustainability while also ensuring adequate benefits (for example, increase the retirement age, restructure benefits, increase taxes, and/or create individual accounts)?
- What changes should be made to enhance the retirement income security of workers while protecting the fiscal integrity of the **PBGC** insurance program (for example, increasing transparency in connection with underfunded plans, modifying PBGC's premium structure and insurance guarantees, reforming plan funding rules, or restricting benefit increases and the distribution of lump sum benefits in connection with certain underfunded plans)?
- How can existing policies be reformed to **encourage income preservation strategies** so that retirement income lasts an individual's entire life (for example, benefit annuitization)?
- How can existing policies and programs be reformed to **encourage older workers to work longer** and to facilitate phased retirement approaches to employment (for example, more flexible work schedules or receiving partial pensions while continuing to work)?

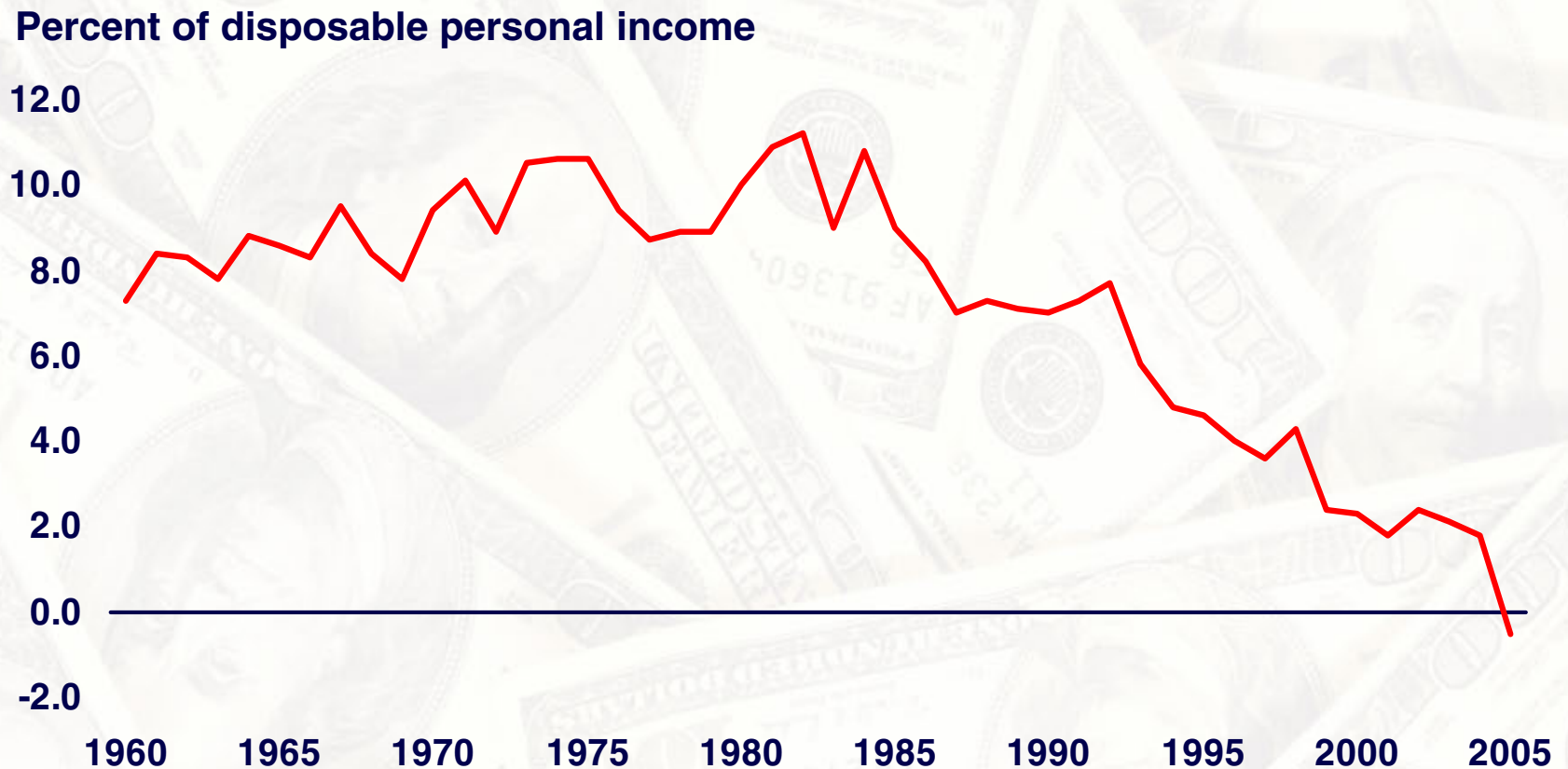
Illustrative 21st Century Questions: Health Care

- How can we make our current **Medicare and Medicaid** programs sustainable? For example, should the eligibility requirements (e.g., age, income requirements) for these programs be modified?
- How can we perform a **systematic reexamination of our current health care system**? For example, could public and private entities work jointly to establish formal reexamination processes that would (1) define and update as needed a minimum core of essential health care services, (2) ensure that all Americans have access to the defined minimum core services, (3) allocate responsibility for financing these services among such entities as government, employers, and individuals, and (4) provide the opportunity for individuals to obtain additional services at their discretion and cost?

Key Elements for Economic Security in Retirement

- **Adequate retirement income**
 - Savings
 - Social Security
 - Pensions
 - Earnings from continued employment (e.g., part-time)
- **Affordable health care**
 - Medicare
 - Retiree health care
- **Long-term care (a hybrid)**
- **Major Players**
 - Employers
 - Government
 - Individuals
 - Family
 - Community

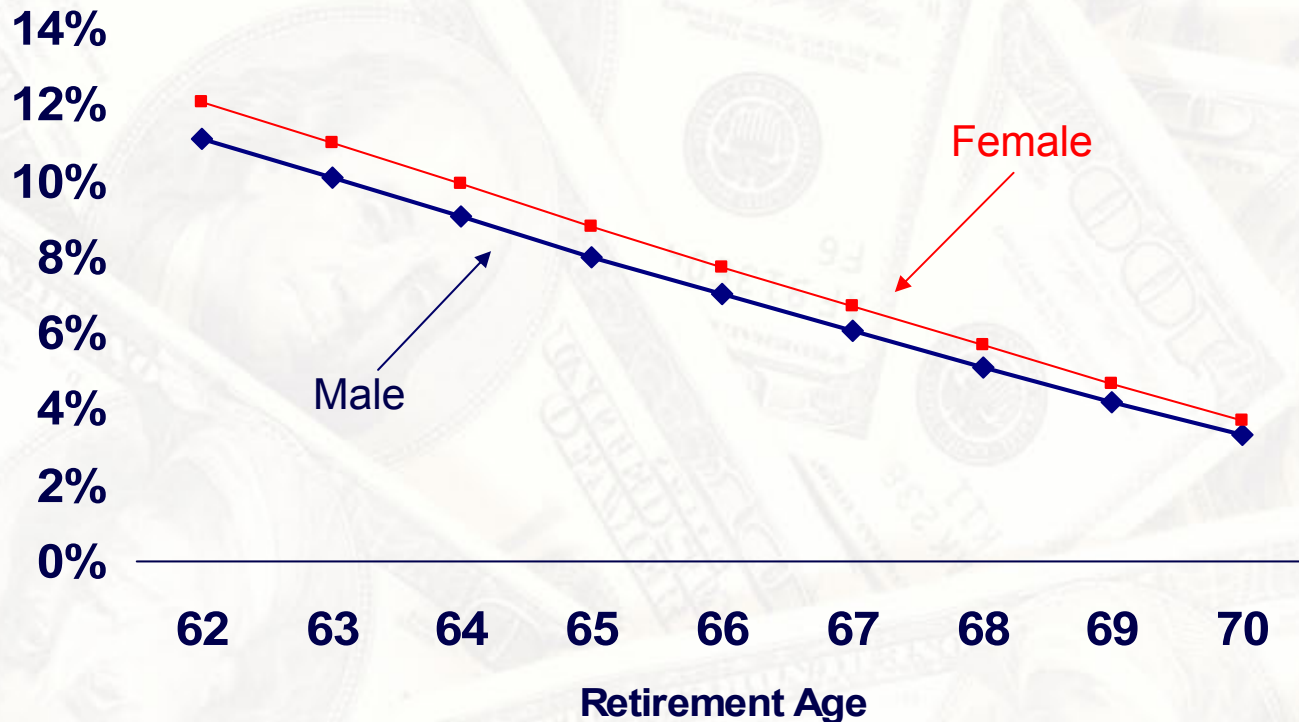
Personal Saving Rate Has Declined



Source: Bureau of Economic Analysis, Department of Commerce.

Annual Saving Required for a 35-Year Old, with Social Security

Required Contribution: Percentage of Gross Income

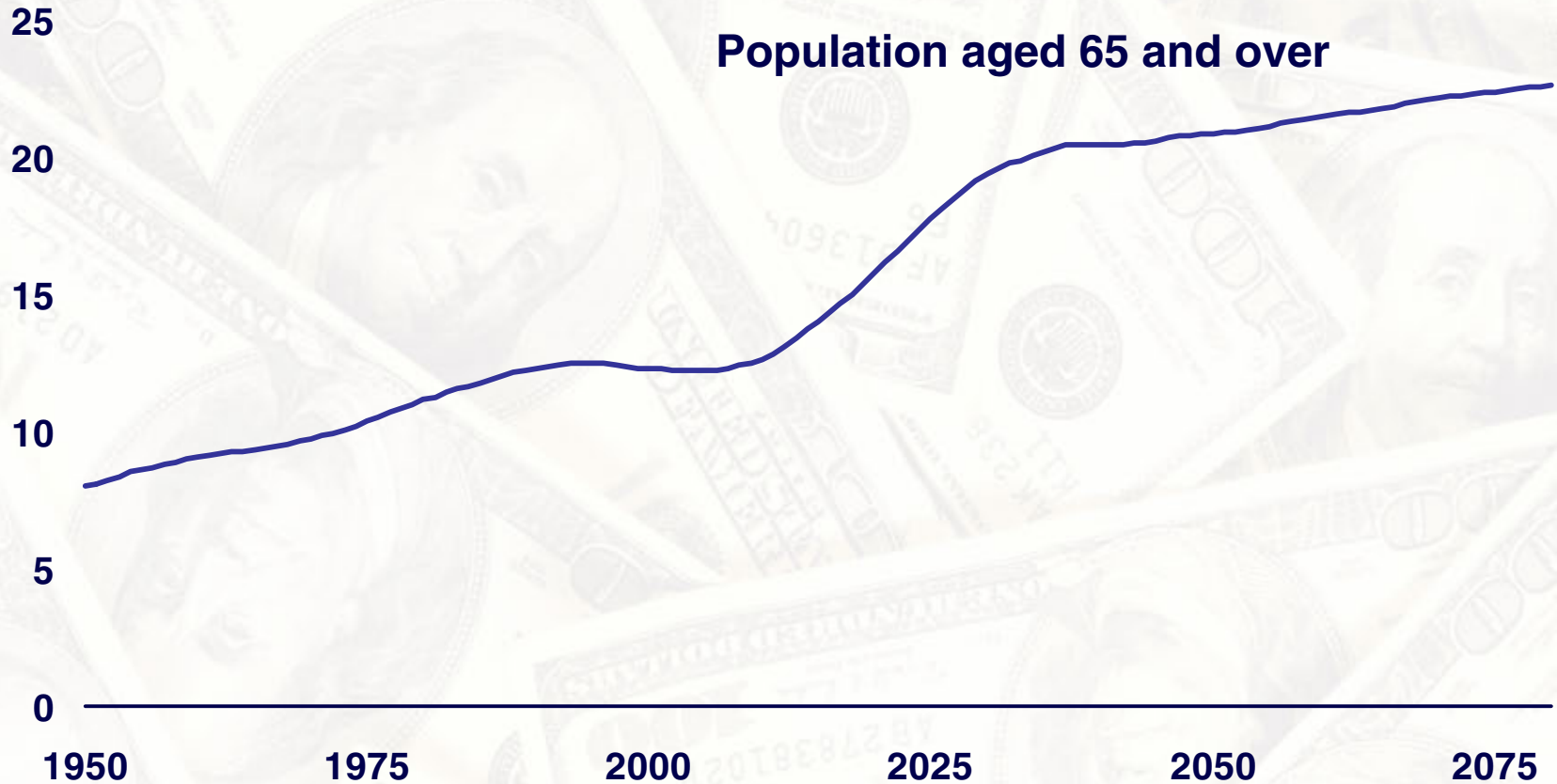


Source: GAO analysis, based on Social Security Administration data.

Note: The chart shows the percentage of gross salary 35-year old male and female earning an average wage in 2005 would need to withhold so that the individual would accumulate funds sufficient, along with scheduled social security benefits, to provide retirement income equal to 75% of his or her pre-retirement income. The projections are based on economic assumptions from the 2005 Social Security Trustees Report for inflation (2.8%), real wage growth (1.1%), real interest rate (3%), and nominal interest rate (5.8%).

Aged Population as a Share of Total U.S. Population

Percent of total population

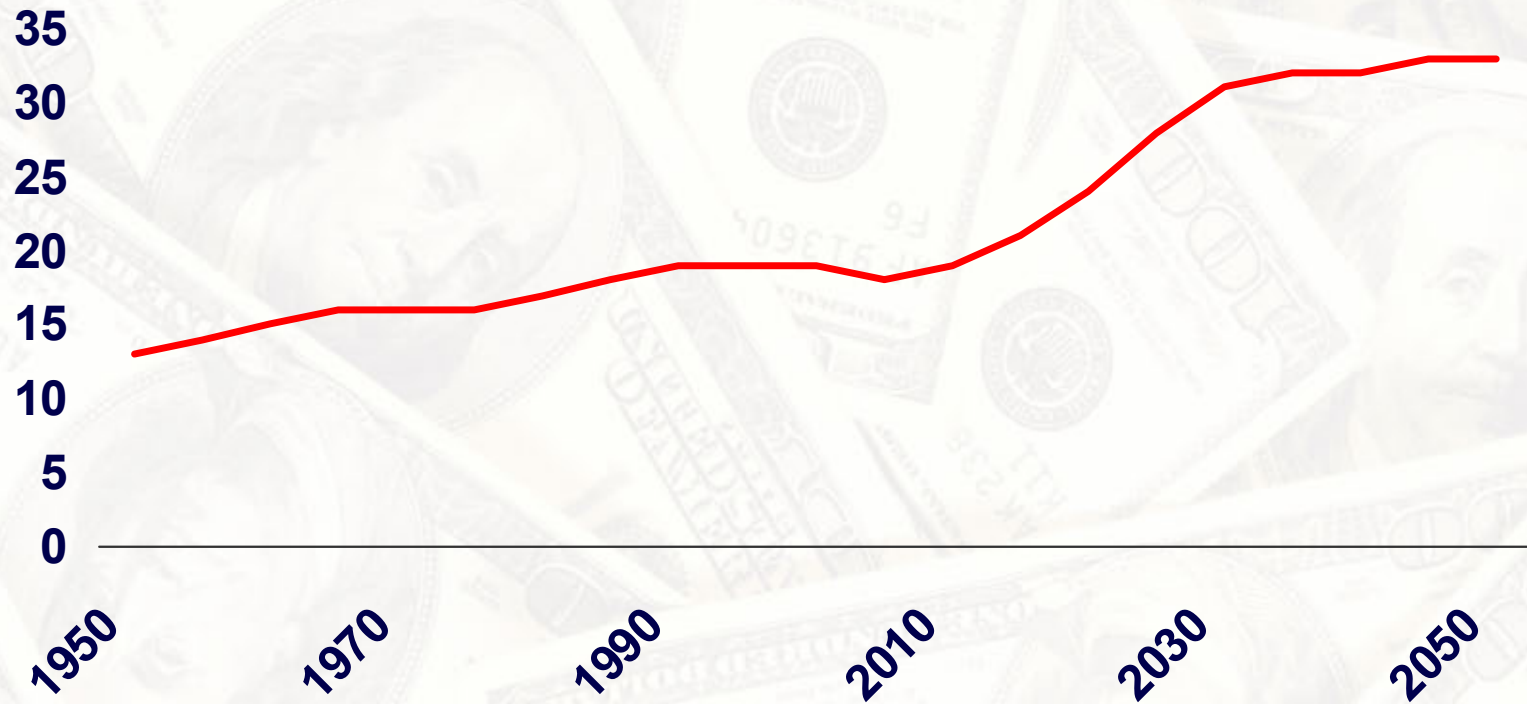


Note: Projections based on the intermediate assumptions of the 2006 Trustees' Reports.

Source: Office of the Chief Actuary, Social Security Administration.

U.S. Elderly Dependency Ratio Expected to Continue to Increase

Elderly Dependency Ratio (in percent)

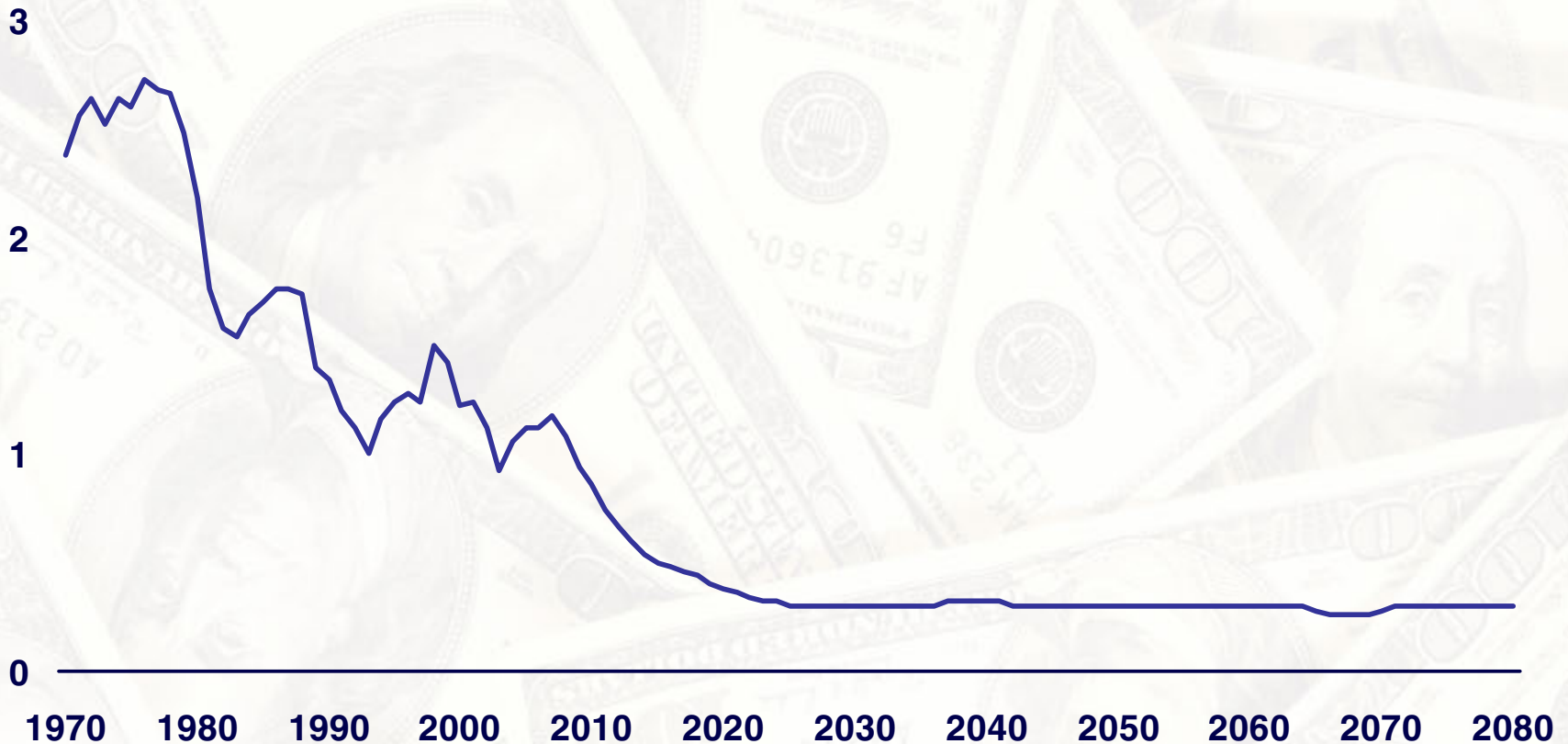


Source: Population Division of the Department of Economic and Social Affairs of the United Nations Secretariat, World Population Prospects: The 2004 Revision and World Urbanization Prospects: The 2003 Revision.

Note: Data for 2005 through 2050 are projected.

U.S. Labor Force Growth Will Continue to Decline

Percentage change (5-yr moving average)

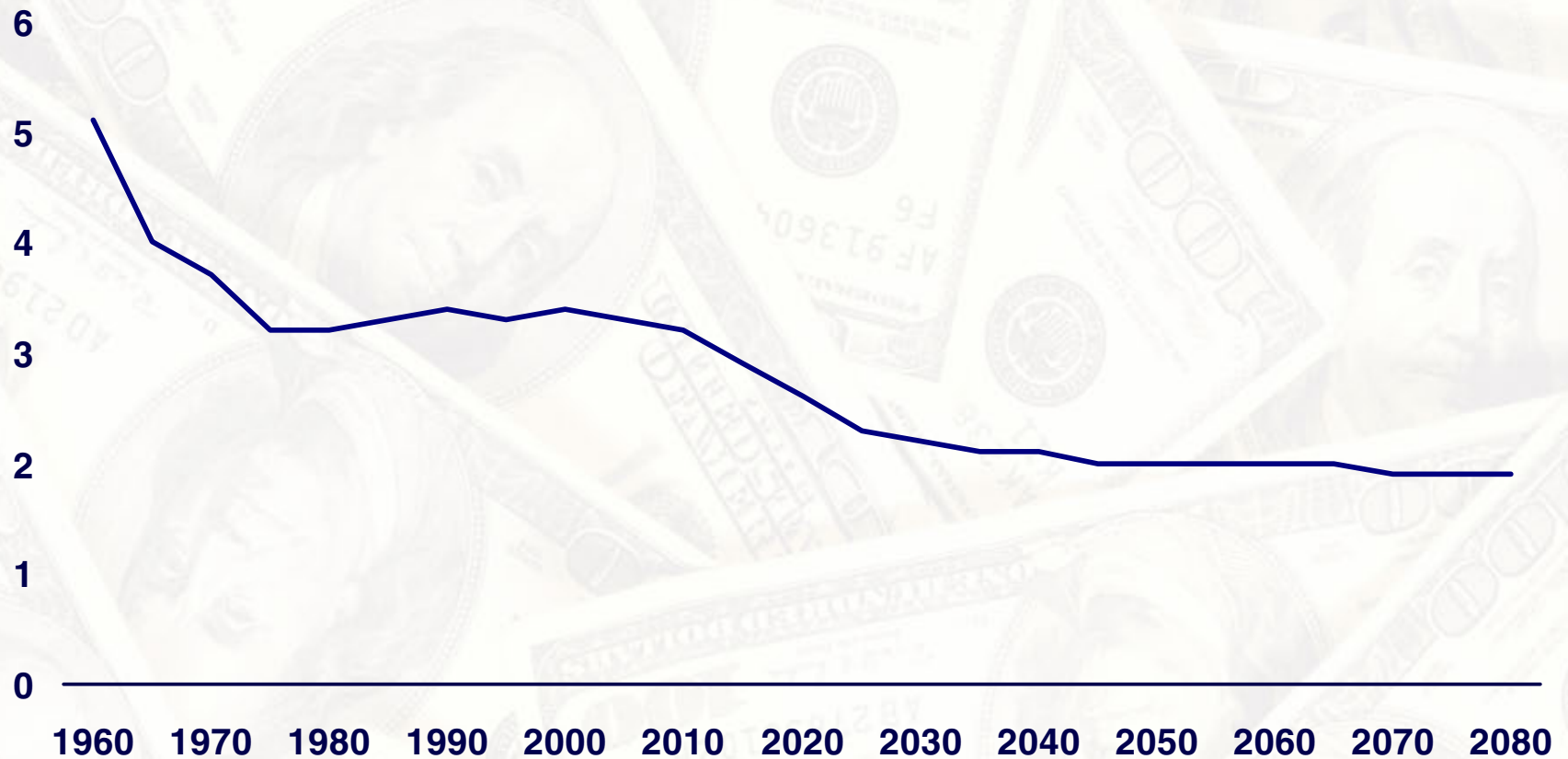


Note: Percentage change is calculated as a centered 5-yr moving average of projections based on the intermediate assumptions of the 2006 Trustees Reports.

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

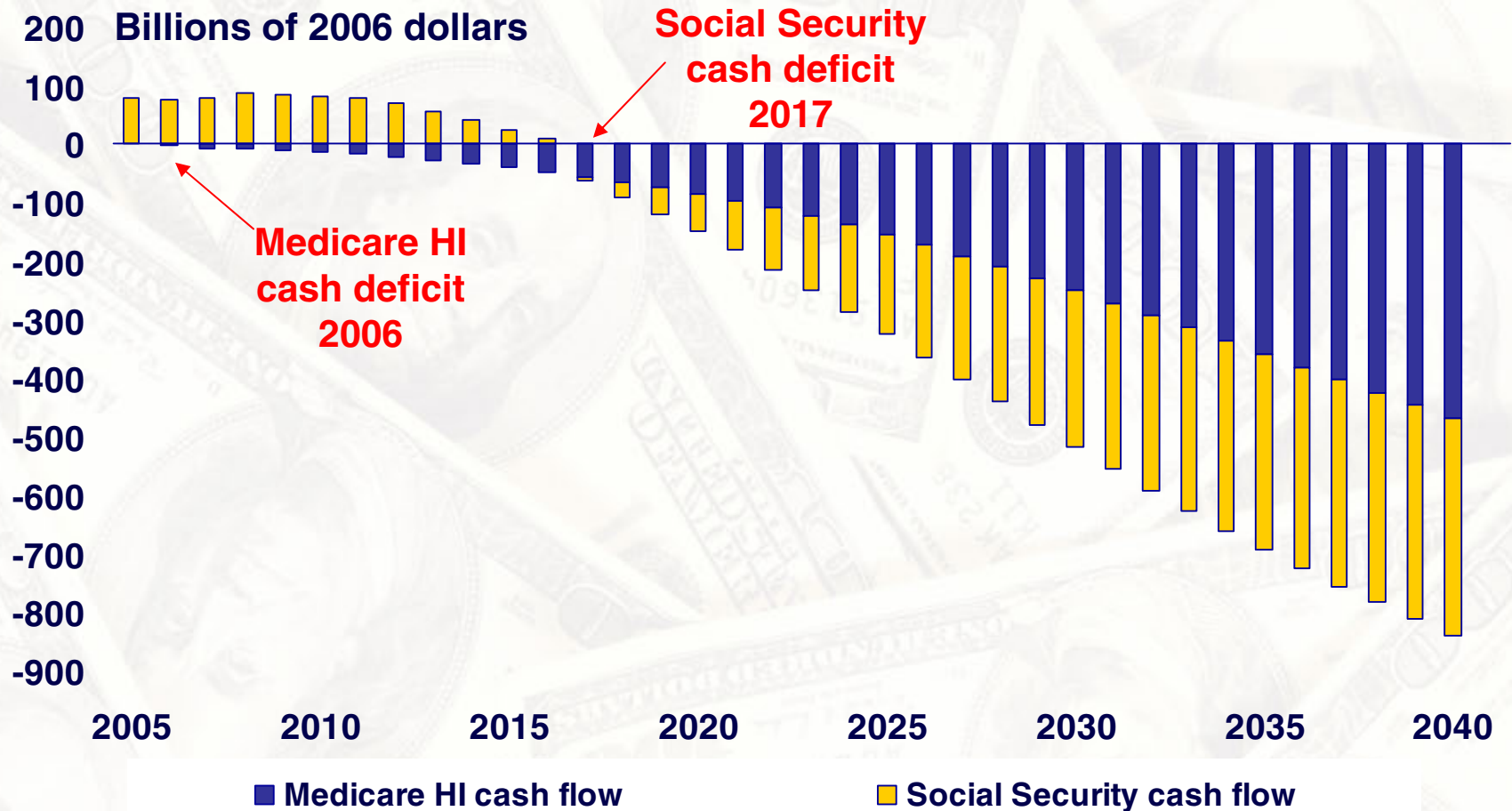
Social Security Workers per Beneficiary

Covered workers per OASDI beneficiary



Note: Projections based on the intermediate assumptions of the 2006 Trustees' Reports.
Source: Office of the Chief Actuary, Social Security Administration.

Social Security and Medicare's Hospital Insurance Trust Funds Face Cash Deficits



Note: Projections based on the intermediate assumptions of the 2006 Trustees' Reports. The CPI is used to adjust from current to constant dollars.

Source: GAO analysis based on data from the Office of the Chief Actuary, Social Security Administration and Office of the Actuary, Centers for Medicare and Medicaid Services.

Key Dates Highlight Long Term Challenges of the Social Security System

Date			Event
OASI	DI	OASDI	
2009	--	2009	Cash surplus begins to decline
2018	2005	2017	Annual benefit costs exceed cash revenue from taxes
2028	2013	2027	Trust fund ceases to grow because even taxes plus interest fall short of benefits
2042	2025	2040	Trust fund exhausted

Sources: Social Security Administration, *The 2006 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds* (Washington, DC: May 2006).

GAO Criteria for Evaluating Social Security Reform Proposals

Reform proposals should be evaluated as packages that strike a balance among individual reform elements and important interactive effects.

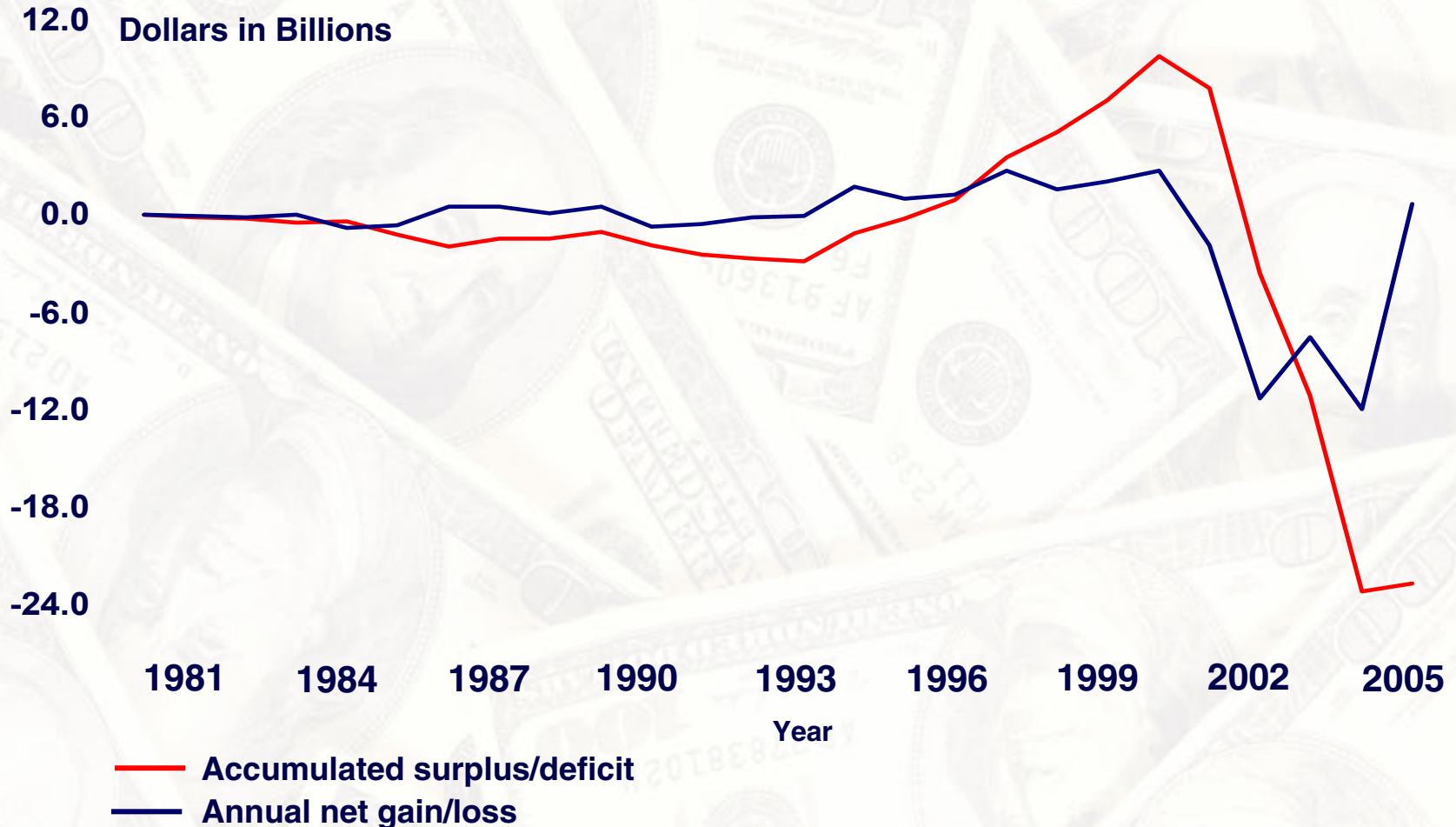
Comprehensive proposals can be evaluated against three basic criteria:

- Financing sustainable solvency
- Balancing adequacy and equity in the benefits structure
- Implementing and administering reforms

Pension System Faces Variety of Challenges

- Significant coverage gaps and pre-retirement leakage
- Long term decline in the number of DB plans and active participants and change in the nature of DB plans
- Recent DB freezes and retiree health plan limitations are likely to accelerate due to prospective changes in current accounting for pension and post-employment benefits
- Recent and prospective large plan terminations by bankrupt sponsors have placed Pension Benefit Guaranty Corporation (PBGC), the federal agency insuring benefits, in financial jeopardy
 - Stock market, interest rate declines this decade have worsened overall plan funding
 - Demographics, global competition (steel, auto), industry deregulation restructuring (airlines) have contributed to both plan and corporate weakness
- Plan funding rules have proven to be inadequate
- Certain PBGC premium insurance issues need to be reviewed
- Selected other issues also require attention (e.g., lump sums, bankruptcy laws)

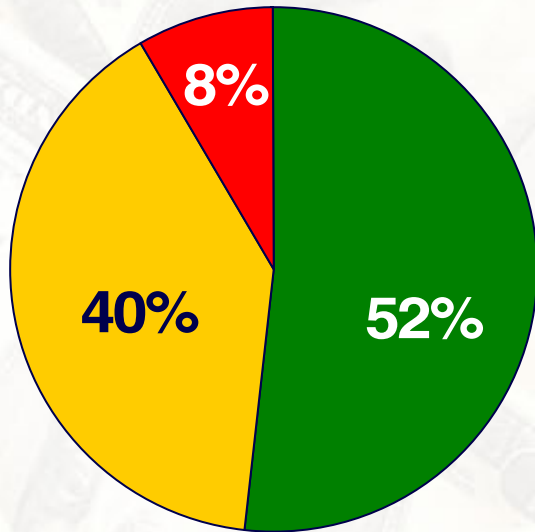
PBGC's Net Accumulated Deficit for Single-Employer Plans Was Nearly \$23 Billion in 2005



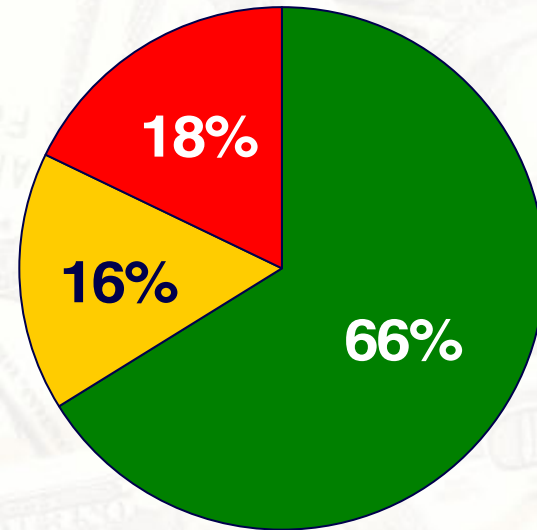
Source: Pension Benefit Guaranty Corporation.

PBGC Claims and Exposures by Principle Industry Category

PBGC Claims by Industry, FY 1975-2005
Total = \$31.7 billion



Reasonably Possible Exposure, FY 2005
Total = \$108 billion



 **Transportation**
(e.g., airlines)

 **Manufacturing**
(e.g., steel, heavy equipment)

 **Other**
(e.g., construction, services)

Source: Pension Benefit Guaranty Corporation. PBGC data for claims based on preliminary data.

Broad Goals for Reform of the DB System

- Provide incentives and safeguards for plan sponsors to improve plan funding without causing terminations that would otherwise not occur
- Hold plan sponsors accountable for adequately funding their plans
- Improve transparency and timeliness of plan financial information

Several Reforms Might Improve Plan Funding and Reduce the Risks to PBGC's Long-term Viability

- Strengthen funding rules applicable to poorly funded plans
- Consider additional tax deductible funding flexibility
- Limit lump sums in underfunded plans
- Modify program guarantees (e.g., phase-in rules)
- Raise and modify pension premiums (e.g., nature of risk related premiums)
- Eliminate floor/offset arrangements with significant investment concentrations in employer securities
- Increase transparency of current plan funding information
- Modify bankruptcy laws
- Address issues surrounding certain hybrid plans (e.g., cash balance plans)
- Consider whether to address industrial restructuring costs/losses differently than normal PBGC losses

Pension Protection Act of 2006: Provisions Affecting DB Plan Funding and Design

- **Revised Plan Funding Rules** - Sponsors have 7 years to fund initial shortfall and each additional shortfall
- **“Smoothing” Period Reduced** - for liabilities, from 4 to 2 years; for assets, also from 4 to 2 years
- **Yield Curve** - Modified corporate bond yield curve replaces 30-year Treasuries as key discount rate
- **Credit Balances** - Use of balances restricted in some cases
- **“At Risk” Plans** - Tougher funding rules, other restrictions for weakly funded “at risk” plans
- **Cash Balance Plans** - not deemed to be age discriminatory prospectively, “wearaway” and whipsaw prohibited, shorter vesting (reduced from 5 years to 3 years)
- **Multiemployer Plans** - Benefit restrictions placed on certain underfunded plans
- **Phase-in** – Funding target phased-in from 2008 to 2011 for certain plans

Pension Protection Act of 2006: Measures Related to PBGC

- **PBGC Premiums:**

- Flat-rate premiums remain at \$30 per participant for this year (as enacted in Deficit Reduction Act or DRA), but will increase in the future in accordance with wage growth
- Loopholes in Variable-Rate Premium closed (e.g. previous exemption for plans at “full-funding” removed)
- Extension of distress termination premium of \$1250 per participant (as originally enacted in DRA)

- **Shutdown Benefits** – Restricts shutdown benefits and their PBGC guarantee

- **Industry Relief** - Longer funding period for airlines and select other industries

Pension Protection Act of 2006: Measures Related to Defined Contribution Plans

- **Automatic Enrollment** - Option of automatic enrollment as default
- **Financial Advice** – Allows for investment companies to offer financial advice to plan participants under certain conditions
- **Employer Stock** - Plans required to allow diversification of employer stock after 3 years

Pension Protection Act of 2006: An Important Reform with Unfinished Business

- PPA shrinks, but does not close, many loopholes regarding DB plan funding
- PBGC deficit expected to continue to grow
- Ultimately does not address fundamental mismatch between DB plan assets and liabilities
- Will likely not reverse long-term decline in DB system
- Financing of adequate retirement for all Americans continues to pose a major national challenge
 - Issues of coverage and plan design remain largely unanswered
 - Appropriate balance of responsibility for retirement among employers, government and workers remains unclear

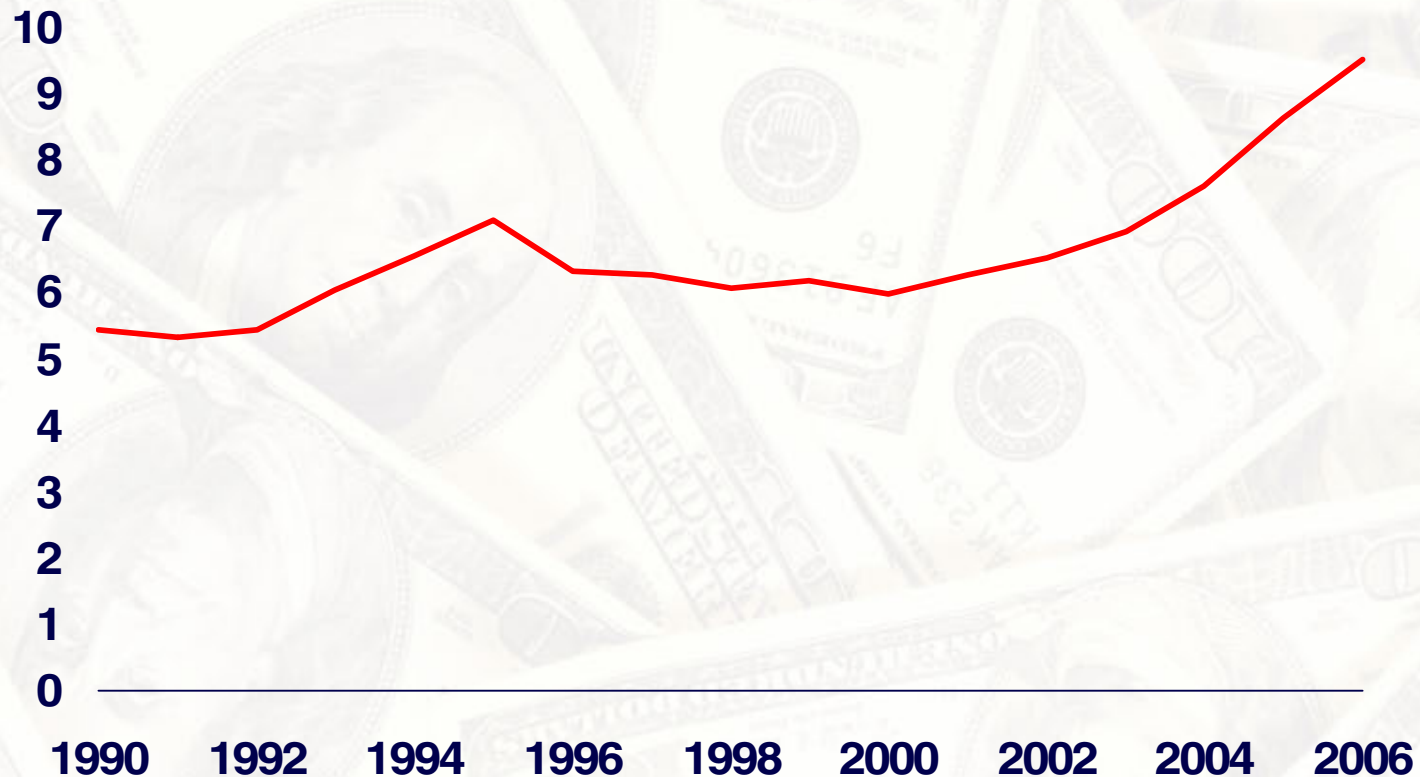
Key Dates Highlight Long Term Challenges of the Medicare Program

Date	Event
2006	HI outlays exceed cash income
2007	Estimated trigger date for “Medicare funding warning”
2012	Projected date that annual “general revenue funding” will exceed 45 percent of total Medicare outlays
2018	HI (Part A) trust fund exhausted, annual income sufficient to pay about 80% of HI promised benefits

Source: 2006 Annual Report of The Boards of Trustees of The Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds (Washington, DC, May 2006).

SMI Premium as Share of Average Social Security (OASI) Benefit

Percent of average OASI benefit

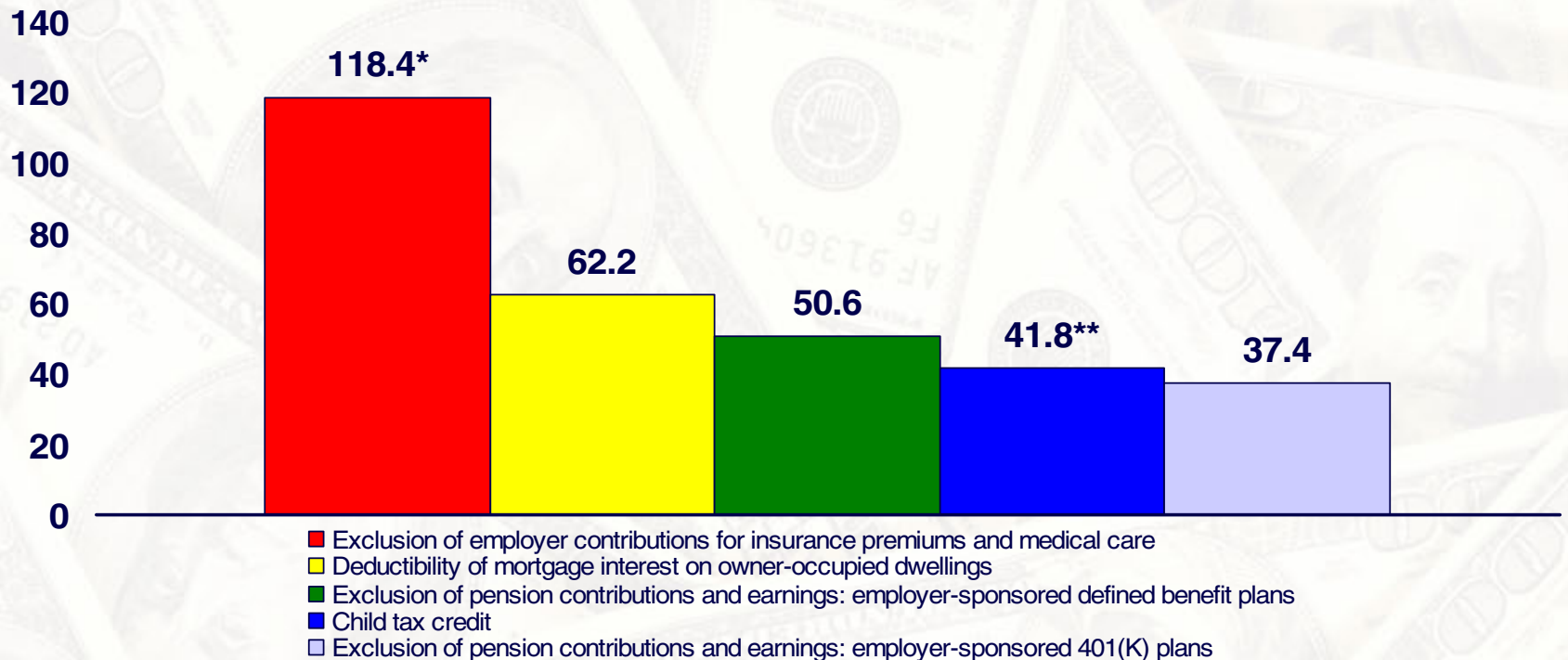


Note: Data for 2006 are based on the announced SMI monthly premium of \$88.50 and do not include the Medicare Prescription Drug premium. In August, the Centers for Medicare & Medicaid Services estimated that the national average monthly premium for prescription drug coverage equivalent to the Medicare standard coverage would be \$32.20.

Source: CMS, Office of the Actuary.

Health Care Is the Nation's Top Tax Expenditure in Fiscal Year 2005

Estimated dollars in billions



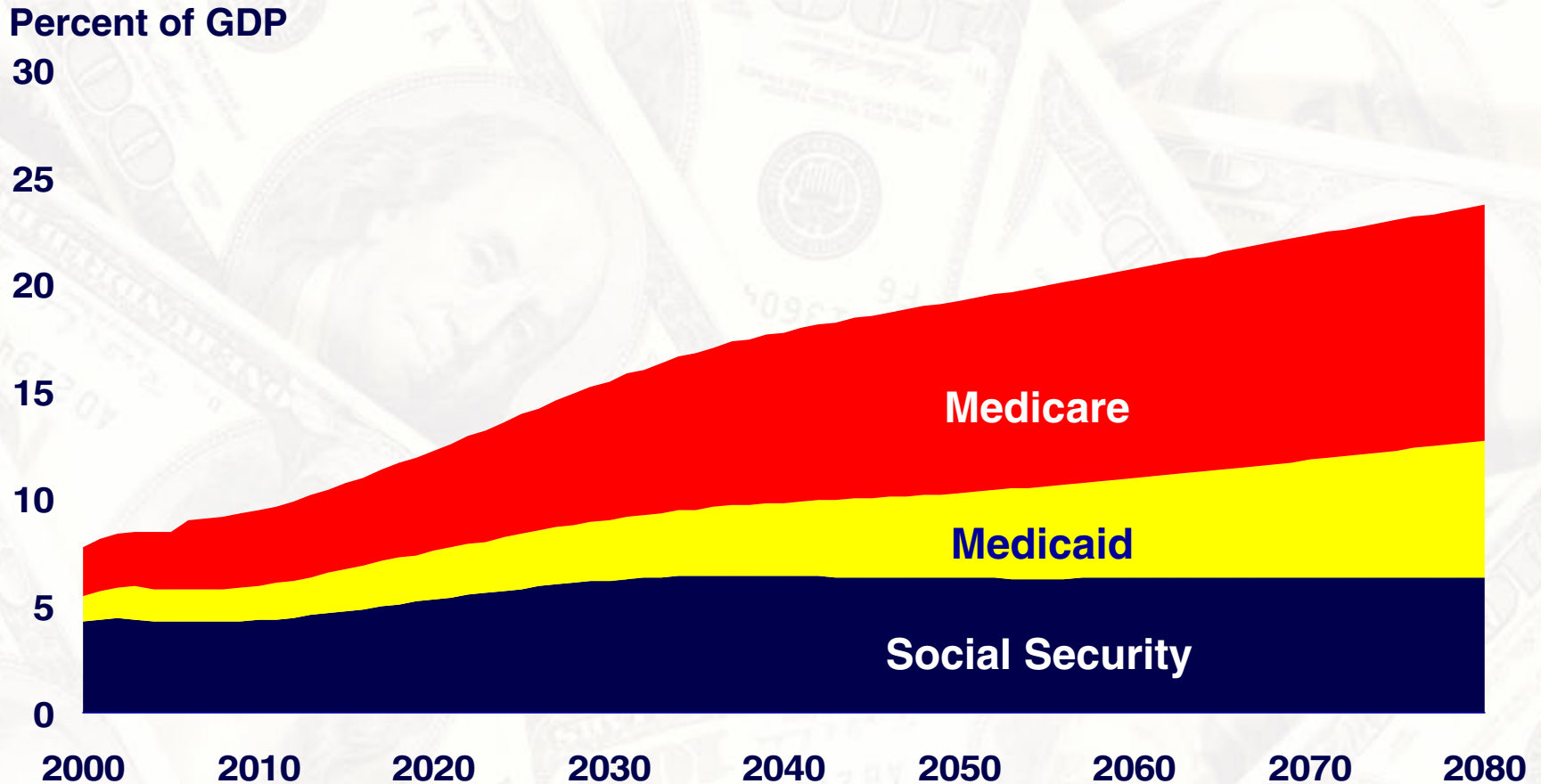
Note: "Tax expenditures" refers to the special tax provisions that are contained in the federal income taxes on individuals and corporations. OMB does not include forgone revenue from other federal taxes such as Social Security and Medicare payroll taxes.

*If the payroll tax exclusion were also counted here, the total tax expenditure for employer contributions for health insurance premiums would be about 50 percent higher or \$177.6 billion.

**This is the revenue loss and does not include associated outlays of \$14.6 billion.

Source: Office of Management and Budget (OMB), *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2007*.

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



Source: GAO analysis based on data from the Office of the Chief Actuary, Social Security Administration, Office of the Actuary, Centers for Medicare and Medicaid Services, and the Congressional Budget Office.

Note: Social Security and Medicare projections based on the intermediate assumptions of the 2006 Trustees' Reports. Medicaid projections based on CBO's January 2006 short-term Medicaid estimates and CBO's December 2005 long-term Medicaid projections under mid-range assumptions.

Issues to Consider in Examining Cost, Access, and Quality Challenges

- In reforming our health care system, the public needs to be educated about the differences between **wants**, **needs**, **affordability**, and **sustainability** at both the individual and aggregate level.
- Ideally, health care reform proposals will
 - align **incentives** for providers and consumers to make prudent choices about health insurance coverage and prudent decisions about the use of medical services,
 - foster **transparency** with respect to the value and costs of care, and
 - ensure **accountability** from health plans and providers to meet standards for appropriate use and quality.

Selected Potential Health Care Reform Approaches

- Reexamine the scope, timing, and structure of Medicare Prescription Drug Benefit.
- Consider re-imposing some limits on direct advertising on prescription drugs
- Consider some limited importation of prescription drugs from selected countries
- Foster more transparency in connection with health care costs and outcomes.
- Encourage case management approaches for people with expensive acute and chronic conditions to improve the quality and efficiency of care delivered and avoid inappropriate care.
- Leverage the government's purchasing authority to foster value-based purchasing for health care products and services.
- Foster the use of information technology to increase consistency, transparency, and accountability in health care.
- Foster more preventative care and wellness services and capabilities, including fighting obesity and encouraging better nutrition
- Provide additional cost sharing mechanisms for individuals.

Selected Potential Health Care Reform Approaches

- Develop a set of national practice standards to help avoid unnecessary care, improve outcomes, and reduce litigation.
- Revise certain federal tax preferences for health care to encourage the efficient use of appropriate care
- The federal government should seek to lead by example in connection with reforming the health care programs for which it is responsible (e.g., VA, DOD, FEHBP).
- Limit spending growth for government-sponsored health care programs (e.g., percentage of the budget and/or the economy).
- Pursue multinational approaches to investing in health care R&D.
- Develop a core set of basic and essential services with supplemental coverage being available as an option but at a cost. Use the Federal Employees Health Benefits Program (FEHBP) model as a possible means to experiment and see the way forward.
- Create insurance pools for alternative levels of coverage, as necessary.

Working Longer May Help Address the Challenges of an Aging Population

- **Impact on the Economy**
 - Larger labor force
 - Additional economic growth
- **Impact on the Federal Budget**
 - Additional tax revenue
 - Reduced expenditures: Social Security & Medicare
- **Impact on Individuals**
 - Enhanced retirement security and quality of life

Why Older Americans Don't Work Longer

- **Cultural Expectation to Retire in Mid-60s**
 - Social Security early retirement age is 62
 - Many private pensions have similar or lower eligibility ages
- **Older Americans Perceive Few Opportunities**
 - Few older workers felt they had opportunities for partial retirement
 - Most older workers and retirees saw low wage, low skilled jobs as their primary employment opportunities
- **Most Employers Do Not Make a Special Effort to Hire and Retain Older Workers**
 - Many employers say they are willing to implement policies to recruit and retain older workers, but few have actually done so
 - Employers cite barriers, such as federal pension regulations, to flexible employment options for older workers

Key Leadership Attributes Needed for These Challenging and Changing Times

- ***Courage***
- ***Integrity***
- ***Creativity***
- ***Stewardship***

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RETIREMENT CHALLENGES IN THE 21ST Century

**International Foundation of Employee Benefit Plans
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The Honorable David M. Walker
Comptroller General of the United States

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On the Web

Web site: www.gao.gov/cghome.htm

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