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SOCIAL SECURITY REFORM

Demographic Trends Underlie Long-Term Financing Shortage

Statement of Barbara D. Bovbjerg, Associate Director
Income Security Issues
Health, Education, and Human Services Division

Social Security Reform: Demographic Trends Underlie Long-Term Financing Shortage

Mr. Chairman and Members of the Task Force:

We are pleased to be here today to speak about Social Security financing reform. Our aging population is placing serious pressures on Social Security and other forms of retirement income. In the United States, the population of people aged 65 and older has tripled since 1940 and is projected to more than double again by 2050. People 65 and older are expected to make up 20 percent of the U.S. population as early as 2030, compared with 13 percent today and just 7 percent in 1940. Moreover, the population aged 85 and older is projected to increase fivefold by 2050. These projections reflect significant increases in life expectancies. As people live longer, they will need more income to sustain them throughout retirement. Unless retirement and work patterns change, fewer workers will be supporting each retiree. These profound demographic trends underlie Social Security's projected financing shortfalls.

Today, I would like to discuss the demographic trends contributing to Social Security's financing problem, when the problem will begin to confront us, the alternatives for addressing the problem, and their implications. My testimony is based on work we have done over the past few years.[1]

In summary, increasing life expectancy and declining fertility rates pose serious challenges not just for our Social Security system but also for Medicare, Medicaid, the federal budget, and our economy as a whole. The aging of the baby-boom generation will simply accelerate this trend.

Today, Social Security receives more from payroll taxes than it pays out in benefits. This excess revenue is helping build substantial trust fund reserves that are projected to help pay full benefits until 2029, according to Social Security's intermediate projections. At the same time, this excess revenue helps reduce the overall federal budget deficit but will start to taper off after 2008. In 2012, Social Security benefit payments are projected to exceed cash revenues, and the federal budget will start to come under considerable strain as the general fund starts to repay funds borrowed from the trust funds.

Although Social Security's revenues currently exceed its expenditures, revenues are expected to be about 14 percent less than total projected expenditures over the next 75 years, according to Social Security Administration (SSA) projections. A variety of benefit reductions and

[1]See the list of related GAO products at the end of this statement.

revenue increases within the current program structure could be combined to restore financial balance. However, some observers believe that the program structure should be reevaluated.

Reform is necessary, and the sooner we address it, the less severe the necessary adjustments will be. Any economic growth and improvements in living standards we can achieve will also mitigate the strains that reform will impose. However, any course we take will substantially affect both workers and retirees, other sources of retirement income, the income distribution, the federal budget, and even the economy as a whole. Such effects should be well understood in making reforms.

Background

When Social Security was enacted in 1935, the nation was in the midst of the Great Depression. About half of the elderly depended on others for their livelihood; roughly one-sixth received public charity. Many had lost their savings in the stock market crash. Social Security was created to help ensure that the elderly had adequate income and did not depend on welfare. It would provide benefits that workers had earned with their contributions and the help of their employers.

In creating Social Security, the Congress recognized an immediate need to bolster the income of the elderly; an individual retirement savings approach would not have significantly affected retirement income for years to come. The Social Security benefits that early beneficiaries received significantly exceeded their contributions, but even the very first beneficiaries had made some contributions. The Social Security Act of 1935 included a companion welfare program to help the elderly who had not earned retired worker benefits under Social Security.

Initially, very few of the elderly qualified for Social Security benefits; therefore, funding the benefits required relatively low payroll taxes. Increases in payroll taxes were always anticipated to keep up with the benefit payments as the system “matured” and more retirees received benefits. From the beginning, Social Security was financed on this type of “pay-as-you-go” basis, with any 1 year’s revenues collected primarily to fund benefits to be paid that year. The Congress had rejected the idea of “advance funding” for the program, or collecting enough revenues to cover future benefit rights as workers accrued them. Many feared that if the federal government amassed huge reserve funds, it would just find a way to spend them elsewhere.

Over the years, the size and scope of the program have changed. In 1939, coverage was extended to dependents and survivors. In the 1950s, state and local governments were given the option of covering their employees. The Disability Insurance program was added in 1956. The Medicare program was added in 1965. Beginning in 1975, benefits were automatically tied to the Consumer Price Index to ensure that the purchasing power of recipients' income was not eroded by inflation. These benefit expansions also contributed to higher payroll tax rates.

Today, Social Security has met the goal of its creators in that it provides the foundation for retirement income. In 1994, about 91 percent of all elderly households received Social Security benefits, compared with 67 percent who received some income from saved assets, just over 40 percent who had income from pensions, and 21 percent who had earned income. Social Security contributed over 40 percent of all elderly income, compared with about 18 percent each for the other sources. It provided the predominant share of income for the lowest three-fifths of the U.S. income distribution. On average, Social Security provided $9,200 to all elderly households. The other sources of retirement income determine which households have the highest income.

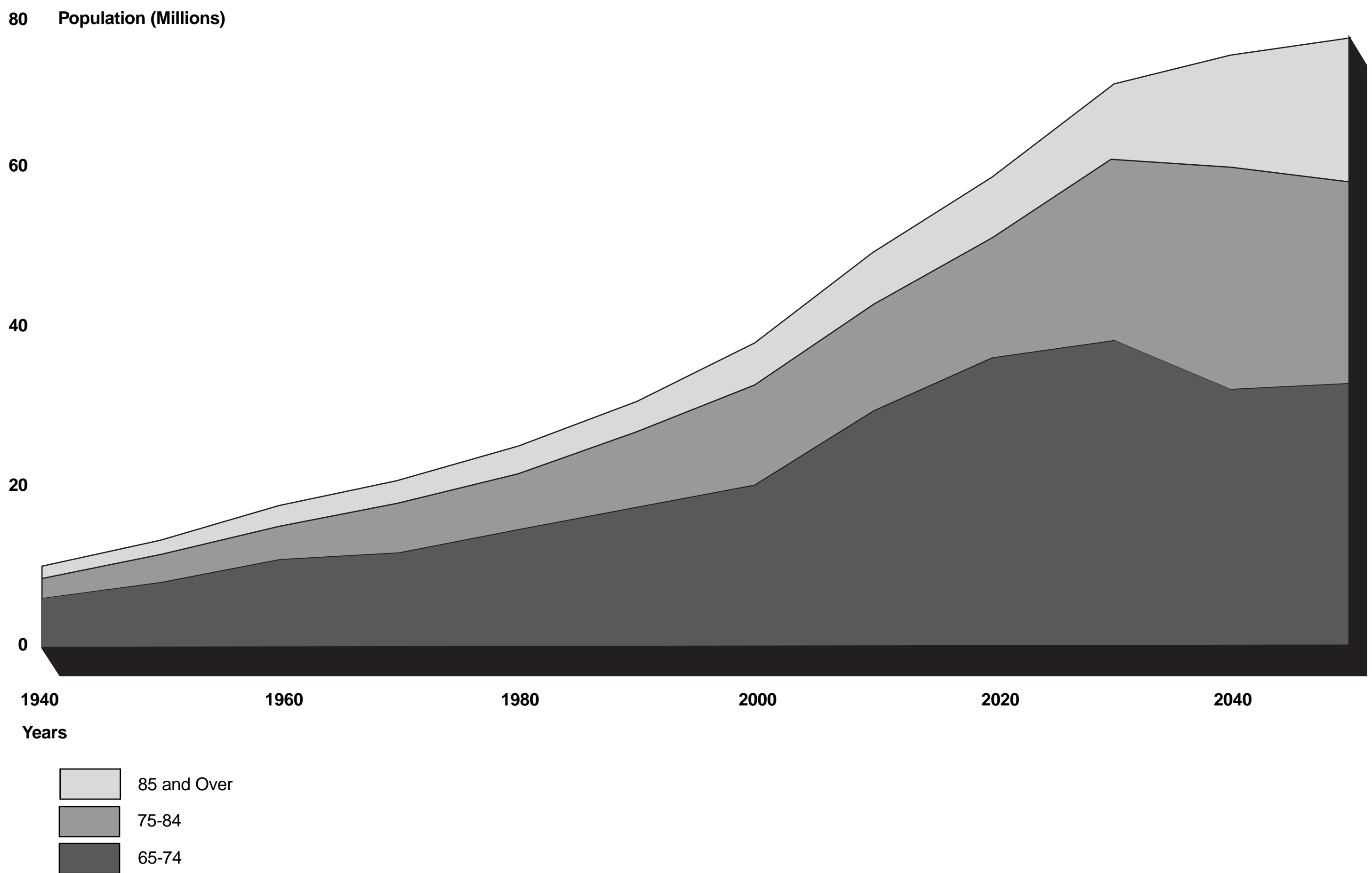
Social Security has contributed substantially to reducing poverty rates for the elderly, which declined dramatically from 35 percent in 1959 to under 11 percent in 1996. In comparison, 11.4 percent of those aged 18 to 64 and 20.5 percent of those under 18 were in poverty in 1996. For over half the elderly, income other than Social Security amounted to less than the poverty threshold in 1994. Still, pockets of poverty do remain. About 30 percent of elderly households are considered poor or nearly poor, having incomes below 150 percent of the poverty threshold. Women, unmarried people, and people aged 75 and over are much more likely to be poor than are other elderly persons. In fact, unmarried women make up over 70 percent of poor elderly households, compared with only 45 percent of all elderly households.

Demographic Roots of Social Security's Financing Problem

In the United States, the elderly population (those aged 65 and older) grew from about 9 million in 1940 to about 34 million in 1995, and it is expected to reach 80 million by 2050, according to Bureau of the Census projections. Moreover, the very old population (those aged 85 and older) is expected to increase almost fivefold, from about 4 million in 1995 to nearly 19 million in 2050. (See fig. 1.) As a share of the total U.S. population, the

elderly population grew from 7 percent in 1940 to 12 percent in 1990; this share is expected to increase to 20 percent by 2050.

Figure 1: Population Aged 65 and Older, by Age Group, 1940-2050



Note: Data for 2000 to 2050 are midrange Bureau of the Census projections.

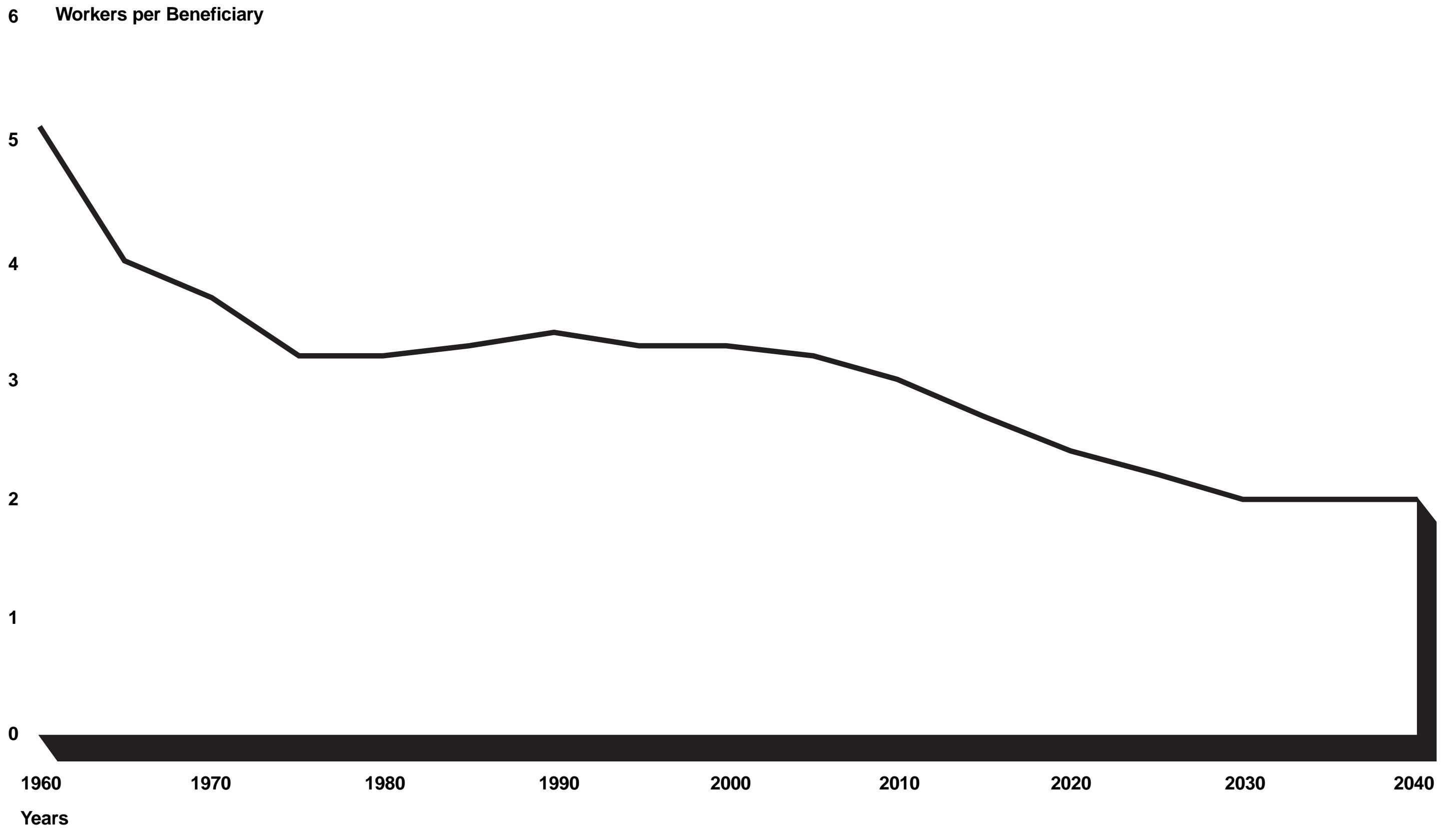
Source: U.S. Bureau of the Census, 65+ in the United States (Washington, D.C.: U.S. Bureau of the Census, 1996).

Although the baby-boom generation will greatly contribute to the growth of the elderly population, other demographic trends are also important. Life expectancy has increased continually since the 1930s, and further improvements are expected. In 1940, 65-year-old men could expect to live another 12 years, and women could expect to live another 13 years. By 1995, these numbers had improved to 15 years for men and 19 for women. By 2040, these numbers are projected to be 17 years and 21 years, according to SSA's intermediate actuarial assumptions. Note that these assumptions yield a lower rate of elderly population growth than do the Census assumptions. Some demographers project even more dramatic growth.

A falling fertility rate is the other principal factor in the growth of the elderly's share of the population. The fertility rate was 3.6 children per woman in 1960. The rate has declined to around 2.0 children per woman today and is expected to level off at about 1.9 by 2020, according to SSA's intermediate assumptions.

Increasing life expectancy and falling fertility rates in combination mean that fewer workers will be contributing to Social Security for each aged, disabled, dependent, or surviving beneficiary. There were 3.3 workers for each Social Security beneficiary in 1995, but by 2030, only 2.0 workers are projected for each beneficiary (see fig. 2).

Figure 2: Workers Contributing to Social Security Per Beneficiary, Historical and Projected, 1960-2040



Note: Projections use SSA's intermediate actuarial assumptions.

Source: Board of Trustees, 1997 Annual Report of the Board of Trustees of the Federal Old Age and Survivors Insurance and Disability Insurance Trust Funds (Washington, D.C.: SSA, 1997).

These demographic trends have fundamental implications for Social Security, other forms of retirement income, and our economy as a whole. Increasing longevity means that each year more people will receive Social Security benefits. As a result, Social Security revenues must be increased, benefits must be reduced, or both. For pensions and retirement savings, increasing longevity means these income sources will have to provide income over longer periods, which will similarly require increased contributions or reduced retirement income. As already noted, there will

be relatively fewer workers to pay the Social Security taxes needed to fund benefits. However, more fundamentally, unless retirement patterns change, there will be relatively fewer workers producing the goods and services that both workers' households and elderly households will consume. Yet in recent years, workers have been retiring earlier, not later, and not always by choice.

These demographic trends also pose challenges for our long-term budget outlook. They will lead to higher costs in Medicare and Medicaid as well as in Social Security. In a recent report to the Chairmen of the Senate and House Budget Committees,[2] we discussed the results of our latest simulations of the long-term budget outlook. Recent congressional action to bring about a balanced budget and surplus in the next 10 years will give us some breathing room, but spending pressures in these programs, if left unchecked, will prompt the emergence of unsustainable deficits over the longer term.

How Social Security's Problem Will Develop Over Time

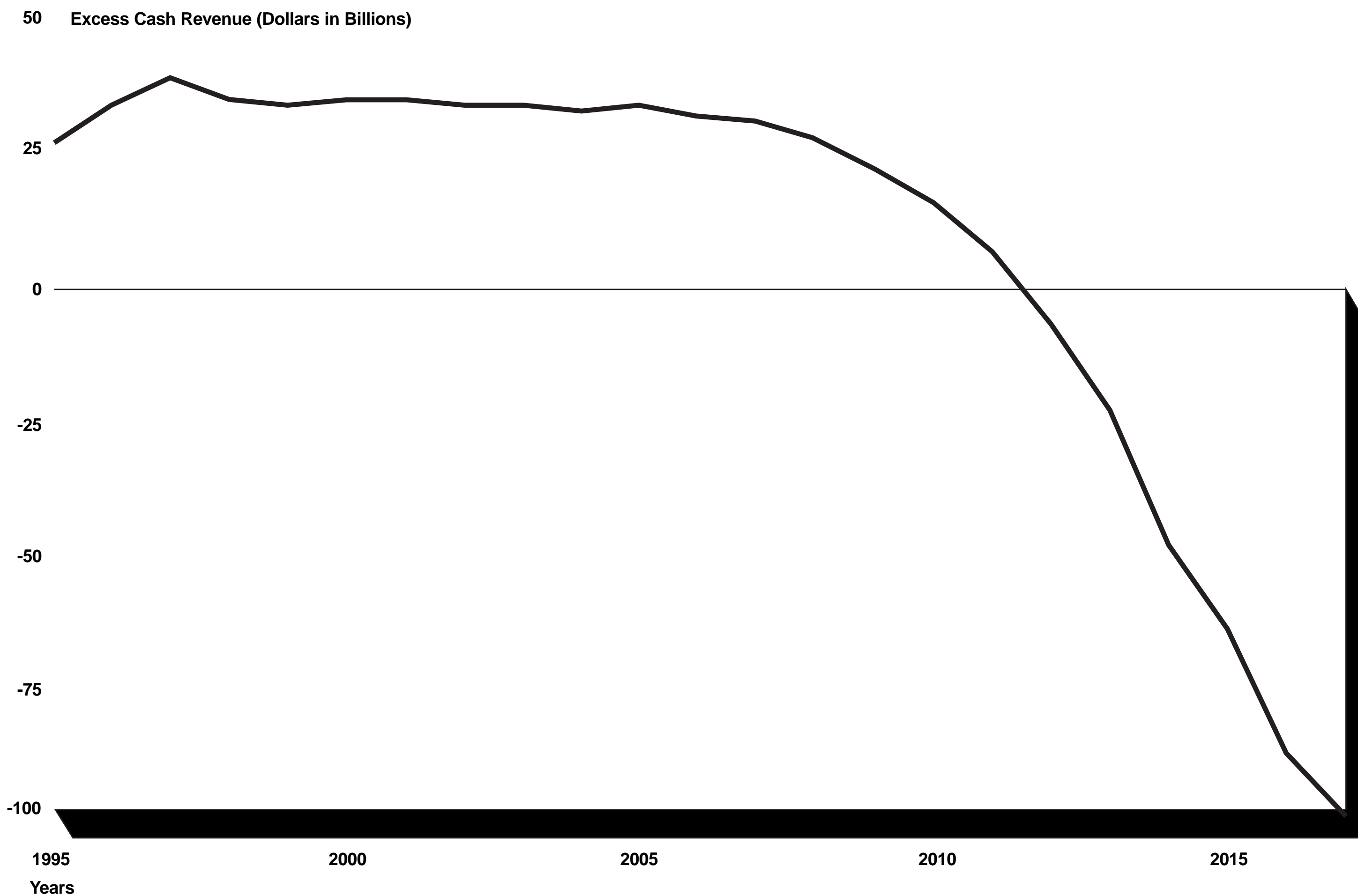
These demographic trends pose long-term financing challenges for both Social Security and the federal budget. Social Security revenues are expected to be about 14 percent less than expenditures over the next 75 years, and demographic trends suggest that this imbalance will grow over time. In 2029, the Social Security trust funds are projected to be depleted. From then on, Social Security revenues are expected to be sufficient to pay only about 70 to 75 percent of currently promised benefits, given currently scheduled tax rates and SSA's intermediate assumptions about demographic and economic trends. In 2031, the last members of the baby-boom generation will reach age 67, when they will be eligible for full retirement benefits under current law.

While Social Security funds are expected to be sufficient to pay full benefits for more than 30 years, Social Security's financing will begin having significant implications for the federal budget in only 10 years. Moreover, restoring Social Security's long-range financial balance would not necessarily address the significant challenge that its current financing arrangements pose for the overall federal budget. Social Security cash revenues currently exceed expenditures by roughly $30 billion each year (see fig. 3). Under current law, the Department of the Treasury issues interest-bearing government securities to the trust funds for these excess revenues. In effect, Treasury borrows Social Security's excess revenues and uses them to help reduce the amount it must borrow from the public.

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

In other words, Social Security's excess revenues help reduce the overall, or unified, federal budget deficit. Moreover, the trust funds earned $38 billion in interest last year, which Treasury pays by issuing more securities. If Treasury could not borrow from the trust funds, it would have to borrow more in the private capital market and pay such interest in cash to finance current budget policy.

Figure 3: Social Security's Cash Revenues Exceed Expenditures Now but Fall Short Later



Sources: 1997 Annual Report of the Board of Trustees of the Federal Old Age and Survivors Insurance and Disability Insurance Trust Funds and unpublished SSA data.

Ten years from now, these excess cash revenues are expected to start diminishing, and so will their effect in helping balance the budget. In just 15 years, Social Security's expenditures are expected to exceed its cash revenues, and the government's general fund will have to make up the difference, in effect repaying Social Security. As a result, Social Security's cash flow will no longer help efforts to balance the budget but will start to hinder them. In 2028, repayments from the general fund to Social Security are expected to reach about $183 billion in 1997 dollars. In that year, this amount would equal the same share of gross domestic product as the deficit for the entire federal government in fiscal year 1996, or 1.4 percent, according to SSA projections.

Alternatives for Reform

Restoring Social Security's long-term financial balance will require some combination of increased revenues and reduced expenditures. A variety of options is available within the current structure of the program. However, some proposals would go beyond restoring financial balance and fundamentally alter the program structure. These more dramatic changes attempt to achieve other policy objectives as well.

The current Social Security system attempts to balance two competing policy objectives. The progressive benefit formula tries to ensure the "adequacy" of retirement income by replacing a higher portion of lower earners' income than of higher earners' income. In effect, Social Security redistributes income from higher earners to lower earners. At the same time, the formula attempts to maintain some degree of "equity" for higher earners by providing that benefits increase somewhat with earnings.

Within the current program structure, a wide range of options is available for reducing costs or increasing revenues. Previously enacted reforms have used many of these in some form. Current reform proposals also rely, at least in part, on many of these more traditional measures, regardless of whether the proposals largely preserve the current program structure or alter it significantly.

Ways to reduce program expenditures include

- reducing initial benefits by changing the benefit formula for all or some beneficiaries, for example, by changing the number of years of earnings used in the formula;
- raising the retirement age or accelerating the currently scheduled increase;
- lowering the annual automatic cost-of-living adjustment; and

- means-testing benefits, or limiting benefits on the basis of beneficiaries' other income and assets.

Ways to increase revenues include

- increasing Social Security payroll taxes,
- investing trust funds in securities with potentially higher yields than the government bonds in which they are currently invested, and
- increasing income taxes on Social Security benefits.

A variety of proposals would address Social Security's long-term funding problems by significantly restructuring the program, usually by privatizing at least a portion of it. Such proposals still essentially achieve financial balance by effectively raising revenues and reducing costs, but they do so in ways that pursue other policy objectives as well. Some of these proposals would reduce the role of Social Security and the federal government in providing retirement income and would give individuals greater responsibility and control over their own retirement incomes. These proposals often focus on trying to improve the rates of return that individuals earn on their retirement contributions and thus place greater emphasis on the equity objective. Also, some proposals focus on trying to increase national saving and on funding future Social Security benefits in advance rather than on the current pay-as-you-go basis. In this way, the relatively larger generation of current workers could finance some of their future benefits now rather than leaving a relatively smaller generation of workers with the entire financing responsibility. Moreover, the investment earnings on the saved funds would reduce the total payroll tax burden.

Generally, privatization proposals focus on setting up individual retirement savings accounts and requiring workers to contribute to them. The accounts would usually replace a portion of Social Security, whose benefits would be reduced to compensate for revenues diverted to the savings accounts. Some privatization proposals combine new mandatory saving and Social Security benefit cuts, hoping to produce a potential net gain in retirement income. The combination of mandated savings deposits and revised Social Security taxes would be greater than current Social Security taxes, in most cases.

Virtually all proposals addressing long-term financing issues would increase the proportion of retirement assets invested in the stock market or in other higher-risk investments. Some proposals call for the accounts to be managed by individuals, while others would have them managed by

the government. The common objective is to finance a smaller share of retirement costs with worker contributions and a larger share of the costs with anticipated higher investment returns.

In the case of individual savings accounts, workers would bear the risk of economic and market performance. Individuals with identical earning histories and retirement contributions could have notably different retirement incomes because of market fluctuations or individual investment choices. Some proposals would require retirees to purchase a lifetime annuity with their retirement savings to ensure that the savings provided income throughout their retirement.

Privatization proposals raise the issue of how to make the transition to a new system. Social Security would still need revenues to pay benefits that retirees and current workers have already earned, yet financing retirement through individually owned savings accounts requires advance funding. The revenues needed to fund both current and future liabilities would clearly be higher than those currently collected. For example, to fund the transition, one proposal would increase payroll taxes by 1.52 percent for 72 years and involve borrowing $2 trillion during the first 40 years of the transition.

Privatization would also have a significant effect on the distribution of retirement income between high and low earners. The current Social Security benefit formula redistributes income and implicitly gives low earners a somewhat higher rate of return on their contributions than high earners. Privatization proponents claim that all earners would be better off under privatization, although high earners would have relatively more to gain from any increased rates of return that privatization might provide. Moreover, if workers were contributing to their own retirement savings, their contributions would not be available for redistribution as they are now. Some privatization proposals would retain some degree of Social Security coverage and therefore permit some redistribution to continue.

Privatization proposals also tend to separate retirement benefits from Social Security's survivors' and disability benefits. In the case of death or disability before retirement, individual savings may not have been building long enough to sufficiently replace lost income. Some privatization proposals, therefore, leave these social insurance programs largely as they are now.

Implications of Reform

Financing reforms could affect the nation's economy in various ways. For example, raising the retirement age could affect the labor market for elderly workers. Also, if reforms increased national saving, they could help increase investment, which in turn could increase productivity and economic growth. Economic growth could help ease the strains of providing for a growing elderly population. However, reforms may not produce notable increases in national saving since, to some degree, any new retirement saving might simply replace other forms of individual saving. Moreover, any additional Social Security savings in the federal budget would add to national saving only if they were not offset by other budget initiatives.

Reforms would affect other sources of retirement income and related public policies as well. For example, raising payroll taxes could affect the ability of workers to save for retirement, especially if these increases were combined with tax increases enacted to help with Medicare or Medicaid financing. Raising Social Security's retirement age or cutting its benefit amounts could increase costs for private pensions that adjust benefits in relation to Social Security benefits. Reforms would also interact with other income support programs, such as Social Security's Disability Insurance program or the Supplemental Security Income public assistance program.

Reforms could have effects both immediately and far into the future. For example, bringing newly hired state and local government workers into the Social Security system would immediately increase revenues but would increase benefit payments only when the newly covered workers retired. However, even changes that take effect years from now can affect how workers plan now for their retirement, especially how much they choose to save. Therefore, the sooner solutions are enacted, the more time workers will have to adjust their retirement planning. Acting sooner rather than later also would mean that the funding shortfall could be addressed over a longer period at a lower annual cost.

Finally, any financing reforms would implicitly have distributional effects. For example, increasing Social Security taxes would reduce the disposable income of current workers but would help sustain retirement benefits for retirees in the future. Cutting benefits instead of increasing payroll taxes would have the opposite distributional effect. Also, Social Security redistributes income from high to low earners to some degree; some reforms would change this. In particular, reform proposals vary considerably in their effects on specific subpopulations, some of which are at greater risk of poverty, such as older women and unmarried women.

For example, since men and women have different earnings histories, life expectancies, and investment behaviors, reforms could exacerbate differences in benefits that already exist.

Observations

Ensuring that Americans have adequate retirement income in the 21st century will require that the nation and the Congress make some difficult choices. Social Security has been effective in ensuring a reliable source of income in retirement and greatly reducing poverty among the elderly, and reforms will determine what role it will play in the future. The effect of reforms on other retirement income sources and on various groups within the aged population should be well understood when making reforms.

Also, the demographic trends underlying Social Security's financing problem are contributing significantly to increasing cost pressures for Medicare and Medicaid. Federal budget policy faces a profound challenge from the tremendous imbalance between these promised entitlements and the revenues currently planned to fund them. While Social Security's financing is projected to pay full benefits until 2029, it will start to pose challenges for the federal budget much earlier—only 10 years from now. This fact illustrates the critical importance of examining how budget policy interacts with proposed reforms to Social Security and other entitlements. It also illustrates the need to act sooner rather than later. Timely policy adjustments can help us get onto a more sustainable fiscal path and may even help increase national saving and promote economic growth, which could ease the adjustments that current demographic trends will require.

This concludes my testimony. I will be happy to answer any questions.

Related GAO Products

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

401(k) Pension Plans: Loan Provisions Enhance Participation but May Affect Retirement Income Security for Some (GAO/HEHS-98-5, Oct. 1, 1997).

Retirement Income: Implications of Demographic Trends for Social Security and Pension Reform (GAO/HEHS-97-81, July 11, 1997).

Social Security Reform: Implications for the Financial Well-Being of Women (GAO/T-HEHS-97-112, Apr. 10, 1997).

401(k) Pension Plans: Many Take Advantage of Opportunity to Ensure Adequate Retirement Income (GAO/HEHS-96-176, Aug. 2, 1996).

Social Security: Issues Involving Benefit Equity for Working Women (GAO/HEHS-96-55, Apr. 10, 1996).

Federal Pensions: Thrift Savings Plan Has Key Role in Retirement Benefits (GAO/HEHS-96-1, Oct. 19, 1995).

Social Security Retirement Accounts (GAO/HEHS-94-226R, Aug. 12, 1994).

Social Security: Analysis of a Proposal to Privatize Trust Fund Reserves (GAO/HRD-91-22, Dec. 12, 1990).

Social Security: The Trust Fund Reserve Accumulation, the Economy, and the Federal Budget (GAO/HRD-89-44, Jan. 19, 1989).

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