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SOCIAL SECURITY

Issues in Evaluating Reform Proposals

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GAO

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Mr. Chairman and Members of the Committee:

Thank you for inviting me here today as you continue the ongoing discussion on how best to ensure the long-term viability of our nation's Social Security program.[1] Social Security not only represents the foundation of our retirement income system; it also provides millions of Americans with disability insurance and survivor's 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 we have said in congressional testimonies over the past several years,[2] the system faces both solvency and sustainability challenges in the longer term. The challenges of combating terrorism and otherwise addressing homeland security have now come to the fore as new, unexpected, and urgent claims on the federal budget. Still, none of the changes since September 11 have lessened Social Security's long-term pressures on the budget. In fact, the events of September 11 have served to increase our long-range challenges. Without reforms to Social Security and Medicare, these programs are unsustainable, and their long-term impact on the federal budget and the economy will be dramatic.

Over the past few years, a wide array of proposals have been put forth to restore Social Security's long-term solvency, and now a commission appointed by the President is deliberating possible reform recommendations. It is not my intention to take a position for or against any individual reform proposal, element, or approach. Rather, I hope my testimony today, which is based on a body of work we have published over the past several years, will help clarify some of the key issues in the debate.[3] To do that, I'm going to talk about the nature and timing of the Social Security problem, a framework and criteria for evaluating reform proposals, and findings from our recent report on Social Security's role in helping ensure income adequacy.[4]

[1] Social Security refers here to the Old Age, Survivors, and Disability Insurance (OASDI) program.

[2] *Social Security: Criteria for Evaluating Social Security Reform Proposals* (GAO/T-HEHS-99-94, Mar. 25, 1999); *Social Security: The President's Proposal* (GAO/T-HEHS/AIMD-00-43, Nov. 9, 1999); *Long-Term Budget Issues: Moving from Balancing the Budget to Balancing Fiscal Risk* (GAO-01-385T, Feb. 6, 2001).

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

[4] *Social Security: Program's Role in Helping Ensure Income Adequacy* (GAO-02-62, Nov. 30, 2001).

In summary, our Social Security challenge is more urgent than it may appear and is part of a larger and significant fiscal and economic challenge. The Social Security program, combined with rapid growth in Medicare and Medicaid, will dominate the federal government's future fiscal outlook. Absent reform, the nation will ultimately have to choose between persistent, escalating federal deficits, significant tax increases and/or dramatic budget cuts; waiting only makes it harder. Although Social Security's Trust Funds will not be exhausted until 2038, according to the latest trustees' report's intermediate projections,[5] the program's cash demands on the rest of the federal government will begin much sooner.[6] Beginning in 2016, 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 ongoing costs—a pressure that will continuously increase over time. Failure to take remedial action will, in combination with other entitlement spending, place unsustainable pressure on the government and, ultimately, the economy. Focusing on trust fund solvency alone is not sufficient. We need to put the program on a path toward sustainable solvency. Aiming for sustainable solvency would increase the chance that future policymakers would not have to face these difficult questions on a recurring basis. Moreover, while addressing Social Security reform will not be easy, Medicare presents a much greater, more complex, and urgent fiscal challenge.

Still, this problem is about more than finance. A comprehensive framework for addressing the problem can help. To assist the Congress in its deliberations, GAO has developed criteria for evaluating Social Security reform proposals: financing sustainable solvency, balancing adequacy and equity, and implementing and administering reforms. 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. Reform proposals should be evaluated as packages that strike a balance among individual reform elements, and important interactive effects should be

[5] For the annual report of the Board of Trustees for the Social Security Trust Funds, SSA actuaries project future revenues and benefits. For these projections, they use alternative assumptions regarding economic and demographic trends, including average earnings, mortality, fertility, and immigration. The intermediate assumptions represent the board's best estimate of future trends.

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

considered. If we focus on the pros and cons of each element of reform, it will be more difficult to build the bridges necessary to achieve consensus. In addition, overall evaluation of each proposal depends on the weight individual policymakers place on each criterion.

Finally, our recent report on Social Security and income adequacy provides some specific insights on one of our criteria. First, no single measure of adequacy provides a complete picture; each measure reflects a different outlook on what adequacy means. So a variety of measures should be considered. In addition, all adequacy measures depend significantly on what types of income are counted. In particular, noncash benefits such as Medicare play a major role in sustaining standards of living for their beneficiaries. Any examination of income adequacy should acknowledge the major role of noncash benefits and the needs they help support. Second, given the currently projected long-term financial shortfall of the program, it is important to compare proposals to both benefits at currently promised levels and benefits funded at current tax levels. We have developed benchmark policy scenarios to illustrate the range of possible outcomes and used these benchmarks to examine the outlook for income adequacy. However, since our report was focused on income adequacy, it did not examine measures of individual equity, which should be balanced against adequacy measures. Third, various approaches to benefit reductions, in particular, would have differing effects on adequacy. More progressive approaches to reducing monthly benefits would have a smaller effect on poverty rates, for example, than less progressive approaches. Also, reductions that preserve current law benefits for survivors, disabled workers, and the very old would help minimize reductions to income adequacy, though they could place other beneficiaries at greater risk of poverty.

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

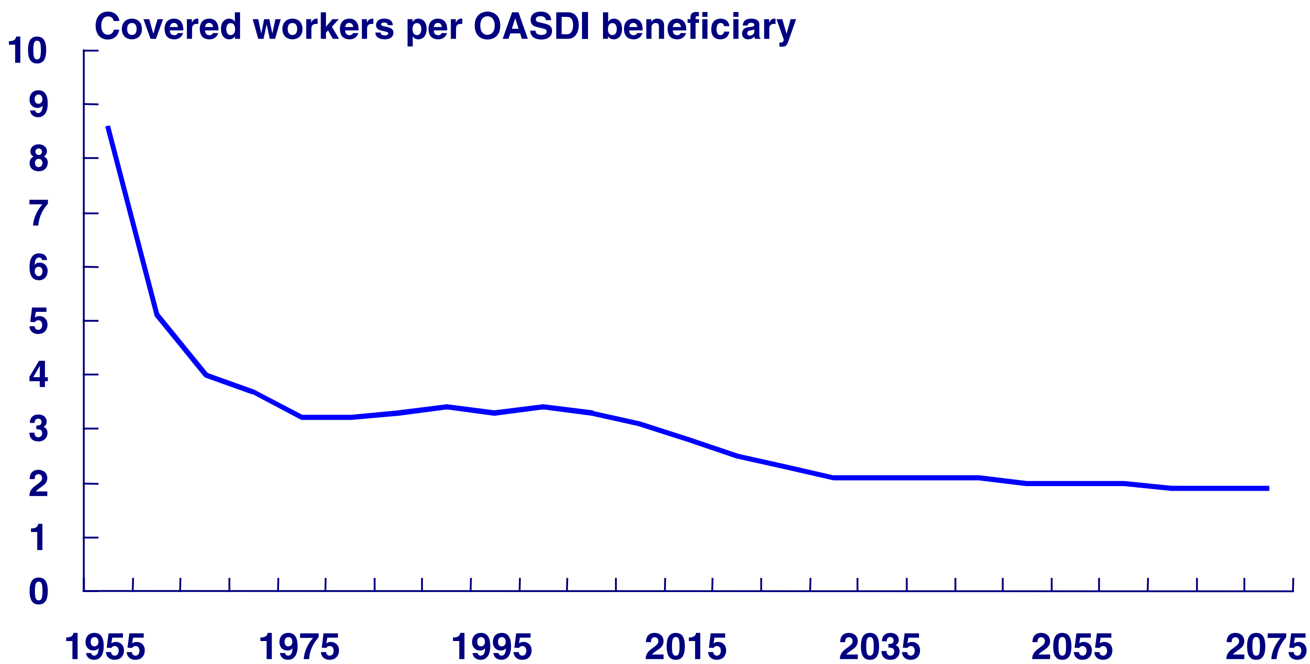
Today the Social Security program does not face an immediate crisis but rather a long-range and more fundamental financing problem driven largely by known demographic trends. The lack of an immediate solvency crisis changes the challenge, but it does not eliminate the need for action. Acting sooner rather than later 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." It is also important to put the overall federal budget on a sustainable footing over the long term, thereby promoting higher economic growth and more fiscal flexibility to finance other priorities.

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'd 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 affect the program's financial condition. This ratio, however, is changing: today the ratio of workers paying Social Security taxes to beneficiaries 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. Taken together, these trends threaten the financial solvency and sustainability of this important program. (See fig. 1.)

Figure 1: Ratio of Covered Workers to Beneficiaries

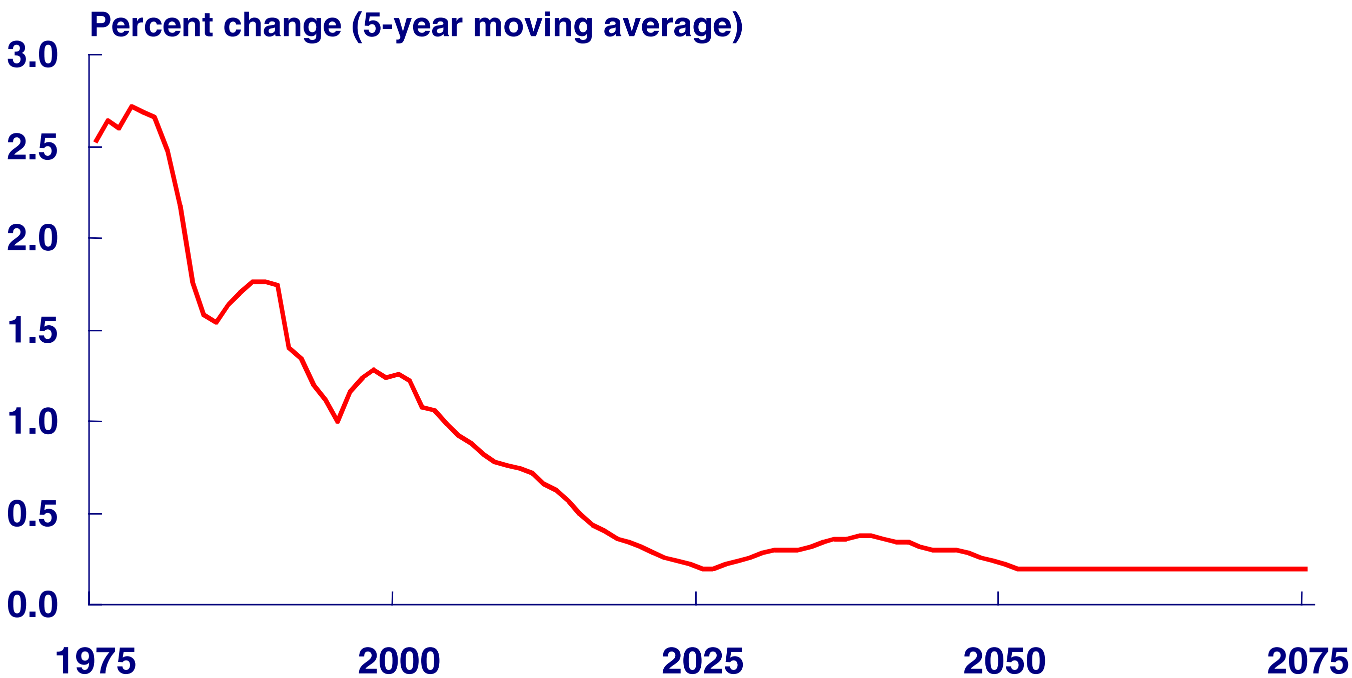


Note: Based on the intermediate assumptions of the 2001 OASDI Trustees' Reports.

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

The combination of these trends means that labor force growth will begin to slow after 2010 and become negligible by 2025. (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 inevitably lead to slower growth in the economy and, absent a change in tax policy, 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



Note: Based on the intermediate assumptions of the 2001 OASDI Trustees' Reports.

Source: GAO analysis of data from Office of the Chief Actuary, SSA.

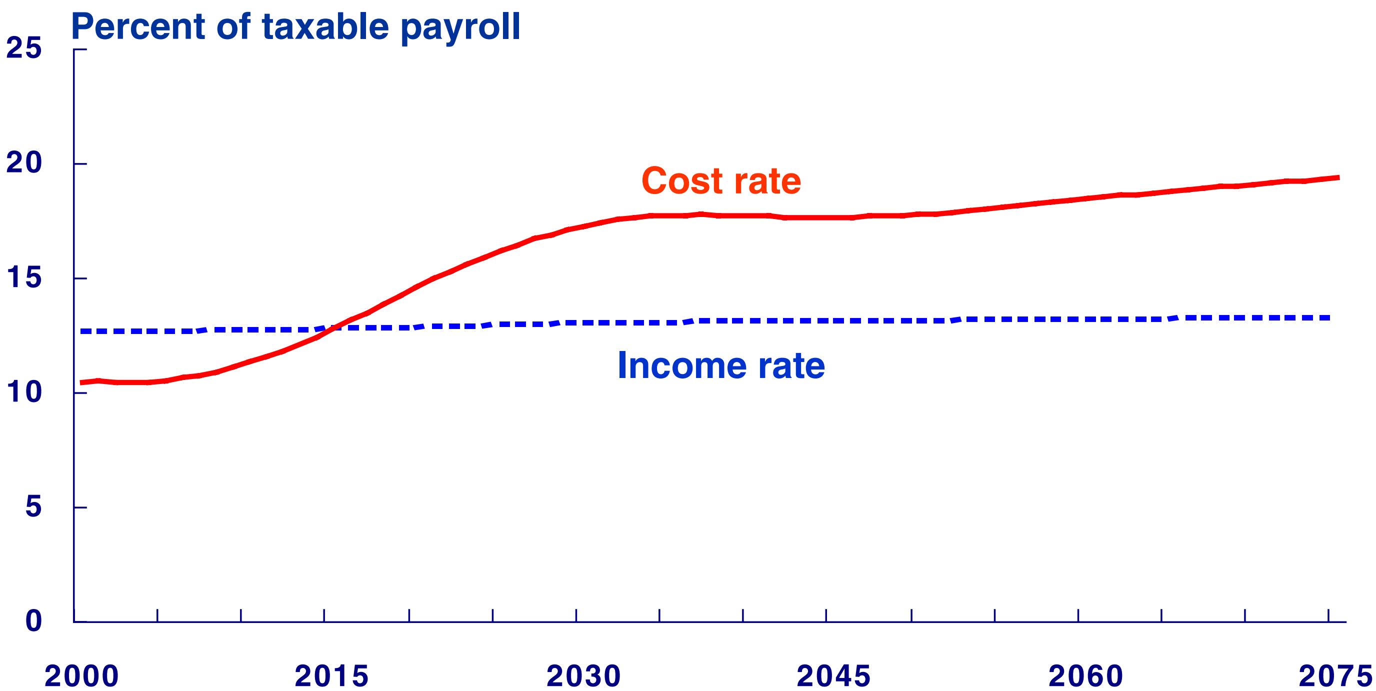
This slowing labor force growth is not always considered as part of the Social Security debate. Fundamentally, there are only two ways to mitigate the slowdown in labor force growth: keep people in the labor force longer or bring in more people. Given longer life expectancies, improving health status of older workers, economic needs, and budget realities, it may be appropriate to consider finding ways to encourage people to work longer. Social Security's retirement ages are often the subject of discussion and debate. 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 finances of Social Security and Medicare would be improved, and the expected slowdown in labor force growth might be mitigated. However, in the case of Social Security, absent any new increases in the full retirement age, any improvement could be offset to some degree by the higher benefits that workers could have as a result of delaying receipt of their benefits.

Another key uncertainty is new entrants into the labor force. In domestic social policy, we have seen an increasing focus on encouraging those previously outside the labor force (such as welfare recipients and the disabled) into the workforce. Concern about the slowdown in the labor force may also lead to discussions about immigration and its role. These are issues that the Congress may wish to explore further in the next few years.

Because of these demographic trends, current estimates show that within 15 years benefit payments will begin to exceed program revenue, which is composed largely of payroll taxes on current workers.[7] (See fig. 3.)

[7] Income tax revenue resulting from taxation of up to 50 percent of Social Security benefits for certain higher income beneficiaries is credited to the OASI and DI Trust Funds and provided 2 percent of total income in 2000.

Figure 3: Social Security Income and Cost Rates



Note: Cost rates reflect the cost of Social Security benefits and other program costs as a percent of taxable payroll, while income rates reflect payroll tax receipts and other program revenues as a percent of taxable payroll. Projections based on intermediate assumptions of the 2001 OASDI Trustees' Report.

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

Social Security Cash Flows, Trust Funds, and the Federal Budget

Within the federal budget, Social Security—more properly, the Old-Age and Survivors Insurance and Disability Insurance programs (OASDI)—has two trust funds that authorize Treasury to pay benefits as long as the applicable trust fund has a positive balance. Currently, Social Security's cash income exceeds cash expenditures. The Trust Funds, by law, invest the resulting surplus in U.S. government obligations or securities that are backed by the full faith and credit of the U.S. government. At present, the Trust Funds' assets are in the form of special, nonmarketable Treasury securities that are backed by the full faith and credit of the U.S.

government and so carry no risk of default.[8] Although the Trust Funds cannot sell their holdings in the open market, the Trust Funds face no liquidity or interest rate risk since it can redeem its special Treasury securities before maturity at face value. These securities earn interest credits at a statutory rate linked to market yields, and this interest from the Treasury is credited to the Trust Funds in the form of additional Treasury securities.

Social Security is included in the most commonly used measure of the government's financial balance, known as the unified budget deficit/surplus. The unified budget measure includes all federal spending and revenue. Between 1983 and 1998, surpluses in the Social Security trust funds were used to partially offset a deficit in all other government accounts within the unified budget.[9] Since 1998 when the federal government began running unified surpluses, some or all of the Social Security surpluses have been used to reduce federal debt held by the public.[10]

I think it is useful to pause for a moment here and reflect on what the term "trust fund" means in the federal budget.[11] Trust funds in the federal budget are not like private trust funds. Individuals can create a private trust fund using his or her own assets to benefit a stated individual(s). The creator, or settlor, of the trust names a trustee who has a fiduciary responsibility to manage the designated assets in accordance with the stipulations of the trust. In contrast federal trust funds are budget accounts used to record receipts and expenditures earmarked for specific purposes. The Congress creates a federal trust fund in law and designates

[8]Under current law, the Secretary of the Treasury as trustee may purchase marketable Treasury and agency securities if the Secretary determines that such purchase is "in the public interest." Such purchases have been rare. As of the end of fiscal year 2000, about 0.004 percent of OASDI trust fund holdings were in marketable Treasury securities.

[9] The interest credited to the trust fund does not currently affect the unified surplus or deficit because it is an internal transaction of the government. One part of the government (the Treasury) credits the interest to another part (the trust fund), so the two transactions offset one another and there is no net budgetary effect.

[10]A portion of the Social Security surpluses offset an on-budget deficit in fiscal year 1998. Fiscal year 1999 was the first year since 1960 that the federal government ran an on-budget surplus.

[11] For a discussion of trust funds and other earmarked funds in the budget, see *Federal Trust and Other Earmarked Funds: Answers to Frequently Asked Questions* (GAO-01-199SP, Jan. 2001).

a funding source to benefit stated groups or individuals. Unlike most private trustees, the federal government can raise or lower future trust fund collections and payments or change the purposes for which the collections are used by changing existing laws. Moreover, the federal government has custody and control of the funds, including the earnings of most federal trust funds.

Under current law, when the Social Security Trust Funds' receipts exceed costs—that is, when the Trust Funds have an annual cash surplus—this surplus is invested in Treasury securities and can be used to meet current cash needs of the government or to reduce debt held by the public. In either case, the solvency of the Trust Funds is unchanged. However, while the Treasury securities are an asset to the Trust Funds, they are a liability to the Treasury. Any increase in assets to the Trust Funds creates an increase of equal size in future claims on the Treasury. One government fund is lending to another. As a result, these transactions net out on the government's consolidated books.

While the accumulated balances in a trust fund reflect the government's commitment to pay benefits, limited to the assets held in the fund, they do not in and of themselves increase the government's ability to meet the related program commitments. That is, simply increasing trust fund balances does not improve program sustainability. Increases in trust fund balances can strengthen the ability to pay future benefits if a trust fund's cash surpluses are used to improve the government's overall fiscal position. For example, when a trust fund's cash surpluses are used to reduce debt held by the public, this increases national saving, contributes to higher economic growth over the long term, and enhances the government's ability to raise cash in the future to pay benefits. It also reduces federal interest costs below what they otherwise would have been, thereby promoting greater fiscal flexibility in the future.

The combined Social Security Trust Funds will be solvent through 2038 according to the Trustees' intermediate estimates.[12] However, our long-term model shows that well before that time program spending will constitute a rapidly growing share of the budget and the economy. Ultimately, the critical question is not how much a trust fund has in assets, but whether the government as a whole can afford the promised benefits now and in the future and at what cost to other claims on scarce

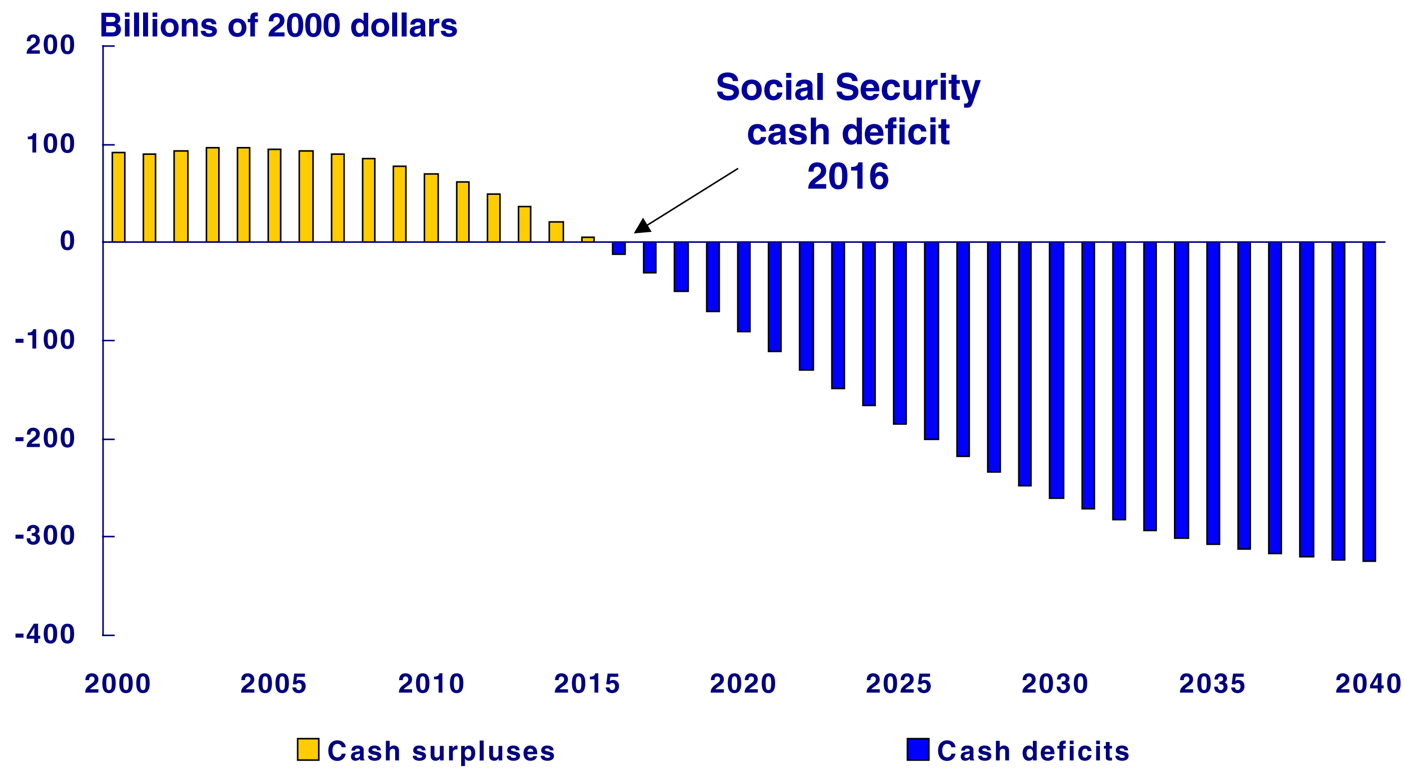
[12] Separately, the DI fund is projected to be exhausted in 2026 and the OASI fund in 2040.

resources. The future sustainability of programs is a key policy 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. General fund transfers to the Trust Funds can improve solvency, but unless accompanied by program reforms and/or reductions in debt held by the public will have no effect on the program's overall sustainability.

Social Security's Cash Flow Is Expected To Turn Negative in 2016

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 program revenues in 2016. At that time, the program will become a net claimant on the rest of the federal budget. (See fig. 4.)

Figure 4: Social Security's Trust Funds Face Cash Deficits as Baby Boomers Retire



Note: Projections based on intermediate assumptions of The 2001 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds.

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

As I noted above, the special Treasury securities represent assets for the Trust Funds but are future claims against the Treasury. To cover the cash shortfall, —which is expected to grow— the Trust Funds will begin drawing on the Treasury, first relying on its interest income and eventually drawing down its accumulated trust fund assets. Regardless of whether the Trust Funds are drawing on interest income or principal to make benefit payments, 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.[13] The projected change in Social Security cash flow in 2016 will not mean a crisis in program financing: promised benefits will continue to be paid in full. However, this 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 Will Be Severely Exacerbated Absent Entitlement Reform

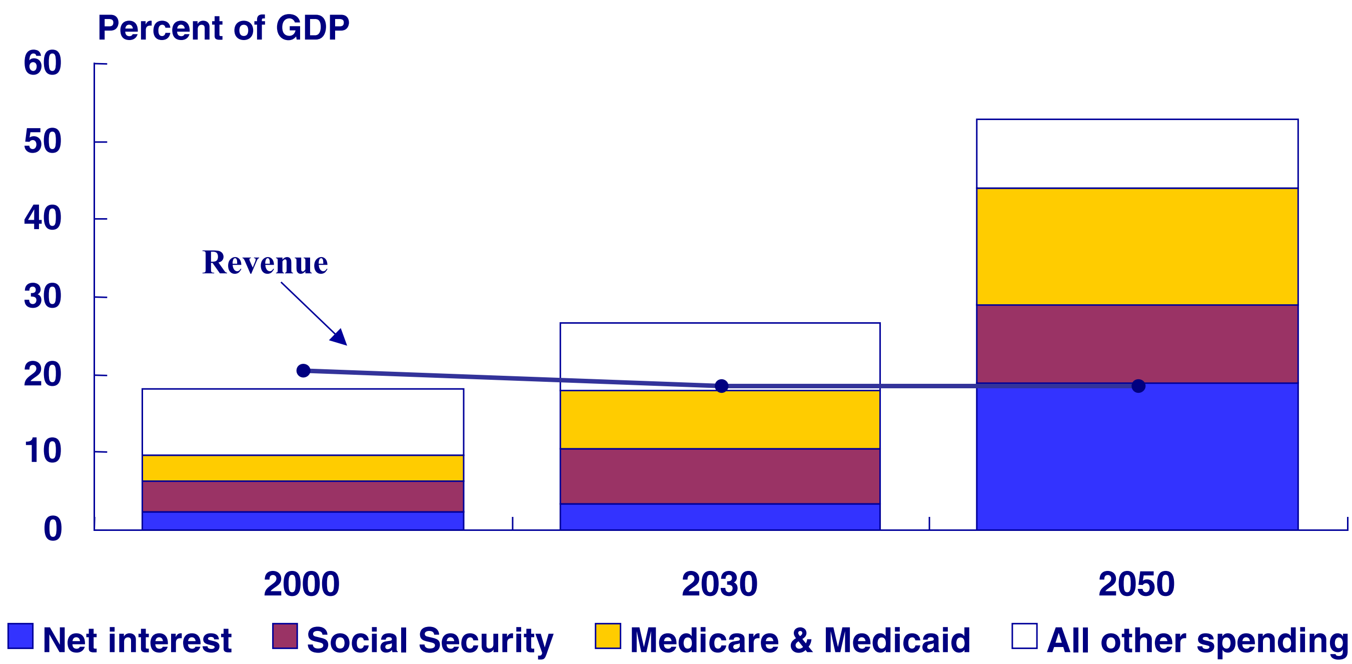
From the perspective of the federal budget and the economy, the expected growth in Social Security spending is a major challenge in combination with the even faster expected growth in Medicare and Medicaid spending. This growth in spending on federal entitlements for retirees will become increasingly 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. For example, prior to the creation of the Medicare and Medicaid programs, in 1962 mandatory spending accounted for about 33 percent of total federal spending. By 2000, this share had more than doubled to approximately 66 percent of the budget.

The Director of the Office of Management and Budget (OMB) has recently suggested the possibility of federal budget deficits through fiscal year 2004, and other budget analysts appear to be in agreement. While we do not know today what the 10-year budget projections will be in the next updates by CBO and the Office of Management and Budget (OMB), we do know the direction: they will be considerably less optimistic than before September 11, and the long-term outlook will look correspondingly worse. For example, if we assume that the 10-year surpluses CBO projected in August are eliminated, by 2030 absent changes in the structure of Social Security and Medicare, there would be virtually no room for any other federal spending priorities, including national defense, education, and law enforcement. (See fig. 5.) The resource demands that come from the events of September 11—and the need to address the gaps these events surfaced—will demand tough choices. Part of that response must be to deal with the threats to our long-term fiscal health. Ultimately, restoring our long-term fiscal flexibility will involve both promoting higher long-term economic growth and reforming the federal entitlement programs.

[13] If the unified budget is in surplus at this point, then financing benefits in excess of dedicated tax revenue would result in less debt redemption rather than increased borrowing.

When Congress returns for its next session, these issues should be placed back on the national agenda.

Figure 5: August 2001 Projection – Composition of Federal Spending Under the "Eliminate Unified Surpluses" Simulation



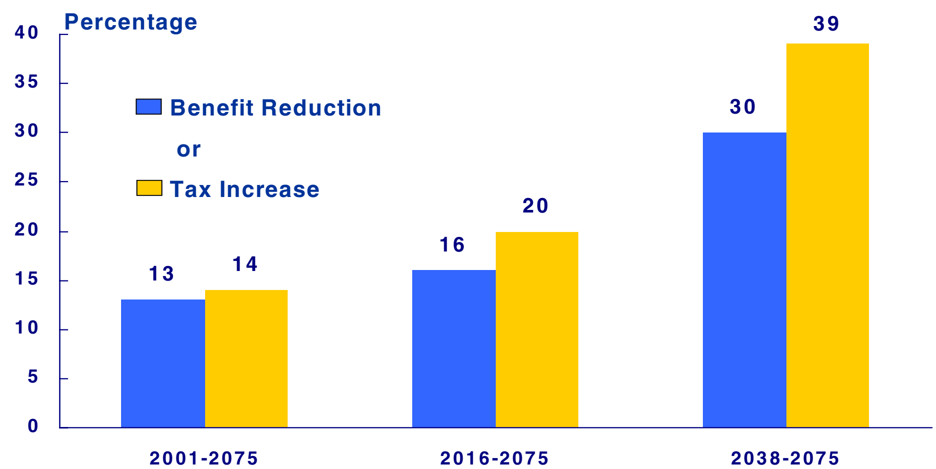
Notes: Revenue as a share of GDP declines from its 2000 level of 20.6 percent due to unspecified permanent policy actions. In this display, policy changes are allocated equally between revenue reductions and spending increases.

Source: GAO's August 2001 analysis.

Since Social Security will constitute claims on real resources in the future when it redeems assets to pay benefits, taking action now to increase the future pool of resources is important. As Federal Reserve Chairman Greenspan has said, 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.[14] The most direct way we can raise national saving is by increasing government saving. Saving a good portion of the surpluses would allow the federal government to reduce the debt overhang from past deficit spending, provide a strong foundation for future economic growth and enhance future budgetary flexibility.

Correspondingly, taking action now on Social Security not only would promote increased budgetary flexibility in the future and stronger economic growth but would also require less dramatic action than if we wait. Perhaps the best way to show this is to compare what it would take to achieve actuarial balance at different points in time. Figure 6 shows this. If we did nothing until 2038—the year the Trust Funds are estimated to be exhausted—achieving actuarial balance would require benefit reductions of 30 percent or a tax increase of 39 percent.[15] As figure 6 shows, earlier action shrinks the size of the necessary adjustment.

Figure 6: Changes Needed to Maintain Social Security Solvency



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

[14] Testimony before the Committee on Banking, House, and Urban Affairs, U. S. Senate, July 24, 2001.

[15] Based on estimates of program income from both the payroll tax and taxation of OASDI benefits.

Source: GAO analysis of data from the intermediate assumptions of the 2001 OASDI Trustees Report.

Thus both sustainability concerns and solvency considerations must drive us to act sooner rather than later. Trust Fund exhaustion may be more than 30 years away, but the squeeze on the federal budget is only 15 years in our future. 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 is not the only consideration. Social Security remains the foundation of the nation's retirement system. Yet it is 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 1999, 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, GAO has developed a broad framework for evaluating reform proposals that considers not only solvency but other aspects of the program as well. Arguably, similar frameworks can also be applied to other programs like Medicare.

The analytic framework GAO has 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 would 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

Any reforms to Social Security must ensure that program revenues continue to exceed the cost of benefit payments if the Social Security program is to achieve sustainable solvency. Historically, the program's solvency has generally been measured over a 75-year projection period. If projected revenues equal projected outlays over this time horizon, then the system is declared in actuarial balance. Unfortunately, this measure is itself unstable. 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. This means that changes that restore solvency only for the 75-year period will not hold. For example, if we were to raise payroll taxes by 1.86 percentage points of taxable payroll today—which, according to the 2001 Trustees Report, is the amount necessary to achieve 75-year balance—the system would be out of balance next year. Reforms that lead to sustainable solvency are those that avoid the automatic need to periodically revisit this issue.

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 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, and 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 sub-populations, 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.

After I finish this brief overview of our evaluation framework, I would like to come back to this criterion and share some results from our recent report on income adequacy.

Implementing and Administering Proposed Reforms

Program complexity can both make implementation and administration more difficult, and make it harder to explain to the public. Some degree of implementation and administrative complexity arises in virtually all proposed reforms 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. There is also the necessary and complex task of harmonizing any system of individual accounts with the extensive existing regulatory framework governing our nation's private pension system. In evaluating such proposals, the complexities of meshing these systems would have to be balanced against the opportunity of extending pension participation to millions of uncovered workers.

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 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. 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. From a practical stand-point, the phase-in of any reform should reflect individual fairness and political feasibility. With regard to proposals that involve individual accounts, an essential challenge would be to help the American people understand the relationship between their individual accounts and traditional Social Security benefits, thereby ensuring that we avoid any gap in expectations about current or future benefits.

Examining Effects of Reform on Income Adequacy

Over the past few years, we have been developing a capacity at GAO to estimate the quantitative effects of Social Security reform on individuals. Such estimates speak directly to applying our adequacy/equity criterion to reform proposals. We have just issued a new report that includes such estimates to illustrate the varying effects of different policy scenarios on individuals.[16] Today, I would like to share our findings regarding what measures can be used to examine income adequacy, defining appropriate benchmarks for assessing the future outlook for individuals' Social Security benefits, and how varying approaches to reducing benefits could have different effects on adequacy. Our recent report did not, however, present estimates of effects on individual equity.[17] In addition to these points, our report looked at how concern over income adequacy has shaped the Social Security program over the years and how income adequacy has changed over time, especially for different groups of beneficiaries.

No Single Measure Gives Complete Picture of Income Adequacy

Various measures help examine different aspects of income adequacy, but no single measure can provide a complete picture. Three examples illustrate the variety of approaches.

[16] *Social Security: Program's Role in Helping Ensure Income Adequacy* (GAO-02-62, Nov. 30, 2001).

[17] For information on such issues, see *Social Security: Issues in Comparing Rates of Return with Market Investments* (GAO/HEHS-99-110, Aug. 5, 1999).

- Dependency rates measure what proportion of the population depends on others for income support or, more specifically, on government income support programs such as Supplemental Security Income (SSI). Such rates reflect one of Social Security's goals, reducing dependency on public assistance, which was articulated very early in the program's history.

- Poverty rates measure what proportion of the population have incomes below the official poverty threshold, which is just one of many adequacy standards used in similar rate calculations. The poverty threshold provides a minimal standard of adequacy; other standards reflect different outlooks on what adequacy means.

- Earnings replacement rates measure the extent to which retirement income replaces pre-retirement income for particular individuals and thereby helps them maintain a pre-retirement standard of living. When applied to Social Security benefits, this measure reflects the way the benefit formula is designed to replace earnings.

For any of these measures, the meaning of a given value of the measure is not clear. For example, what value of a dependency or poverty rate is considered low enough and what replacement rate is considered high enough are quite subjective. Moreover, all of these types of measures depend significantly on what types of income are counted, such as before- or after-tax income or noncash benefits such as Medicare and Medicaid. As a result, the measures are most useful not for their estimated values in isolation but rather for making comparisons, whether over time, across different subpopulations, or across different policy scenarios.

Benchmark Policy Scenarios Illustrate Range of Possible Outcomes

In the past, we have pointed out the importance of establishing the proper benchmarks against which reforms must be measured. Often reform proposals are compared to currently promised benefits, but currently promised benefits are not fully financed. It is also necessary to use a benchmark of a fully financed system to fairly evaluate reform proposals. To illustrate a full range of possible outcomes, our recent report on income adequacy used hypothetical benchmark scenarios that would restore 75-year solvency either by only increasing payroll taxes or by only reducing benefits. Our tax-increase-only benchmark simulated benefits at currently promised levels while our benefit-reduction-only benchmarks simulated benefits funded at current tax levels. These benchmarks used the program's current benefit structure and the 2001 OASDI Trustees' intermediate, or best-estimate, assumptions. The benefit reductions were phased in between 2005 and 2035 to strike a balance between the size of the incremental reductions each year and the size of the ultimate reduction. At our request, SSA actuaries scored our benchmark policies and determined the parameters for each that would achieve 75-year solvency. For our benefit reduction scenarios, the actuaries determined these parameters assuming that disabled and survivor benefits would be reduced on the same basis as retired worker and dependent benefits. If disabled and survivor benefits were not reduced at all, reductions in retired worker benefits would be deeper than shown in this analysis.[18]

Varying Approaches to Benefit Reductions Would Have Different Effects on Adequacy

Future benefit levels and income adequacy will depend considerably on how any benefit reductions are made. Figure 7 shows the percentage of retired workers[19] with Social Security benefits that fall below the official poverty threshold for various benchmarks. Note that this graph does not show poverty rates, which would require projections of total income;[20] instead, it focuses only on Social Security benefits. The percentage with total incomes below the poverty threshold would be lower if other forms of retirement income were included. The figure shows that the percentage with benefits below the poverty threshold would be greater under a proportional benefit reduction than under a progressive benefit reduction. The proportional benefit-reduction-only benchmark would reduce benefits by the same proportion for all beneficiaries born in the same year. The progressive benefit-reduction-only benchmark would reduce benefits by a smaller proportion for lower earners and a higher proportion for higher

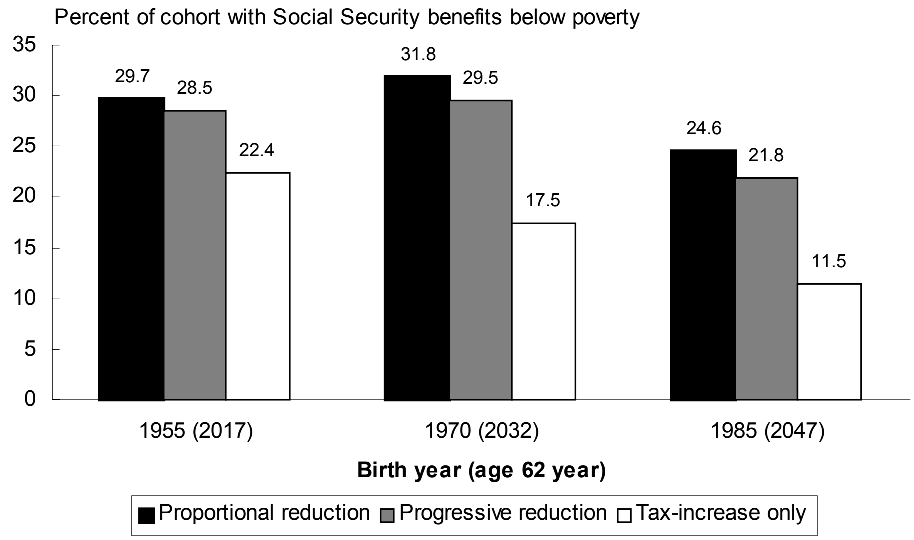
[18] See *Social Security: Program's Role in Helping Ensure Income Adequacy* (GAO-02-62, Nov. 30, 2001), appendix III, for more details on the alternative benefit reduction benchmarks.

[19] We used retired workers for simplicity. Our focus is on the difference between benefit reduction approaches, holding everything else equal, and not on the type of beneficiary. We use age 62 as the retirement age because most retired worker beneficiaries retire at that age. Because of a variety of complexities concerning beneficiary and household type, our estimates should not be interpreted as poverty rates. See *Social Security: Program's Role in Helping Ensure Income Adequacy* (GAO-02-62, Nov. 30, 2001), appendixes III and IV.

[20] Given that our analysis examined only Social Security benefits and not total income, the focus should not be on the specific estimates of adequacy measures but rather the differences between them across types of measures, across beneficiary groups, and across policy scenarios. . See *Social Security: Program's Role in Helping Ensure Income Adequacy* (GAO-02-62, Nov. 30, 2001).

earners. The tax-increase-only (no benefit reduction) benchmark estimates are shown for reference.[21]

Figure 7: Adequacy of Income in Future Depends on Benefit Reduction Approach (Retired Workers, All Retiring at Age 62)



Notes: The rates shown in the graph are not poverty rates because they reflect only Social Security income, not total income. For the 1935 birth cohort, which reached age 62 in 1997, 51 percent of our simulated sample had Social Security benefits below poverty. Under the proportional reduction approach, all beneficiaries in a given birth year are subject to a benefit reduction that is a constant proportion of their benefits. Under the progressive reduction, beneficiaries with lower benefits receive a smaller proportional reduction than those with higher benefits. See appendix III in Social Security: Program's Role in Helping Ensure Income Adequacy (GAO-02-62, Nov. 30, 2001) for more details on the alternative benefit reduction benchmarks.

Source: GAO's analysis using the GEMINI model.

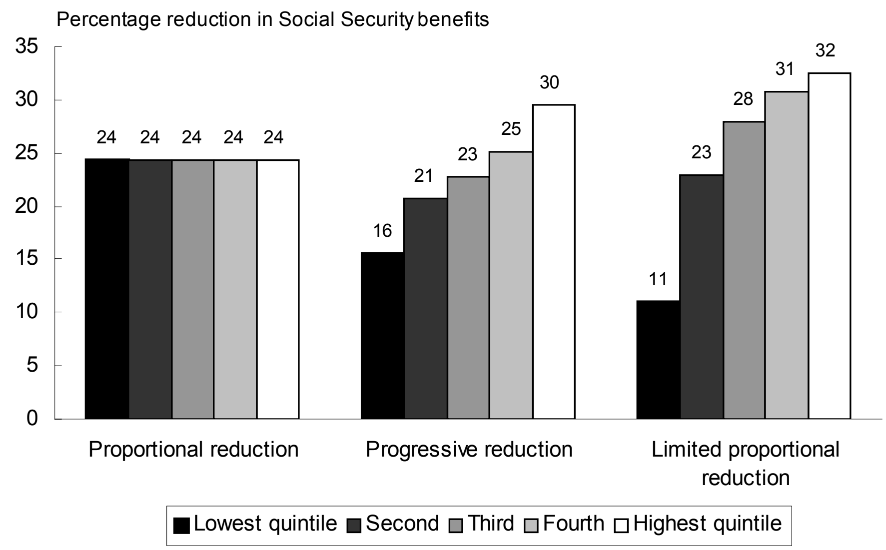
Different approaches to reducing benefits would have different effects on income adequacy because their effects would vary with earnings levels. Smaller reductions for lower earners, who are most at risk of poverty, would decrease the chances that their benefits would fall below poverty.

[21] Figure 7 also shows that percentage of workers with benefits below the poverty threshold would be slightly higher in our simulations for those retiring in 2032 rather than 2017. This reflects primarily that the benefit reductions in our benchmarks are more fully phased in for the 2032 group than for the later group. The declines in the percentages from the 2032 to 2047 retirement years largely reflects that initial benefit levels increase with wages while the poverty threshold increases with prices, which are assumed to grow more slowly than wages. Since the benefit reductions are fully phased in by 2035, the last two age groups experience nearly the same benefit reductions.

Figure 8 illustrates how different approaches would have benefit reductions that would vary by benefit levels (which are directly related to earnings). The proportional benchmark would reduce benefits by an identical percentage for all earnings levels. In contrast, the two alternative, progressive benchmarks would reduce benefits less for lower earners than for higher earners. The so-called “limited-proportional” benefit-reduction benchmark would be even more progressive than the progressive benefit-reduction benchmark because a portion of benefits below a certain level are protected from any reductions while reductions above that level are proportional.[22] Moreover, different benefit reduction approaches would have varying effects on different beneficiary groups according to the variation in the typical earnings levels of those subgroups. For example, women, minorities, and never married individuals all tend to have lower lifetime earnings than men, whites, and married individuals, respectively. Therefore, benefit reductions that favor lower earners would help minimize adequacy reductions for such groups that typically have lower earnings.

[22] The 1985 birth cohort will be subject to the largest benefit reductions of the four cohorts we simulated; therefore, it best illustrates the potential disparity in benefit reductions by benefit level.

Figure 8: Benefit Reduction Approaches Have Different Effects on Different Benefit Levels (Retired Workers Born in 1985, All Retire at Age 62)



Notes: Quintiles are by benefit levels. Percentage reductions are calculated for beneficiaries closest to the median of each quintile that appear in each scenario's sample. For the 1985 birth cohort, all benefit reductions are fully phased-in under our benchmark scenarios. Under the proportional reduction approach, all beneficiaries in a given birth year are subject to a benefit reduction that is a constant proportion of their benefits. Under the progressive reduction, beneficiaries with lower benefits receive a smaller proportional reduction than those with higher benefits. Under the limited proportional reduction, a portion of benefits below a certain level are protected from any reductions while reductions above that level are proportional. See appendix III in Social Security: Program's Role in Helping Ensure Income Adequacy (GAO-02-62, Nov. 30, 2001) for more details on the alternative benefit reduction benchmarks.

Source: GAO's analysis using the GEMINI model.

As our report also showed, the effects of some reform options parallel those of benefit reductions made through the benefit formula, and those parallels provide insights into the distributional effects of those reform options. For example, if workers were to retire at a given age, an increase in Social Security's full retirement age results in a reduction in monthly benefits; moreover, that benefit reduction would be a proportional, not a progressive reduction. Another example would be indexing the benefit formula to prices instead of wages. Such a revision would also be a proportional reduction, in effect, because all earnings levels would be treated the same under such an approach. In addition, indexing the benefit formula to prices would implicitly affect future poverty rates. Since the official poverty threshold increases each year to reflect price increases and benefits would also be indexed to prices, poverty rates would not be expected to change notably, holding all else equal. In contrast, under the current benefit formula, initial benefit levels would grow faster on average than the poverty threshold and poverty rates would fall, assuming that wages increase faster than prices on average, as the Social Security trustees' report assumes they will.

Conclusion

Changes to the Social Security system should be made sooner rather than later—both because earlier action yields the highest fiscal dividends for the federal budget and because it provides a longer period for future beneficiaries to make adjustments in their own planning. The events of September 11 and the need to respond to them do not change this. It remains true that the longer we wait to take action on the programs driving long-term deficits, the more painful and difficult the choices will become.

Today I have described GAO's three basic criteria against which Social Security reform proposals may be measured: financing sustainable solvency, balancing adequacy and equity, and implementing and administering reforms. These may not be the same criteria every analyst would suggest, and certainly how policymakers weight the various elements may vary. But if comprehensive proposals are evaluated as to (1) their financing and economic effects, (2) their effects on individuals, and (3) their feasibility, we will have a good foundation for devising agreeable solutions, perhaps not in every detail, but as an overall reform package that will meet the most important of our objectives.

Our recent report on Social Security and income adequacy showed that more progressive approaches to reducing monthly benefits would have a smaller effect on poverty, for example, than less progressive approaches. Also, reductions that protect benefits for survivors, disabled workers, and the very old would help minimize reductions to income adequacy, though they would place other beneficiaries at greater risk of poverty. More broadly, the choices the Congress will make to restore Social Security's long-term solvency and sustainability will critically determine the distributional effects of the program, both within and across generations. In turn, those distributional effects will determine how well Social Security continues to help ensure income adequacy across the population. Still, such adequacy effects then need to be balanced against an assessment of the effects on individual equity. In addition, all adequacy measures depend significantly on what types of income are counted. In particular, noncash benefits such as Medicare play a major role in sustaining standards of living for their beneficiaries. Any examination of income adequacy should acknowledge the major role of noncash benefits and the needs they help support.

In finding ways to restore Social Security's long-term solvency and sustainability, the Congress will address a key question, whether explicitly or implicitly:

What purpose does it want Social Security to serve in the future?

- to minimize the need for means-tested public assistance programs;
- to minimize poverty; using what standard of poverty;
- to replace pre-retirement earnings;
- to maintain a certain standard of living; or
- to preserve purchasing power?

The answer to this question will help identify which measures of income adequacy are most relevant to examine. It will also help focus how options for reform should be shaped and evaluated. Our work has illustrated how the future outlook depends on both the measures used and the shape of reform. While the Congress must ultimately define Social Security's purpose, our work has provided tools that inform its deliberations.

Still, Social Security is only one part of a much larger picture. Reform proposals should be evaluated as packages that strike a balance among their component parts. Furthermore, Social Security is only one source of income and only one of several programs that help support the standard of living of our retired and disabled populations. All sources of income and all of these programs should be considered together in confronting the demographic challenges we face. In addition to Social Security, employer-sponsored pensions, individual savings, Medicare, employer-provided health benefits, earnings from continued employment, and means-tested programs such as SSI and Medicaid all should be considered, along with any interactions among them. In particular, compared to addressing our long-range health care financing problem, reforming Social Security is easy lifting. We at GAO look forward to continuing to work with this Committee and the Congress in addressing these important issues.

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

GAO Contact and Staff Acknowledgments

For information regarding this testimony, please contact me at (202) 512-7215. Individuals making key contributions to this testimony include Ken Stockbridge, Charles Jeszeck, Alicia Cackley, Jay McTigue, Linda Baker, and Melissa Wolf.

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