

GAO

Testimony
Before the Special Committee on Aging,
U.S. Senate

For Release on Delivery
Expected at 2:00 p.m. EST
Thursday, February 3, 2005

SOCIAL SECURITY

**Long-Term Challenges
Warrant Early Action**

Statement of David M. Walker
Comptroller General of the United States





Highlights of [GAO-05-303T](#), a report to the Special Committee on Aging, U.S. Senate

SOCIAL SECURITY

Long-Term Challenges Warrant Early Action

Why GAO Did This Study

Social Security is the foundation of the nation's retirement income system, helping to protect the vast majority of American workers and their families from poverty in old age. However, it is much more than a retirement program and also provides millions of Americans with disability insurance and survivors' benefits. Over the long term, as the baby boom generation retires and as Americans continue to live longer and have fewer children, Social Security's financing shortfall presents a major program solvency and sustainability challenge that is growing as time passes.

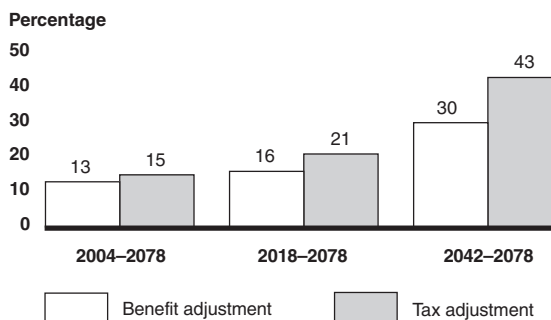
The Chairman and Ranking Member of the Senate Special Committee on Aging asked GAO to discuss the future of the Social Security program. This testimony will address the nature of Social Security's long-term financing problem and why it is preferable for Congress to take action sooner rather than later, as well as the broader context in which reform proposals should be considered.

What GAO Found

Although the Social Security system is not in crisis today, it faces serious and growing solvency and sustainability challenges. Furthermore, Social Security's problems are a subset of our nation's overall fiscal challenge. Absent reform, the nation will ultimately have to choose among escalating federal deficits and debt, huge tax increases and/or dramatic budget cuts. GAO's long-term budget simulations show that to move into the future with no changes in federal retirement and health programs is to envision a very different role for the federal government. With regard to Social Security, if we did nothing until 2042, achieving actuarial balance would require a reduction in benefits of 30 percent or an increase in payroll taxes of 43 percent. In contrast, taking action soon will serve to reduce the amount of change needed to ensure that Social Security is solvent, sustainable, and secure for current and future generations. Acting sooner will also serve to improve the federal government's credibility with the markets and the confidence of the American people in the government's ability to address long-range challenges before they reach crisis proportions.

However, financial stability should not be the only consideration when evaluating reform proposals. Other important objectives, such as balancing the adequacy and equity of the benefits structure need to be considered. Furthermore, any changes to Social Security should be considered in the context of the broader challenges facing our nation, such as the changing nature of the private pension system, escalating health care costs, and the need to reform Medicare and Medicaid.

Size of Action Needed to Achieve Social Security Solvency



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

Note: This is based on the intermediate assumptions of the 2004 Social Security trustees' report. The benefit adjustments in this graph represent a one-time, permanent change to all existing and future benefits beginning in the first year indicated. Estimates cover the time period from January 1st of the first year to December 31, 2078.

www.gao.gov/cgi-bin/getrpt?GAO-05-303T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Barbara Bovbjerg (202) 512-7215 or bovbjergb@gao.gov.

Mr. Chairman and Members of the Committee:

Thank you for inviting me here to talk about our nation's Social Security program and how to address the challenges presented in ensuring the long-term viability of this important social insurance system. Social Security not only represents the foundation of our retirement income system, it also provides millions of Americans with disability insurance and survivors' benefits. As a result, Social Security provides benefits that are critical to the current and future well-being of tens of millions of Americans. As I have said in congressional testimonies over the past several years, the system faces both solvency and sustainability challenges in the longer term. While the Social Security program does not face an immediate crisis, it does have a \$3.7 trillion gap between promised and funded benefits in current dollar terms. This gap is growing rapidly and, given this and other major fiscal challenges, it would be prudent to act sooner rather than later to reform the Social Security program. Failure to take steps to address our large and structural long-range fiscal imbalance, which is driven in large part by projected increases in Medicare, Medicaid and Social Security spending, will ultimately have significant adverse consequences for our future economy and quality of life.

Let me begin by highlighting a number of important points concerning the Social Security challenge.

- **Solving Social Security's long-term financing problem is more important and complex than simply making the numbers add up.** Social Security is an important and successful social insurance program that affects virtually every American family. It currently pays benefits to more than 47 million people, including retired workers, disabled workers, the spouses and children of retired and disabled workers, and the survivors of deceased workers. The number of individuals receiving benefits is expected to grow to almost 69 million by 2020. The program has been highly effective at reducing the incidence of poverty among the elderly, and the disability and survivor benefits have been critical to the financial well-being of millions of others.
- **Focusing on trust fund solvency alone is not sufficient. We need to put the program on a path toward sustainable solvency.** Trust fund solvency is an important concept, but focusing on trust fund solvency alone can lead to a false sense of security about the overall financial condition of the Social Security program. For example, the size of the trust fund does not tell us whether the program is

sustainable—that is, whether the government will have the capacity to pay future claims or what else will have to be squeezed to pay those claims. Furthermore, estimates of what it would take to achieve 75-year trust fund solvency understate the extent of the problem because the program’s financial imbalance gets worse in the 76th and subsequent years.

- **Social Security reform is part of a broader fiscal and economic challenge.** If you look ahead in the federal budget, the combined Social Security or Old-Age and Survivors Insurance and Disability Insurance (OASDI) program, together with the rapidly growing health programs, will dominate the federal government’s future fiscal outlook. While this hearing is not about the complexities of Medicare, it is important to note that Medicare presents a much greater, more complex, and more urgent fiscal challenge than does Social Security. Medicare growth rates reflect not only a burgeoning beneficiary population, but also the escalation of health care costs at rates well exceeding general rates of inflation. Taken together, Social Security, Medicare, and Medicaid represent an unsustainable burden on future generations. Under the 2004 Trustees’ intermediate estimates and the Congressional Budget Office’s (CBO) long-term Medicaid estimates, spending for Social Security, Medicare, and Medicaid combined will grow to 15.6 percent of GDP in 2030 from today’s 8.5 percent. Absent meaningful changes to these programs, the nation will ultimately have to choose among persistent, escalating federal deficits, huge tax increases, and/or dramatic budget cuts. Furthermore, any changes to Social Security should be considered in the context of the problems currently facing our nation’s private pension system. These include the chronically low level of coverage of the private workforce, the continued decline in defined benefit plans coupled with the termination of large underfunded plans by bankrupt firms, and the shift by employers to defined contribution plans, where workers face the potential for greater return but also assume greater financial risk.
- **Acting sooner rather than later helps to ease the difficulty of change.** As I noted previously, the challenge of facing the imminent and daunting budget pressure from Medicare, Medicaid, and OASDI increases over time. Social Security will begin to constrain the budget long before the trust fund is exhausted in 2042. The trust fund cash surpluses that are now helping to finance the rest of the government’s budgetary needs will begin to decline after 2008, and by 2018, the cash surpluses will turn into deficits. At that point, Social Security’s cash shortfall will begin to place increasing pressure on the rest of the budget to raise the resources necessary to meet the program’s costs.

Waiting until Social Security faces an immediate solvency crisis will limit the scope of feasible solutions and could reduce the options to only those choices that are the most difficult. It could also contribute to a further delay of the really tough decisions on Medicare and Medicaid. Acting sooner rather than later would allow changes to be phased in so that future and near-term retirees have time to adjust their retirement planning. Furthermore, acting sooner rather than later would serve to increase our credibility with the markets and improve the public's confidence in the federal government's ability to deal with our significant long-range fiscal challenges before they reach crisis proportions.

- **Reform proposals should be evaluated as packages.** The elements of any package interact; every package will have pluses and minuses, and no plan will satisfy everyone on all dimensions. If we focus on the pros and cons of each element of reform by itself, we may find it impossible to build the bridges necessary to achieve consensus. It is also important to establish the appropriate comparisons or benchmarks against which reforms should be measured. Given the current projected financial shortfall of the program, it is important to compare proposals to at least two benchmarks—one that raises revenue to fund currently scheduled benefits (promised benefits) and one that adjusts to current tax financing by reducing benefits (funded benefits). Comparing the benefit impact of reform proposals solely to currently scheduled Social Security benefits is inappropriate since all current scheduled benefits are not funded over the longer term. Estimating future effects on Social Security benefits should reflect the fact that the program faces a long-term actuarial deficit and that benefit reduction and/or revenue increases will be necessary to restore solvency. The key point is that there is a significant gap between scheduled benefits and projected revenues. In fact, a primary purpose of most Social Security reform proposals is to close or eliminate this gap.

Failure to address the Social Security financing problem will, in combination with other entitlement spending, constitute an unsustainable burden on both the federal government and, ultimately, the economy. However, this problem is about more than finances. It is also about maintaining an adequate safety net for American workers against loss of income from retirement, disability, or death. Social Security has prevented many former workers and their families from living their retirement years in poverty. As the Congress considers proposals to restore the long-term financial stability and viability of the Social Security system, it will also need to consider the impact of the potential changes on the millions of

Americans the system serves: specifically, the effects on different types of beneficiaries and the resulting implications for the adequacy and equity of the benefits structure. The fundamental nature of the program's long-term financing challenge means that timely action is needed. I believe it is possible to craft a solution that will protect Social Security benefits for the nation's current and near-term retirees, while ensuring that the system will be solvent, sustainable, and secure for future generations. Stated differently, I believe that it is possible to reform Social Security in a way that will ensure the program's solvency, sustainability, and security while exceeding the expectations of all generations of Americans. I also believe that, given our other fiscal challenges, it is prudent to act sooner rather than later to address this large and growing problem.

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 it does face a long-range financing problem driven primarily by known demographic trends that is growing rapidly. While the crisis is not immediate, the challenge is more urgent than it may appear. Acting soon to address these problems reduces the likelihood that the Congress will have to choose between imposing severe benefit cuts and unfairly burdening future generations with the program's rising costs. Acting soon would also allow changes to be phased in so that 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." On the other hand, failure to take remedial action will, in combination with other entitlement spending, lead to a situation unsustainable for both the federal government and, ultimately, the economy.

The Social Security system has required changes in the past to ensure future solvency. Indeed, the Congress has always taken the actions necessary to do this when faced with an immediate solvency crisis. I would like to spend some time describing the nature, timing, and extent of Social Security's financing problem.

The Causes of Social Security's Long-Term Financing Problem

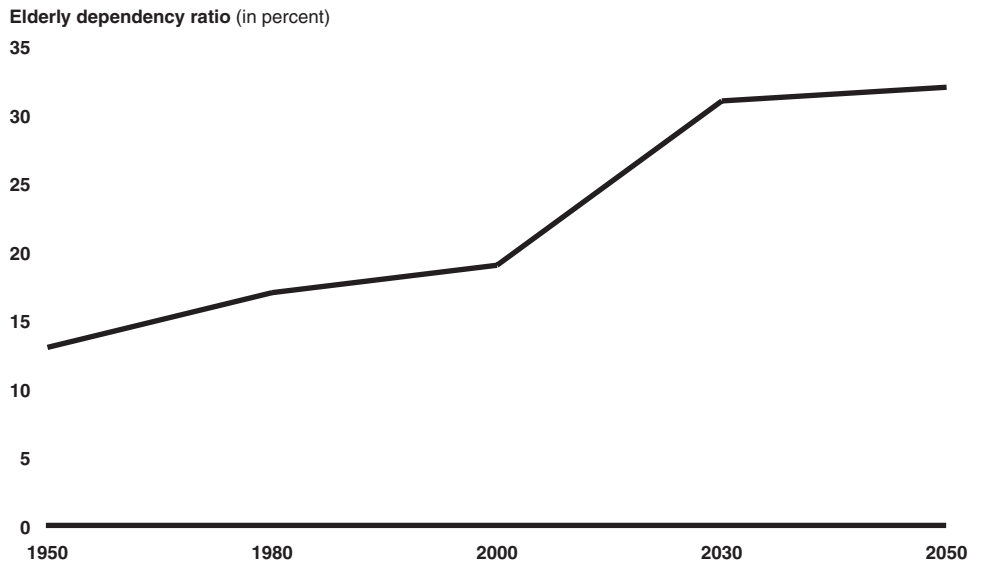
As you all know, Social Security has always been a largely pay-as-you-go system. This means that the system's financial condition is directly affected by the relative size of the populations of covered workers and beneficiaries. Historically, this relationship has been favorable. Now,

however, people are living longer, and spending more time in retirement. As shown in figure 1, the U.S. elderly dependency ratio is expected to continue to increase.¹ The proportion of the elderly population relative to the working-age population in the U.S. rose from 13 percent in 1950 to 19 percent in 2000. By 2050, there is projected to be almost 1 elderly dependent for every 3 people of working age—a ratio of 32 percent. Additionally, the average life expectancy of males at birth has increased from 66.6 in 1960 to 74.3 in 2000, with females at birth experiencing a rise of 6.6 years from 73.1 to 79.7 over the same period. As general life expectancy has increased in the United States, there has also been an increase in the number of years spent in retirement. Improvements in life expectancy have extended the average amount of time spent by workers in retirement from 11.5 years in 1950 to 18 years for the average male worker as of 2003. A falling fertility rate is the other principal factor underlying the growth in the elderly's share of the population. In the 1960s, the fertility rate was an average of 3 children per woman.² Today it is a little over 2, and by 2030 it is expected to fall to 1.95—a rate that is below what it takes to maintain a stable population. Taken together, these trends threaten the financial solvency and sustainability of this important program.

¹The elderly dependency ratio is the ratio of the population aged 65 years or over to the population aged 15 to 64.

²The fertility rate is the average number of children a hypothetical cohort of women would have at the end of their reproductive period if they were subject during their whole lives to the fertility rates of a given period and if they were not subject to mortality. It is expressed as children per woman.

Figure 1: U.S. Elderly Dependency Ratio Expected to Continue to Increase

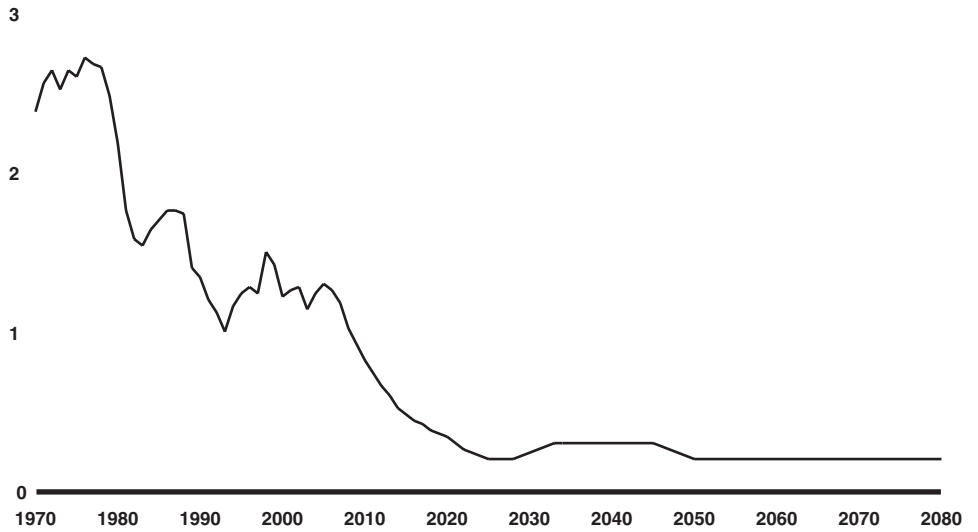


Source: Population Division of the Department of Economic and Social Affairs of the United Nations Secretariat, World Population Prospects: 2002 Revision and World Urbanization Prospects: 2001 Revision. Data for 2030 - 2050 are projected.

The result of these trends is that labor force growth will continue to decline in 2006 and by 2025 is expected to be less than a fifth of what it is today, as shown in figure 2. Relatively fewer U.S. workers will be available to produce goods and services. Without a major increase in productivity or increases in immigration, low labor force growth will lead to slower growth in the economy and to slower growth of federal revenues. This in turn will only accentuate the overall pressure on the federal budget.

Figure 2: U.S. Labor Force Growth Will Continue to Decline

Percentage change (5-year moving average)



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

Note: Percentage change is calculated as a centered 5-year moving average of projections based on the intermediate assumptions of the 2004 Trustees Reports.

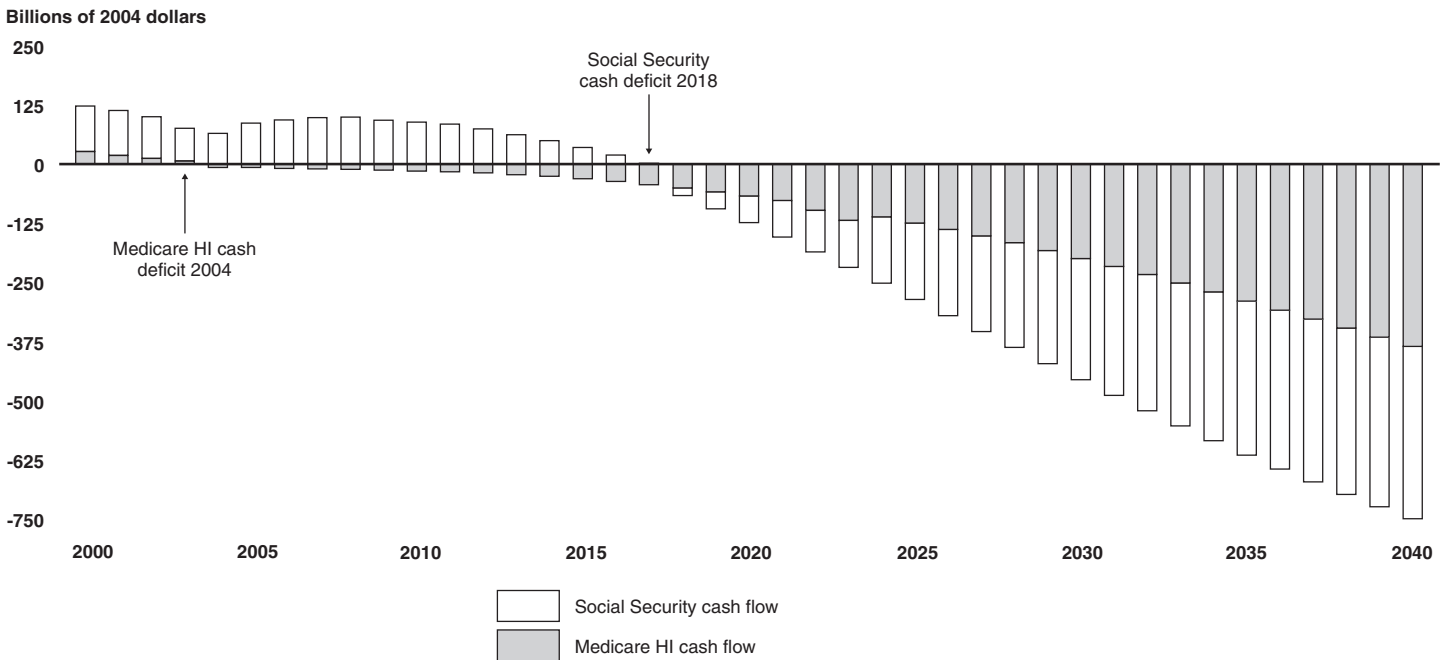
This slowing labor force growth has important implications for the Social Security system. Social Security's retirement eligibility dates are often the subject of discussion and debate and can have a direct effect on both labor force growth and the condition of the Social Security retirement program. It is also appropriate to consider whether and how changes in pension and/or other government policies could encourage longer workforce participation. To the extent that people choose to work longer as they live longer, the increase in the amount of time spent in retirement could be diminished. This could improve the finances of Social Security and mitigate the expected slowdown in labor force growth.

The Social Security program's situation is one symptom of this larger demographic trend that will have broad and profound effects on our nation's future in other ways as well. The aging of the labor force and the reduced growth in the number of workers will have important implications for the size and composition of the labor force, as well as the characteristics of many jobs in our increasingly knowledge-based economy, throughout the 21st century. The U.S. workforce of the 21st century will be facing very different opportunities and challenges than those of previous generations.

Cash Flow Turns Negative in 2018

Today, the Social Security Trust Funds take in more in taxes than they spend. Largely because of the demographic trends I have described, this situation will change. Although the trustees' 2004 intermediate estimates project that the combined Social Security Trust Funds will be solvent until 2042, program spending will constitute a rapidly growing share of the budget and the economy well before that date. Under the trustees' 2004 intermediate estimates, Social Security's cash surplus—the difference between program tax income and the costs of paying scheduled benefits—will begin to decline in 2008. By 2018, the program's cash flow is projected to turn negative—its tax income will fall below benefit payments. At that time, the program will begin to experience a negative cash flow, which will accelerate over time. Social Security will join Medicare's Hospital Insurance Trust Fund, whose outlays exceeded cash income in 2004, as a net claimant on the rest of the federal budget. (See figure 3.)

Figure 3: Social Security and Medicare’s Hospital Insurance Trust Funds Face Cash Deficits



Source: GAO analysis based on the intermediate assumptions of *The 2004 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and the Federal Disability Insurance Trust Funds* and *The 2004 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds*. The above excludes Medicare Part B and the newly enacted Medicare Part D benefit.

In 2018, the combined OASDI Trust Funds will begin drawing on its Treasury securities to cover the cash shortfall. At this point, Treasury will need to obtain cash for these redeemed securities either through increased taxes, spending cuts, and/or more borrowing from the public than would have been the case had Social Security’s cash flow remained positive. Whatever the means of financing, the shift from positive to negative cash flow will place increased pressure on the federal budget to raise the resources necessary to meet the program’s ongoing costs.

Different Measures but Same Challenges and Same Conclusion

There are different ways to describe the magnitude of the problem. A case can be made for a range of different measures, as well as different time horizons. For instance, the actuarial deficit can be measured in present value, as a percentage of GDP, or as a percentage of taxable payroll in the future. The Social Security Administration (SSA) and CBO have both made projections of Social Security’s future actuarial deficit using different horizons. (See table 1.)

Table 1: Different Measures, Same Challenge

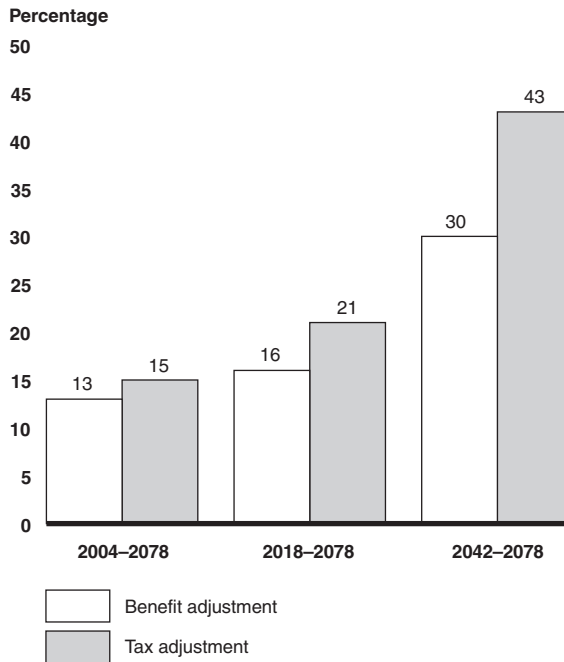
Projection horizon	Projections of actuarial deficit in terms of		
	Present value	Percent of GDP	Percent of payroll
75 year (SSA)	\$3.7 Trillion	0.7%	1.89%
100 year (CBO)	\$4.6 Trillion	0.54%	1.44%
Infinite horizon (SSA)	\$10.4 Trillion	1.2%	3.5%

Sources: Social Security Administration, *The 2004 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds*. Washington, D.C., March 2004. Congressional Budget Office, *The Outlook for Social Security: Potential Range of Social Security Outlays and Revenues Under Current Law*. Washington, D.C., June 2004.

CBO uses a 100-year horizon to project Social Security’s future actuarial deficit, while the Social Security Administration utilizes both 75-year and infinite horizon projections to estimate the future deficit. In addition, both the Social Security Administration and CBO have different economic assumptions for variables such as real earnings, real interest rates, inflation, and unemployment.

While their estimates vary due to different horizons and economic assumptions, each identifies the same long-term challenge: The Social Security system is unsustainable in its present form over the long run. Taking action soon on Social Security would not only make the necessary action less dramatic than if we wait but would also promote increased budgetary flexibility in the future and stronger economic growth. Some of the benefits of early action—and the costs of delay—can be seen in figure 4. This figure compares what it would take to keep Social Security solvent through 2078, if action were taken at three different points in time, by either raising payroll taxes or reducing benefits. If we did nothing until 2042—the year SSA estimates the Trust Funds will be exhausted—achieving actuarial balance would require changes in benefits of 30 percent or changes in taxes of 43 percent. As figure 4 shows, earlier action shrinks the size of the necessary adjustment.

Figure 4: Size of Action Needed to Achieve Social Security Solvency



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

Note: This is based on the intermediate assumptions of the 2004 Social Security trustees' report. The benefit adjustments in this graph represent a one-time, permanent change to all existing and future benefits beginning in the first year indicated.

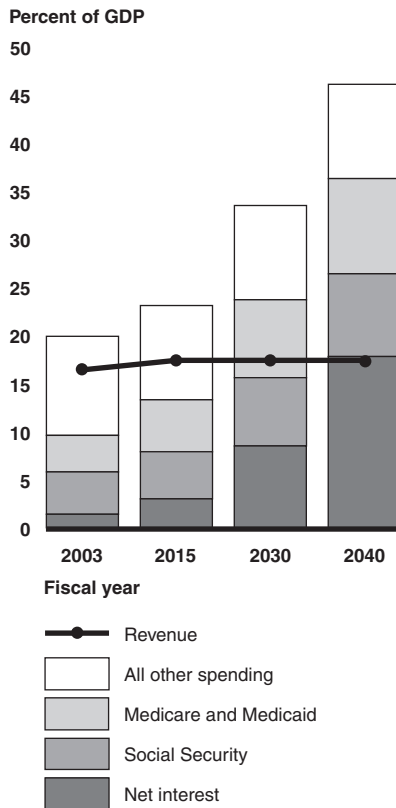
Social Security Reform Is Part of a Broader Fiscal and Economic Challenge

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 Americans in the future. Reforming Social Security and health programs is essential to reclaiming our future fiscal flexibility to address other national priorities.

Changes in the composition of federal spending over the past several decades have reduced budgetary flexibility, and our current fiscal path will reduce it even further. During this time, spending on mandatory programs has consumed an ever-increasing share of the federal budget. In 1964, prior to the creation of the Medicare and Medicaid programs, spending for mandatory programs plus net interest accounted for about 33 percent of total federal spending. By 2004, this share had almost doubled to approximately 61 percent of the budget.

If you look ahead in the federal budget, the Social Security programs (Old-Age and Survivors Insurance and Disability Insurance), together with the rapidly growing health programs (Medicare and Medicaid), will dominate the federal government's future fiscal outlook. Absent reform, the nation will ultimately have to choose among persistent, escalating federal deficits and debt, huge tax increases and/or dramatic budget cuts. GAO's long-term budget simulations show that to move into the future with no changes in federal retirement and health programs is to envision a very different role for the federal government. Assuming that discretionary spending grows with inflation and all existing tax cuts are allowed to expire when scheduled under current law, spending for Social Security and health care programs would grow to consume over three-quarters of federal revenue by 2040. Moreover, if all expiring tax provisions are extended and discretionary spending keeps pace with the economy, by 2040 total federal revenues may be adequate to pay little more than interest on the federal debt. (See figure 5.)

Figure 5: Composition of Spending as a Share of GDP



Source: GAO's September 2004 analysis.

Notes: Although expiring tax provisions are extended, revenue as a share of GDP increases through 2014 due to (1) real bracket creep, (2) more taxpayers becoming subject to the AMT, and (3) increased revenue from tax-deferred retirement accounts. After 2014, revenue as a share of GDP is held constant.

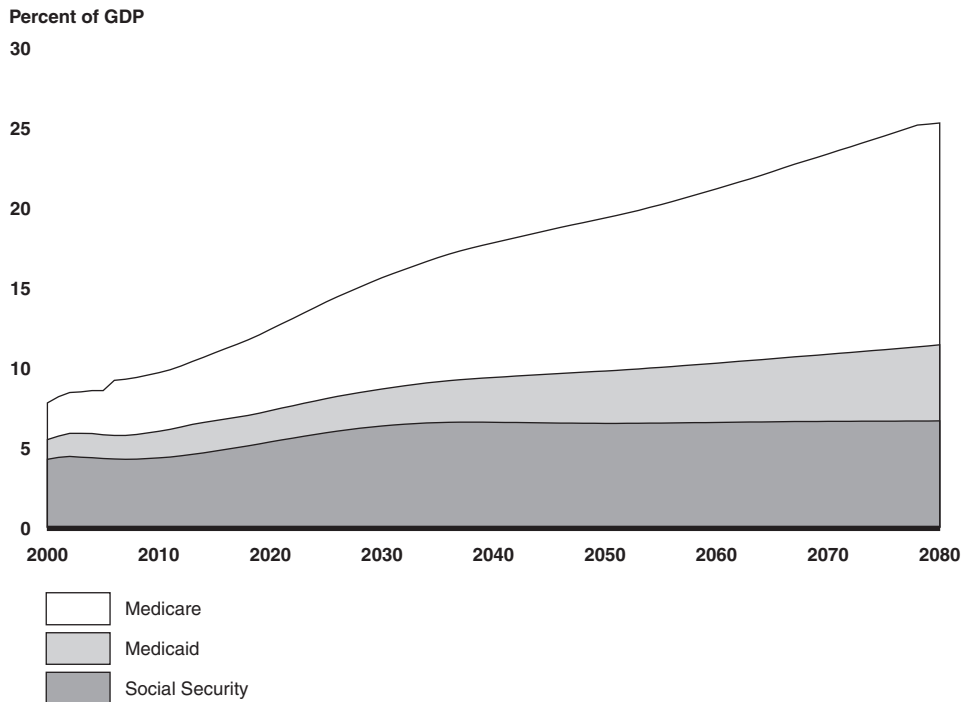
Alternatively, taking action soon on Social Security would not only promote increased budgetary flexibility in the future and stronger economic growth but would also make the necessary action less dramatic than if we wait. Indeed, long-term budget flexibility is about more than Social Security and Medicare. While these programs dominate the long-term outlook, they are not the only federal programs or activities that bind the future. The federal government undertakes a wide range of programs, responsibilities, and activities that obligate it to future spending or create an expectation for spending. GAO has described the range and measurement of such fiscal exposures—from explicit liabilities such as

environmental cleanup requirements to the more implicit obligations presented by life-cycle costs of capital acquisition or disaster assistance.³ Making government fit the challenges of the future will require not only dealing with the drivers— entitlements for the elderly—but also looking at the range of federal activities. A fundamental review of what the federal government does and how it does it will be needed.

Also, at the same time it is important to look beyond the federal budget to the economy as a whole. Under the 2004 Trustees' intermediate estimates and CBO's long-term Medicaid estimates, spending for Social Security, Medicare, and Medicaid combined will grow to 15.6 percent of GDP in 2030 from today's 8.5 percent (See figure 6.) Taken together, Social Security, Medicare, and Medicaid represent an unsustainable burden on future generations.

³GAO, *Fiscal Exposures: Improving the Budgetary Focus on Long-Term Costs and Uncertainties*, [GAO-03-213](#) (Washington, D.C.: Jan 24, 2003).

Figure 6: 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 2004 Trustees' Reports. Medicaid projected based on CBO's January 2004 short-term Medicaid estimates and CBO's December 2003 long-term Medicaid projections under mid-range assumptions.

Considerations in Assessing Reform Options

As important as financial stability may be for Social Security, it cannot be the only consideration. As a former public trustee of Social Security and Medicare, I am well aware of the central role these programs play in the lives of millions of Americans. Social Security remains the foundation of the nation's retirement system. It is also much more than just a retirement program; it pays benefits to disabled workers and their dependents, spouses and children of retired workers, and survivors of deceased workers. In 2004, Social Security paid almost \$493 billion in benefits to more than 47 million people. Since its inception, the program has successfully reduced poverty among the elderly. In 1959, 35 percent of the elderly were poor. In 2000, about 8 percent of beneficiaries aged 65 or older were poor, and 48 percent would have been poor without Social Security. It is precisely because the program is so deeply woven into the fabric of our nation that any proposed reform must consider the program in its entirety, rather than one aspect alone. Thus, GAO has developed a

broad framework for evaluating reform proposals that considers not only solvency but other aspects of the program as well.

The GAO Criteria for Reform

The analytic framework GAO has developed to assess proposals comprises three basic criteria:

- **Financing Sustainable Solvency**—the extent to which a proposal achieves sustainable solvency and how it would affect the economy and the federal budget. Our sustainable solvency standard encompasses several different ways of looking at the Social Security program’s financing needs. While a 75-year actuarial balance has generally been used in evaluating the long-term financial outlook of the Social Security program and reform proposals, it is not sufficient in gauging the program’s solvency after the 75th year. For example, under the trustees’ intermediate assumptions, each year the 75-year actuarial period changes, and a year with a surplus is replaced by a new 75th year that has a significant deficit. As a result, changes made to restore trust fund solvency only for the 75-year period can result in future actuarial imbalances almost immediately. Reform plans that lead to sustainable solvency would be those that consider the broader issues of fiscal sustainability and affordability over the long term. Specifically, a standard of sustainable solvency also involves looking at (1) the balance between program income and costs beyond the 75th year and (2) the share of the budget and economy consumed by Social Security spending.
- **Balancing Adequacy and Equity**—the relative balance struck between the goals of individual equity and income adequacy. The current Social Security system’s benefit structure attempts to strike a balance between the goals of retirement income adequacy and individual equity. From the beginning, Social Security benefits were set in a way that focused especially on replacing some portion of workers’ pre-retirement earnings. Over time other changes were made that were intended to enhance the program’s role in helping ensure adequate incomes. Retirement income adequacy, therefore, is addressed in part through the program’s progressive benefit structure, providing proportionately larger benefits to lower earners and certain household types, such as those with dependents. Individual equity refers to the relationship between contributions made and benefits received. This can be thought of as the rate of return on individual contributions. Balancing these seemingly conflicting objectives through the political process has resulted in the design of the current Social Security

program and should still be taken into account in any proposed reforms.

- **Implementing and Administering Proposed Reforms**—how readily a proposal could be implemented, administered, and explained to the public. Program complexity makes implementation and administration both more difficult and harder to explain to the public. Some degree of implementation and administrative complexity arises in virtually all proposed changes to Social Security, even those that make incremental changes in the already existing structure. Although these issues may appear technical or routine on the surface, they are important issues because they have the potential to delay—if not derail—reform if they are not considered early enough for planning purposes. Moreover, issues such as feasibility and cost can, and should, influence policy choices. Continued public acceptance of and confidence in the Social Security program require that any reforms and their implications for benefits be well understood. This means that the American people must understand why change is necessary, what the reforms are, why they are needed, how they are to be implemented and administered, and how they will affect their own retirement income. All reform proposals will require some additional outreach to the public so that future beneficiaries can adjust their retirement planning accordingly. 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.

The weight that different policy makers may place on different criteria will vary, depending on how they value different attributes. For example, if offering individual choice and control is less important than maintaining replacement rates for low-income workers, then a reform proposal emphasizing adequacy considerations might be preferred. As they fashion a comprehensive proposal, however, policy makers will ultimately have to balance the relative importance they place on each of these criteria. As we have noted in the past before this committee and elsewhere, a comprehensive evaluation is needed that considers a range of effects together. Focusing on comprehensive packages of reforms will enable us to foster credibility and acceptance. This will help us avoid getting mired in the details and losing sight of important interactive effects. It will help build the bridges necessary to achieve consensus.

One issue that often arises within the Social Security debate concerns the appropriate comparisons or benchmarks to be used when assessing a particular proposal. While this issue may seem to be somewhat abstract, it has critical implications, for depending on the comparisons chosen, a

proposal can be made more or less attractive. Some analyses compare proposals to a single benchmark and as a result can lead to incomplete or misleading conclusions. For that reason, GAO has used several benchmarks in assessing reform proposals.⁴ Currently promised benefits are not fully financed, and so any analysis that seeks to fairly evaluate reform proposals should rely on benchmarks that reflect a policy of an adequately financed system. Similarly, it is important to have benchmarks that are consistent with each other. Using one that relies on action relatively soon versus one that posits no action at all are not consistent and could also lead to misleading conclusions. Estimating future effects on Social Security benefits should reflect the fact that the program faces a long-term actuarial deficit and that conscious policies of benefit reduction and/or revenue increases will be necessary to restore solvency and sustain it over time.

Reform Will Have Pervasive Impact on the Social Security Program

A variety of proposals have been offered to address Social Security's financial problems. Many proposals contain reforms that would alter benefits or revenues within the structure of the current defined benefits system. Some would reduce benefits by modifying the benefit formula (such as increasing the number of years used to calculate benefits or using price-indexing instead of wage-indexing), reduce cost-of-living adjustments (COLA), raise the normal and/or early retirement ages, or revise dependent benefits. Some of the proposals also include measures or benefit changes that seek to strengthen progressivity (e.g., replacement rates) in an effort to mitigate the effect on low-income workers. Others have proposed revenue increases, including raising the payroll tax or expanding the Social Security taxable wage base that finances the system; increasing the taxation of benefits; or covering those few remaining workers not currently required to participate in Social Security, such as older state and local government employees.

A number of proposals also seek to restructure the program through the creation of individual accounts. Under a system of individual accounts, workers would manage a portion of their own Social Security contributions to varying degrees. This would expose workers to a greater degree of risk in return for both greater individual choice in retirement investments and the possibility of a higher rate of return on contributions

⁴GAO, *Social Security Reform: Analysis of Reform Models Developed by the President's Commission to Strengthen Social Security*, [GAO-03-310](#) (Washington, D.C.: Jan 15, 2003).

than available under current law. There are many different ways that an individual account system could be set up. For example, contributions to individual accounts could be mandatory or they could be voluntary. Proposals also differ in the manner in which accounts would be financed, the extent of choice and flexibility concerning investment options, the way in which benefits are paid out, and the way the accounts would interact with the existing Social Security program—individual accounts could serve either as an addition to or as a replacement for part of the current benefit structure.

In addition, the timing and impact of individual accounts on the solvency, sustainability, adequacy, equity, net savings, and rate of return associated with the Social Security system varies depending on the structure of the total reform package. Individual accounts by themselves will not lead the system to sustainable solvency. Achieving sustainable solvency requires more revenue, lower benefits, or both. Furthermore, incorporating a system of individual accounts may involve significant transition costs. These costs come about because the Social Security system would have to continue paying out benefits to current and near-term retirees concurrently with establishing new individual accounts.

Individual accounts can contribute to sustainability as they could provide a mechanism to prefund retirement benefits that would be immune to demographic booms and busts. However, if such accounts are funded through borrowing, no such prefunding is achieved. An additional important consideration in adopting a reform package that contains individual accounts would be the level of benefit adequacy achieved by the reform. To the extent that benefits are not adequate, it may result in the government eventually providing additional revenues to make up the difference.

Also, some degree of implementation and administrative complexity arises in virtually all proposed changes to Social Security. 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. The Federal Thrift Savings Plan (TSP) could serve as a model for providing a limited amount of options that reduce risk and administrative costs while still providing some degree of choice. However, a system of accounts that

spans the entire national workforce and millions of employers would be significantly larger and more complex than the TSP or any other system we have in place today.

Harmonizing a system that includes individual accounts with the regulatory framework that governs our nation's private pension system would also be a complicated endeavor. However, the complexity of meshing these systems should be weighed against the potential benefits of extending participation in individual accounts to millions of workers who currently lack private pension coverage.

Social Security Reform Should Be Considered in the Context of Broader Challenges

Another important consideration for Social Security reform is assessing a proposal's effect on national saving. Individual account proposals that fund accounts through redirection of payroll taxes or general revenue do not increase national saving on a first order basis. The redirection of payroll taxes or general revenue reduces government saving by the same amount that the individual accounts increase private saving. Beyond these first order effects, the actual net effect of a proposal on national saving is difficult to estimate due to uncertainties in predicting changes in future spending and revenue policies of the government as well as changes in the saving behavior of private households and individuals. For example, the lower surpluses and higher deficits that result from redirecting payroll taxes to individual accounts could lead to changes in federal fiscal policy that would increase national saving. On the other hand, households may respond by reducing their other saving in response to the creation of individual accounts. No expert consensus exists on how Social Security reform proposals would affect the saving behavior of private households and businesses.

Finally, the effort to reform Social Security is occurring as our nation's private pension system is also facing serious challenges. Only about half of the private sector workforce is covered by a pension plan. A number of large underfunded traditional defined benefit plans—plans where the employer bears the risk of investment—have been terminated by bankrupt firms, including household names like Bethlehem Steel, US Airways, and Polaroid. These terminations have resulted in thousands of workers losing promised benefits and have saddled the Pension Benefit Guaranty Corporation, the government corporation that partially insures certain defined benefit pension benefits, with billions of dollars in liabilities that threaten its long-term solvency. Meanwhile, the number of traditional defined benefit pension plans continues to decline as employers increasingly offer workers defined contribution plans like 401(k) plans

where, like individual accounts, workers face the potential of both greater return and greater risk. These challenges serve to reinforce the imperative to place Social Security on a sound financial footing.

Regardless of what type of Social Security reform package is adopted, continued confidence in the Social Security program is essential. This means that the American people must understand why change is necessary, what the reforms are, why they are needed, how they are to be implemented and administered, and how they will affect their own retirement income. All reform proposals will require some additional outreach to the public so that future beneficiaries can adjust their retirement planning accordingly. 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.

Conclusions

Social Security does not face an immediate crisis but it does face a large and growing financial problem. In addition, our Social Security challenge is only part of a much broader challenge that includes, among other things, the need to reform Medicare, Medicaid and our overall health care system.

Today many retirees and near retirees fear cuts that would affect them in the immediate future while young people believe they will get little or no Social Security benefits in the longer term. I believe that it is possible to reform Social Security in a way that will ensure the program's solvency, sustainability, and security while exceeding the expectations of all generations of Americans.

In my view, there is a window of opportunity to reform Social Security; however, this window of opportunity will begin to close as the baby boom generation begins to retire. Furthermore, it would be prudent to move forward to address Social Security now because we have much larger challenges confronting us that will take years to resolve. The fact is, compared to addressing our long-range health care financing problem, reforming Social Security should be easy lifting.

We at GAO look forward to continuing to work with this Committee and the Congress in addressing this and other important issues facing our nation. In doing so, we will be true to our core values of accountability, integrity, and reliability.

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