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SOCIAL SECURITY

Long-Term Financing Shortfall Drives Need for Reform

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Mr. Chairman and Members of the Committee:

Thank you for inviting me here to discuss ensuring the long-term viability of our nation's Social Security program. 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 I have said in congressional testimonies over the past several years,[1] the system faces both solvency and sustainability challenges in the longer term. Although the Social Security Trustees now project that under the intermediate or "best estimate" assumptions the combined Social Security Trust Funds[2] will be exhausted 3 years later than in last year's estimates, the magnitude of the long-term funding shortfall is virtually unchanged. In their 2002 report, the Trustees emphasized that while the program's near-term financial condition has improved slightly, Social Security faces a substantial financial challenge in the not-too-distant future that needs to be addressed soon. In essence, the program's long-term outlook remains unchanged. Without reform, Social Security, Medicare, and Medicaid are unsustainable, and the long-term impact of these entitlement programs on the federal budget and the economy will be dramatic.

Over the past few years, a wide array of proposals has been put forth to restore Social Security's long-term solvency, and last December a commission appointed by the President presented three models for modifying the current program. The Commission's final report[3] called for a period of discussion lasting at least a year before legislative action is taken to strengthen and restore sustainability to Social Security. It is not my intention to discuss the specifics of or 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

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

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

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

the past several years, will help clarify some of the key issues in the debate. To do that, I'm going to talk about the nature and timing of the Social Security problem and a framework you might use in addressing it.

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

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

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

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

- **Given the current financial shortfall of the program, it is important to compare proposals to both current promised and funded benefits**. Comparing the beneficiary impact of reform proposals solely to current Social Security promised benefits is inappropriate since all current promised benefits are not funded over the longer term. As a result, comparisons to current promised benefits after the point of trust fund insolvency assume a payroll tax increase or general revenue infusion that have not been enacted and may not occur. Likewise, comparisons of reform proposals solely to funded benefits after the point of trust fund insolvency are also inappropriate since that assumes a reduction in benefits that has not been enacted and may not occur. The key point is that there is a significant gap between promised and funded benefits that must be closed. In fact, a primary purpose of most Social Security reform proposals is to close or eliminate this gap.

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

- **Acting sooner rather than later helps to ease the difficulty of change.** As I noted previously, the challenge of facing the imminent and daunting budget pressure from Medicare, Medicaid, and OASDI increases over time. Social Security will begin to constrain the budget long before the Trust Funds are exhausted. The program's annual cash surplus will enter a steady decline beginning in 2006,[4] and from 2017 on, Social Security's annual cash deficit will place increasing pressure on the rest of the budget to raise the resources necessary to meet the program's costs. Waiting until Social Security faces an immediate solvency crisis will limit the scope of feasible solutions and could reduce the options field to only those choices that are the most difficult and could also delay the really tough decisions on Medicare and Medicaid. Acting sooner rather than later would allow changes to be

[4]This calendar year estimate is based on projected tax receipts and outlays in constant 2002 dollars under the intermediate assumptions of the 2002 Trustees Report.

phased in so that future and near retirees have time to adjust their retirement planning.

- **We believe it is possible to structure a Social Security reform proposal that will exceed the expectations of all generations of Americans.** Today many retirees and near-retirees fear cuts will affect them while young people believe they will get little or no Social Security benefits. We believe the time has come to craft a solution that will protect Social Security benefits for the nation's current and near-term retirees, while ensuring that the system will be there for future generations.

Our Social Security challenge is more urgent than it may appear. Although the combined Trust Funds will not run dry until 2041, the Social Security program's pressure and cash demands on the rest of the federal government will begin much sooner. Failure to take remedial action will, in combination with other entitlement spending, place unsustainable pressure on the government and, ultimately, the economy. This problem is about more than finances. It is also about maintaining an adequate safety net for American workers against loss of income from retirement, disability, or death; Social Security provides a foundation of retirement income for millions of Americans, and has prevented many former workers from living their retirement years in poverty. As the Congress considers proposals to restore the long-term financial stability and viability of the Social Security system, it also needs to consider the impact of the potential changes on different types of beneficiaries. Moreover, while addressing Social Security reform is important and will not be easy, Medicare presents a much greater, more complex, and more urgent fiscal challenge.

To assist the Congress in its deliberations, GAO has developed criteria for evaluating Social Security reform proposals. These criteria aim to balance financial and economic considerations with benefit adequacy and equity issues and the administrative challenges associated with various proposals. The use of these criteria can help facilitate fair consideration and informed debate of Social Security reform proposals. Although making policy decisions of this importance requires appropriate deliberation, the time to act is now. Waiting only makes the problem larger, the magnitude of the required changes greater, and the time available to phase in changes shorter. Waiting also may serve to further delay the really hard decisions on Medicare and Medicaid.

Social Security's Long-Term Financing Problem Is More Urgent Than 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 affects the nature of the challenge, but it does not eliminate the need for action. Acting soon reduces the likelihood that the Congress will have to choose between imposing severe benefit cuts and unfairly burdening future generations with the program's rising costs. Acting soon would allow changes to be phased in so the individuals who are most likely to be affected, namely younger and future workers, will have time to adjust their retirement planning while helping to avoid related "expectation gaps." Mr. Chairman, as you heard earlier this month while hosting the second Annual OECD International Conference of Chairpersons of Parliamentary Budget Committees, we are not alone in facing long-term budget challenges due to an aging population. Our counterparts in many European countries are debating these same issues, and a number of developed and developing countries have already engaged in fundamental reform of their systems to deal with their long-range challenges.

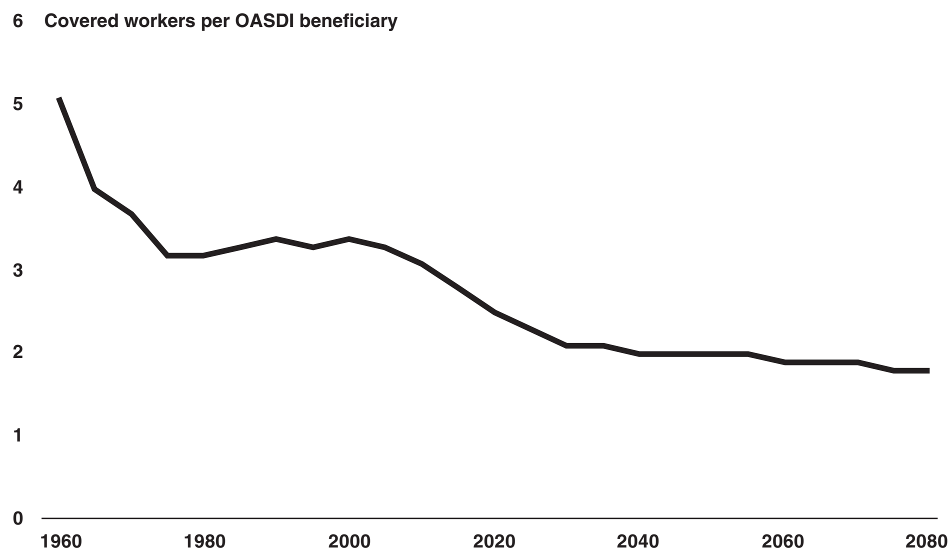
Acting soon will also help put the overall federal budget on a more sustainable footing over the long term, thereby promoting both higher economic growth and more fiscal flexibility. The importance of such flexibility was brought dramatically home last September. The budgetary surpluses of recent years put us in a stronger position to respond both to the events of September 11 and to the economic slowdown than would otherwise have been the case. Going forward, the nation's commitment to surpluses will truly be tested. None of the changes since September 11 have lessened the pressures placed by Social Security, Medicare, and Medicaid on the long-term fiscal outlook. Indeed, the events of September 11 have served to increase our long-range fiscal challenges.

Since there is a great deal of confusion about Social Security's current financing arrangements and the nature of its long-term financing problem, I would like to spend some time describing the nature, timing, and extent of the financing problem.

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

As you all know, Social Security has always been largely a pay-as-you-go system. This means that current workers' taxes pay current retirees' benefits. As a result, the relative numbers of workers and beneficiaries has a major impact on the program's financial condition. This ratio, however, is changing. In the 1960s, the ratio averaged 4.2:1. Today it is 3.4:1 and it is expected to drop to around 2:1 by 2030. The retirement of the baby boom generation is not the only demographic challenge facing the system. People are retiring early and living longer. A falling fertility rate is the other principal factor underlying the growth in the elderly's share of the population. In the 1960s, the fertility rate was an average of 3 children per woman. Today it is a little over 2, and by 2030 it is expected to fall to 1.95—a rate that is below replacement. Taken together, these trends threaten the financial solvency and sustainability of this important program. (See fig. 1.)

Figure 1: Social Security Workers per Beneficiary

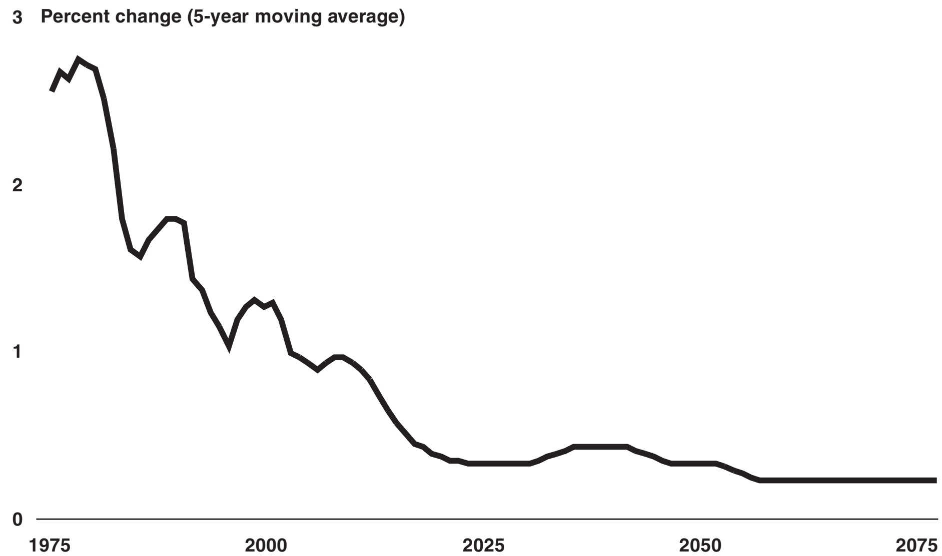


Note: Projections based on intermediate assumptions of the 2002 Trustees' Report.

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

The combination of these trends means that labor force growth will begin to slow after 2010 and become negligible by 2050. (See fig. 2.) Relatively fewer workers will be available to produce the goods and services that all will consume. Without a major increase in productivity, low labor force growth will lead to slower growth in the economy and to slower growth of federal revenues. This in turn will only accentuate the overall pressure on the federal budget.

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



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

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

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

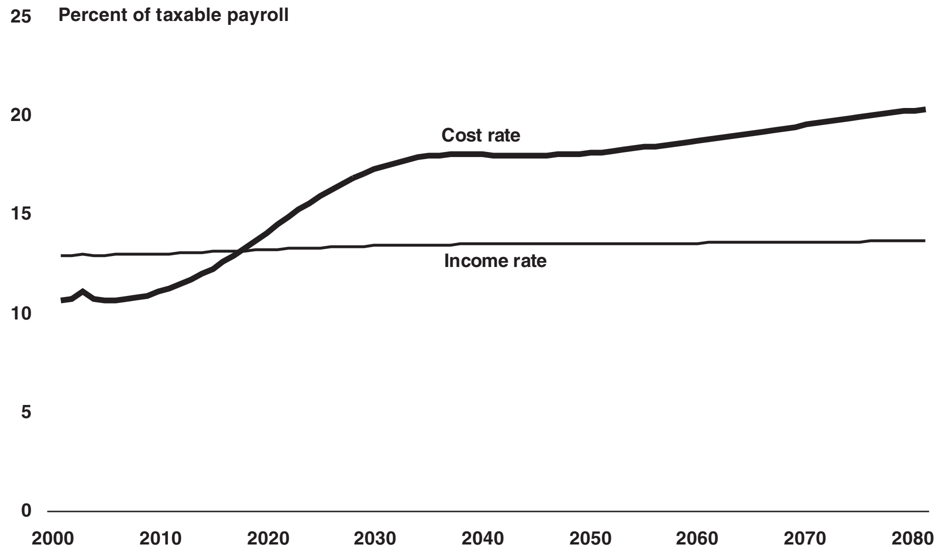
In addition to encouraging people to work longer, a second approach to addressing labor force growth would be to bring more people into the labor force. In domestic social policy, we have seen an increasing focus on encouraging those previously outside the labor force (i.e., welfare recipients, the disabled) into the workforce. Concern about the slowdown in the growth of the labor force may also lead to discussions about immigration and its role. Increased immigration, however, poses complex issues and is unlikely to be the sole solution. For example, according to a recent United Nations study,[5] it would take more than a sustained tenfold increase in projected immigration to maintain the ratio of workers to retirees at recent levels. These are issues that the Congress may wish to explore further in the next few years.

Because of the demographic trends discussed above, 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.[6] (See fig. 3.)

[5]United Nations Population Division, *Replacement Migration: Is it a Solution to Declining and Ageing Populations?* (March 2000).

[6]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 a little more than 2 percent of total income in 2001.

Figure 3: Social Security Cost and Income as a Percent of Taxable Payroll



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

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

Social Security Trust Funds, Cash Flow, 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, annual tax revenues to Social Security exceed annual benefit payments. The Trust Funds, by law, invest the resulting cash 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.[7] Although the Trust Funds cannot sell their holdings in the open market, the Trust Funds face no liquidity risk since they can redeem their special Treasury securities before maturity without penalty. These securities earn interest credits at a statutory rate linked to

[7]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 calendar year 2001, about 0.003 percent of OASDI trust fund holdings were in marketable Treasury securities.

market yields, and this interest from the Treasury is credited to the Trust Funds in the form of additional Treasury securities.

I think it is useful to pause for a moment here and reflect on what the term "trust fund" means in the federal budget.[8] Trust funds in the federal budget are not like private trust funds. An individual 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 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.

Under current law, when the Social Security Trust Funds' tax 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.[9]

The accumulated balances in a trust fund 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

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[8]For a discussion of trust funds and other earmarked funds in the budget, see U.S. General Accounting Office, *Federal Trust and Other Earmarked Funds: Answers to Frequently Asked Questions*, GAO-01-199SP (Washington D.C.: Jan. 2001).

[9]Under current accounting standards, the long-term funding gap—the difference between promised benefits and expected contributions—for Social Security and Medicare is reported as required supplementary stewardship information but not treated as a liability in the government's financial statements. The recognized liability is the amount of benefits due and payable to or on behalf of beneficiaries at the end of the reporting period.

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.

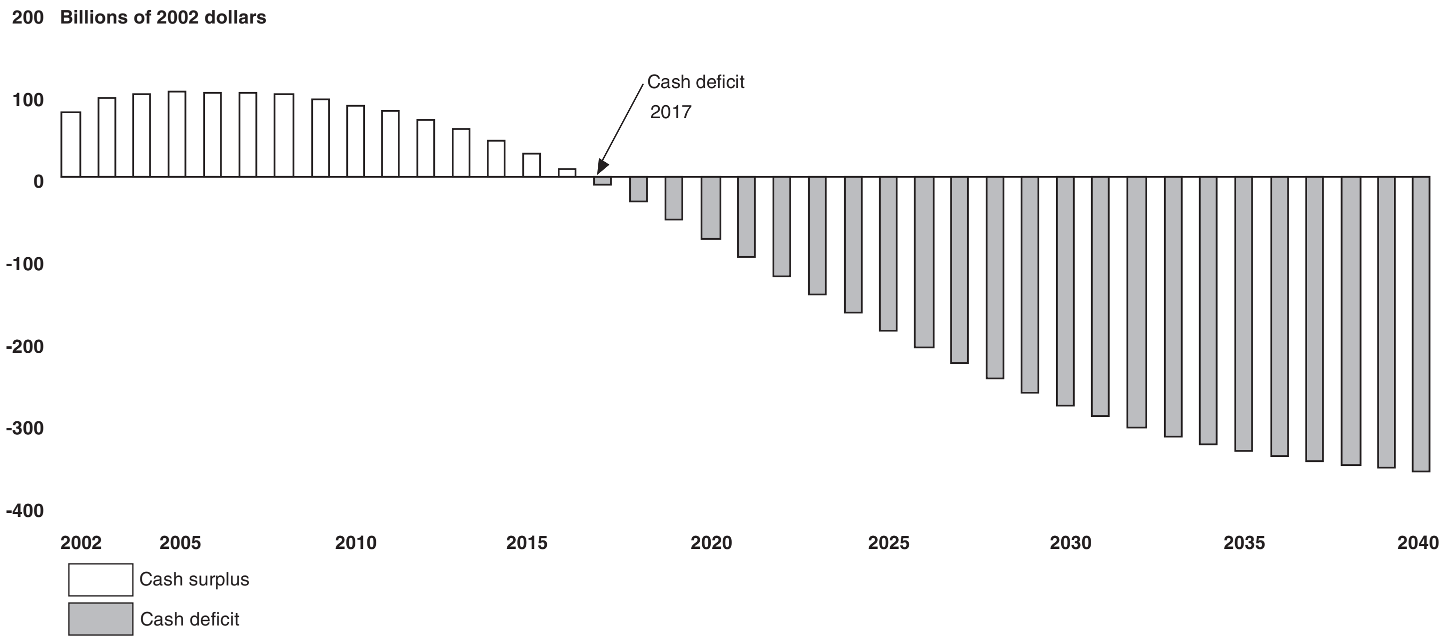
According to the Trustees' intermediate estimates, the combined Social Security Trust Funds will be solvent until 2041.[10] However, our long-term model shows that well before that time program spending will constitute a rapidly growing share of the budget and the economy. Ultimately, the critical question is not how much a trust fund has in assets, but whether the government as a whole can afford the promised benefits in the future and at what cost to other claims on scarce resources. As I have said before, the future sustainability of programs is the key issue policymakers should address—i.e., the capacity of the economy and budget to afford the commitment. Fund solvency can help, but only if promoting solvency improves the future sustainability of the program.

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

Today, the Social Security Trust Funds take in more in taxes than they spend. Largely because of the known demographic trends I have described, this situation will change. Under the Trustees' intermediate assumptions, annual cash surpluses begin to shrink in 2006, and combined program outlays begin to exceed dedicated tax receipts in 2017, a year after Medicare's Hospital Insurance Trust Fund (HI) outlays are first expected to exceed program tax revenues. At that time, both programs will become net claimants on the rest of the federal budget. (See fig. 4.)

[10]Separately, the DI fund is projected to be exhausted in 2028 and the OASI fund in 2043.

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



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

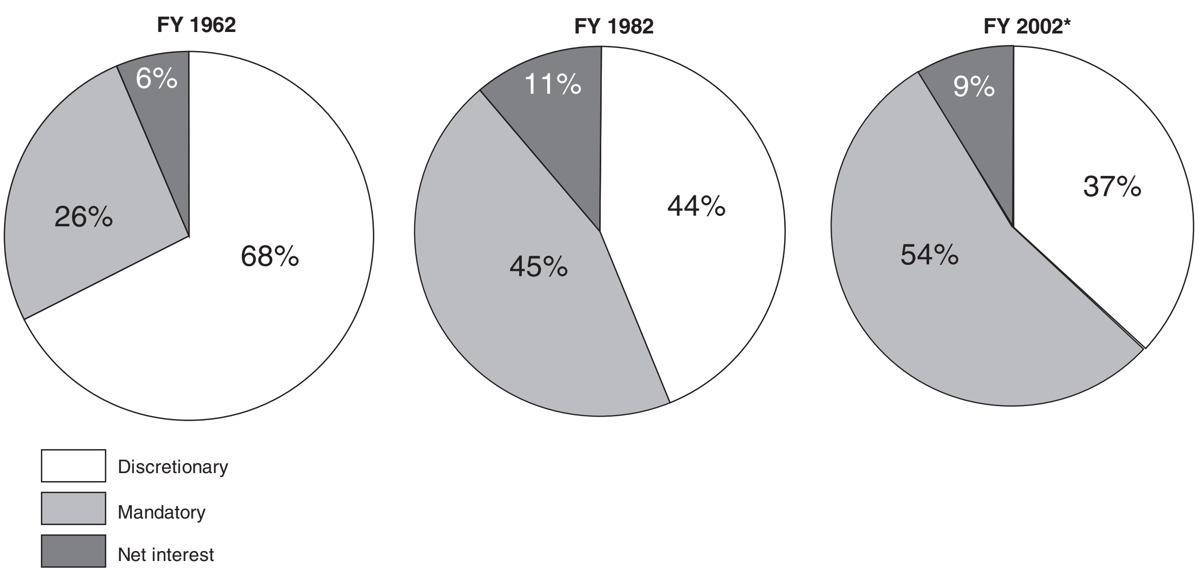
As I noted above, the special Treasury securities represent assets for the Trust Funds but are future claims against the Treasury. Beginning in 2017, the Trust Funds will begin drawing on the Treasury to cover the cash shortfall, first relying on interest income and eventually drawing down accumulated trust fund assets. 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.[11] Neither the decline in the cash surpluses nor the cash deficit will affect the payment of benefits. However, the shift affects the rest of the budget. The negative cash flow will place increased pressure on the federal budget to raise the resources necessary to meet the program's ongoing costs.

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

Decline in Budgetary Flexibility Will Be Severely Exacerbated Absent Entitlement Reform

From the perspective of the federal budget and the economy, the challenge posed by the growth in Social Security spending becomes even more significant in combination with the more rapid expected growth in Medicare and Medicaid spending. This growth in spending on federal entitlements for retirees will become increasingly unsustainable over the longer term, compounding an ongoing decline in budgetary flexibility. Over the past few decades, spending on mandatory programs has consumed an ever-increasing share of the federal budget. Prior to the creation of the Medicare and Medicaid programs, in 1962 mandatory spending plus net interest accounted for about 32 percent of total federal spending. By 2002, this share had almost doubled to approximately 63 percent of the budget. (See fig. 5.)

Figure 5: Federal Spending for Mandatory and Discretionary Programs, Fiscal Years 1962, 1982, and 2002



*Office of Management and Budget current services estimate.

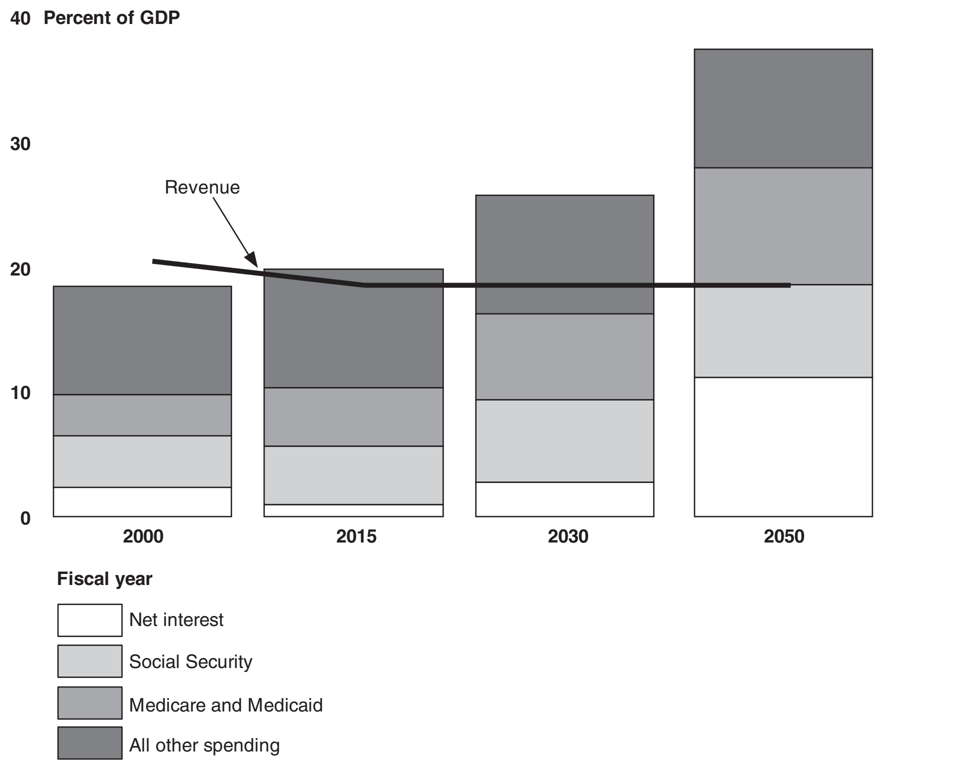
Source: GAO analysis of data from the Office of Management and Budget.

In much of the last decade, reductions in defense spending helped accommodate the growth in these entitlement programs. This, however, is no longer a viable option. Even before September 11, reductions in defense spending were no longer available to help fund other claims on the budget. Indeed, spending on defense and homeland security will grow as we seek to combat new threats to our nation's security.

Our long-term budget simulations continue to show that to move into the future with no changes in federal retirement and health programs is to envision a very different role for the federal government. Assuming, for example, that the tax reductions enacted last year do not sunset and discretionary spending keeps pace with the economy, by midcentury federal revenues may only be adequate to pay Social Security and interest on the federal debt. Spending for the current Medicare program—without the addition of a drug benefit—is projected to account for more than one-quarter of all federal revenues.[12] To obtain balance, massive spending cuts, tax increases, or some combination of the two would be necessary. (See fig. 6.) Neither slowing the growth of discretionary spending nor allowing the tax reductions to sunset eliminates the imbalance.

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

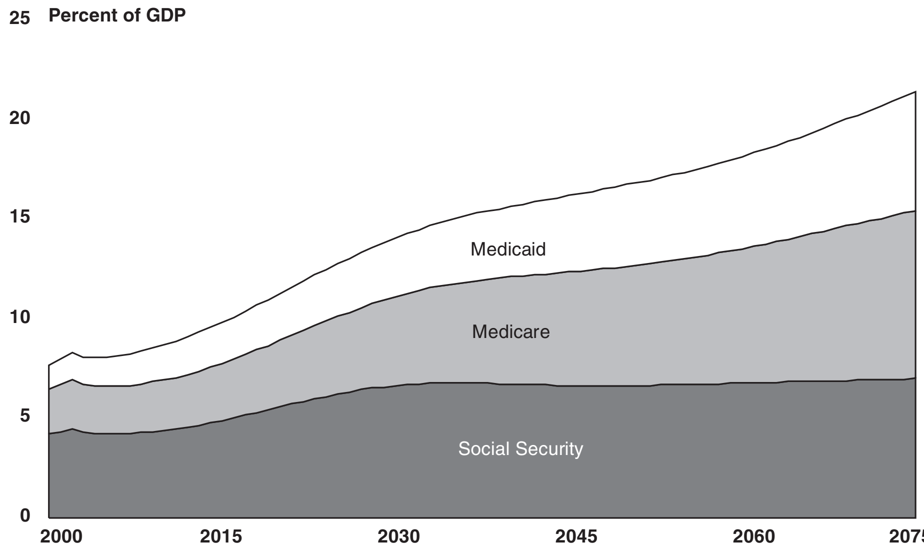
Figure 6: Composition of Spending as a Share of Gross Domestic Product (GDP) Assuming Discretionary Spending Grows with GDP and the Tax Cuts Do Not Sunset



Source: GAO's March 2002 analysis.

It is important as well to look beyond the federal budget to the economy as a whole. Figure 7 shows the total future draw on the economy represented by Social Security, Medicare, and Medicaid. Under the 2002 Trustees' intermediate estimates and the Congressional Budget Office's (CBO) most recent long-term Medicaid estimates, spending for these entitlement programs combined will grow to 14.1 percent of GDP in 2030 from today's 8.3 percent. Taken together, Social Security, Medicare, and Medicaid represent an unsustainable burden on future generations.

Figure 7: Social Security, Medicare, and Medicaid Spending as a Percent of GDP



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

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

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

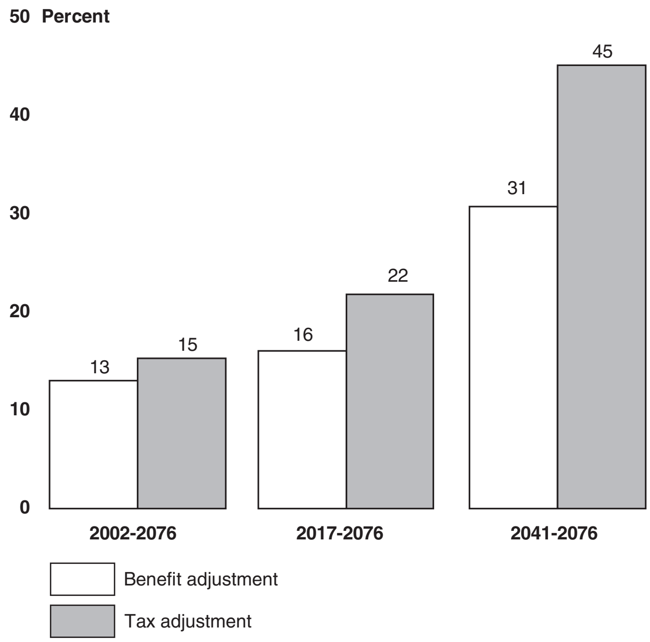
When Social Security redeems assets to pay benefits, the program will constitute a claim on real resources in the future. As a result, taking action now to increase the future pool of resources is important. To echo Federal Reserve Chairman Greenspan, the crucial issue of saving in our economy relates to our ability to build an adequate capital stock to produce enough goods and services in the future to accommodate both retirees and workers in the future.[13] The most direct way the federal government can raise national saving is by increasing government saving. Ultimately, as this Committee recommended last fall, we should attempt to return to a position of surplus as the economy returns to a higher growth path. This 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.

Similarly, taking action now on Social Security would not only promote increased budgetary flexibility in the future and stronger economic growth but would also make less dramatic action necessary than if we wait. Perhaps the best way to illustrate this is to compare what it would take to achieve actuarial balance at different points in time by either raising payroll taxes or reducing benefits.[14] Figure 8 shows this. If we did nothing until 2041—the year the Trust Funds are estimated to be exhausted—achieving actuarial balance would require changes in benefits of 31 percent or changes in taxes of 45 percent. As figure 8 shows, earlier action shrinks the size of the necessary adjustment.

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

[14]Solvency could also be achieved through a combination of tax and benefit actions. This would reduce the magnitude of the required change in taxes or benefits compared to making changes exclusively to taxes or benefits as shown in figure 8.

Figure 8: Size of Action Needed to Achieve Social Security Solvency



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

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

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

Evaluating Social Security Reform Proposals

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

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 will vary, depending on how they value different attributes. For example, if offering individual choice and control is less important than maintaining replacement rates for low-income workers, then a reform proposal emphasizing adequacy considerations might be preferred. As they fashion a comprehensive proposal, however, policymakers will ultimately have to balance the relative importance they place on each of these criteria.

Financing Sustainable Solvency

Historically, Social Security'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 immediately by 1.87 percentage points of taxable payroll today—which, according to the 2002 Trustees Report, is the amount necessary to achieve 75-year balance—the system would be out of balance next year. This is the case because actions taken to close the 75-year imbalance would not fully address the projected deficit in year 76 of 6.49

percent of taxable payroll. 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 federal health programs is essential to reclaiming our future fiscal flexibility to address other national priorities.

Balancing Adequacy and Equity

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

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

Implementing and Administering Proposed Reforms

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

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

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 any gaps in expectations about current or future benefits are avoided. In addition, increasing the public’s level of sophistication and understanding of how to invest in the market, the relationship between risk and return, and the potential benefits of diversification presents an education challenge that must be surmounted so that the American people have the necessary tools to secure their future. The Enron collapse helps to illustrate the importance of this, as well as the need to provide clear and understandable information so that the public can make informed retirement decisions.

Conclusion

Early action to address the financing problems of Social Security yields the highest fiscal dividends for the federal budget and provides a longer period for future beneficiaries to make adjustments in their own planning. The events of September 11 and the challenges of combating terrorism do not change this. In fact, the additional spending that will be required to fight the war on terrorism and protect our homeland will serve to increase our long-range fiscal challenges. 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.

Although the program does not face an immediate solvency crisis as it did in 1983, the fundamental nature of the program's long-term financing challenge means that timely action is needed. The demographic trends recognized in 1983 are now almost upon us. It is these demographic trends—and their implications for both Social Security and Medicare—that lead to the conclusion that the program faces both a solvency and a sustainability problem. For the American people to understand why change is necessary, a public education campaign will be needed that focuses not just on Social Security but also on our long-range fiscal challenges.

We will face many difficult choices in making Social Security sustainable. Focusing on comprehensive packages of reforms that protect the benefits of current retirees while achieving the right balance of equity and adequacy for future beneficiaries will help 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.

Today I have described the three basic criteria against which GAO thinks Social Security reform proposals may be measured. These may not be the same criteria every analyst would suggest, and certainly how policymakers weight the various elements may vary. However, 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.

Today many retirees and near-retirees fear cuts that will affect them while young people believe they will get little or no Social Security benefits. As I said at the start of my testimony, we believe it is possible to structure a Social Security reform proposal that will exceed the expectations of all generations of Americans. Yes, we believe there is a window of opportunity to craft a solution that will protect Social Security benefits for the nation's current and near-term retirees, while ensuring that the system will be there for future generations. However, this window of opportunity will close as the baby boom generation begins to retire. As a result, we must move forward to address Social Security because we have other major challenges confronting us. The fact is, compared to addressing our long-range health care financing problem, reforming Social Security will be easy lifting.

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

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

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