

GAO

Testimony

Before the Committee on Ways and Means,  
House of Representatives

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**SOCIAL SECURITY  
REFORM**

**Early Action Would Be  
Prudent**

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





# SOCIAL SECURITY REFORM

## Early Action Would Be Prudent

Highlights of [GAO-05-397T](#), a report to the Committee on Ways and Means, House of Representatives

### 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, also providing 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 widening as time passes.

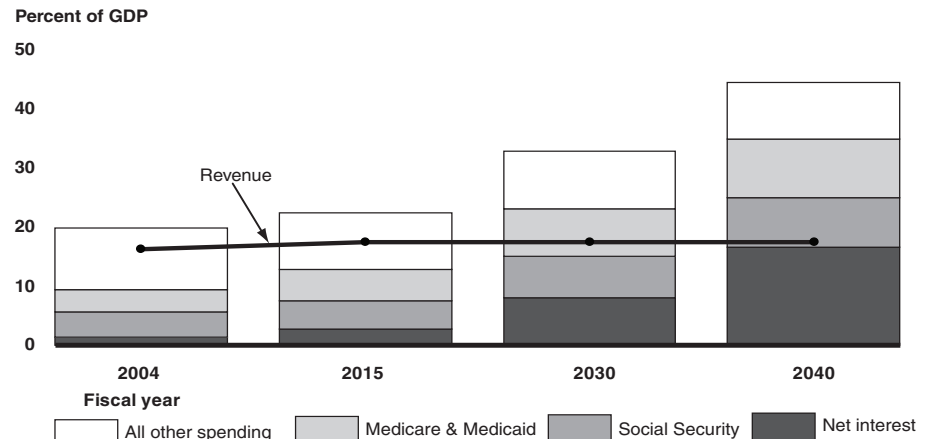
The Committee asked GAO to discuss the need for Social Security reform. This testimony addresses the nature of Social Security's long-term financing problem and why it would be prudent for Congress to take action sooner rather than later. This testimony also notes the broader context in which reform proposals should be considered and the criteria that GAO has recommended as a basis for analyzing any Social Security reform proposals.

### What GAO Found

Although the Social Security system is not in crisis, it faces a serious solvency and sustainability challenge that is growing as time passes. If we do nothing until 2042, achieving actuarial balance would require a 30-percent reduction in benefits or a 43-percent increase in payroll taxes for the period 2042-2078. Furthermore, Social Security's problems are a subset of the grave fiscal challenge facing our nation. Absent changes in budget policy, the nation will ultimately have to choose among escalating federal deficits and debt, huge tax increases and/or dramatic budget cuts. As GAO's long-term budget simulations show, substantive reform of Social Security and our major federal health programs (e.g., Medicare and Medicaid) is critical to saving our nation's fiscal future. (See figure below.) Taking action soon would serve to reduce the magnitude of changes needed to ensure that Social Security is solvent, sustainable, and secure for current and future generations. It would also allow time to phase in certain changes and time for individuals to adjust to any such changes. Acting sooner would also serve to improve the federal government's credibility with financial markets and bolster the confidence of the American people in our government's ability to address long-range financial challenges.

However, financial solvency and sustainability should not be the only consideration when evaluating Social Security reform proposals. Other key objectives, such as balancing the adequacy and equity of the benefit structure and various administrative and operational issues need to be considered. Furthermore, any changes to Social Security should be considered in the context both of the whole program—including disability and survivors' benefits—and of the broader challenges facing our nation, such as the changing nature of the private pension system, long-term care needs, escalating health care costs, and the need to reform the Medicare and Medicaid programs.

**Composition of Spending as a Share of GDP Assuming Discretionary Spending Grows with GDP after 2005 and All Expiring Tax Provisions Are Extended**



Source: GAO's January 2005 analysis

[www.gao.gov/cgi-bin/getrpt?GAO-05-397T](http://www.gao.gov/cgi-bin/getrpt?GAO-05-397T).

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

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Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss the underlying structural problems and long-term challenges facing the Social Security program.<sup>1</sup> Before addressing these matters specifically, I would like to place these challenges in the context of the larger challenges facing the federal government today, which we discuss in our recently issued 21st Century Challenges report.<sup>2</sup> There is a need to bring the federal government and its programs into line with 21st century realities. This challenge has many related pieces: addressing our nation's large and growing long-term fiscal gap; deciding on the appropriate role and size of the federal government-and how to finance that government-and bringing the panoply of federal activities into line with today's world. Continuing on our current unsustainable fiscal path will gradually erode, if not suddenly damage, our economy, our standard of living, and ultimately our national security. We therefore must fundamentally reexamine major spending and tax policies and priorities in an effort to recapture our fiscal flexibility and ensure that our programs and priorities respond to emerging security, social, economic, and environmental changes and challenges.

Social Security represents the foundation of retirement income for millions of Americans and has helped to prevent many former workers and their families from living their retirement years in poverty. It provides millions of Americans with disability insurance and survivors' benefits, thus, providing benefits that are critical to the current and future well-being of tens of millions of Americans. Fixing Social Security 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.

As I have said in congressional testimonies over the past several years, the Social Security system faces serious solvency and sustainability challenges

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<sup>1</sup>In this statement, Social Security refers to the Old-Age and Survivors Insurance and Disability Insurance (OASDI) program.

<sup>2</sup>GAO, *21st Century Challenges: Reexamining the Base of the Federal Government*, [GAO-05-325SP](#) (Washington, D.C.: February 2005).

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in the longer term.<sup>3</sup> 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 over the next 75 years. This gap is growing as time passes and, given this and other major fiscal challenges, including expected growth in federal health spending, 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 the quality of life of our children, grandchildren, and future generations of Americans.

Let me begin by highlighting a number of important points concerning the Social Security challenge and our broader fiscal and economic 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 helping to reduce 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. After all, the Social Security Trust Fund is a subaccount of the federal government rather than a private trust fund. Its assets are not readily marketable nor are they convertible into cash other than through raising revenues, cutting other

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<sup>3</sup>GAO, *Budget Issues: Long-Term Fiscal Challenges*, [GAO-02-467T](#) (Washington, D.C.: Feb. 27, 2002); *Social Security: Long-Term Financing Shortfall Drives Need for Reform*, [GAO-02-845T](#) (Washington, D.C.: June 19, 2002); *Social Security: Long-Term Challenges Warrant Early Action*, [GAO-05-303T](#) (Washington, D.C.: Feb. 3, 2005); and *Long-Term Fiscal Issues: The Need for Social Security Reform*, [GAO-05-318T](#) (Washington, D.C.: Feb. 9, 2005).

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government expenses, increasing debt held by the public, or some combination of these. Furthermore, 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.

- **Social Security reform is part of a broader fiscal and economic challenge.** If you look ahead in the federal budget, Social Security together with the rapidly growing health programs (Medicare and Medicaid) 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 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. Federal and state spending for Medicaid will especially be stressed by anticipated growing demand for long-term care services by the aging baby boom population. 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 from 8.5 percent of GDP today to 15.6 percent in 2030. 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 levels of pension coverage of the private sector workforce, the continued decline in the number of 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. Similarly, the growing demand for long-term care will also likely exacerbate current concerns regarding the provision and financing of these services. These include the potential for families to face the financially catastrophic costs of long-term care. In addition, the heavy reliance on unpaid care from family members and other informal caregivers already has led, in

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many cases, to severe personal burdens. This strain will likely be exacerbated, with possibly fewer caregivers available in the coming decades.

- **Acting sooner rather than later helps to ease the difficulty of change.** The challenge of facing the imminent and daunting budget pressure from Medicare, Medicaid, and Social Security increases over time. Social Security will begin to constrain the budget long before the trust fund is exhausted in 2042. The Social Security cash surpluses that are now helping to finance the rest of the government's budgetary needs will begin to decline in 2008, and by 2018, the cash surpluses will turn to deficits. Beginning in 2008, Social Security's declining cash flow will begin to place increasing pressure on the rest of the budget. In addition, starting in 2018, the government will have to either increase revenues, decrease other government spending, or increase debt held by the public to convert the bonds in the trust funds into cash in order to pay full benefits when due. 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 more modest while also being phased in so that future and near-term retirees will 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 reform proposal interact; every proposal will have pluses and minuses, and no plan will satisfy everyone on all dimensions. Reform elements can take a variety of shapes; examples include benefit reductions, like changing replacement rates, moving from wage to price indexation, or increasing the retirement age, increasing payroll taxes or the taxable wage base, and/or creating individual accounts. 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. However, any analyses of reform proposals should reflect the fact that the program faces a long-term actuarial deficit and that benefit reductions and/or revenue increases will be necessary to restore solvency. Therefore, it is important to establish the appropriate comparisons or benchmarks against which reforms should be measured. This requires looking at proposed reforms from at least two

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benchmarks—one that raises revenue to fund currently scheduled benefits (promised benefits) and one that adjusts benefits to a level supported by current tax financing (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.

Failure to address the Social Security financing problem will, in combination with other entitlement spending, lead to an unsustainable burden on both the federal government and, ultimately, the economy. 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. I also believe that it is possible to exceed the expectations of all generations of Americans. In addition, given our overall fiscal challenge and various trends in the private pension and personal savings areas, I believe it would be prudent to act sooner rather than later to address this large and growing problem.

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## Social Security's Long-term Financing Problem Is More Urgent Than It May Seem

Today, the Social Security program faces not an immediate crisis but rather a long-range financing problem driven primarily by known demographic trends. While the crisis is not immediate, the challenge is more urgent than it may appear since the program will experience increasing negative cash flow starting in 2018. Acting soon to address these problems reduces the likelihood that 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 both for the federal government and, ultimately, the economy.

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The Social Security system has required changes in the past to ensure its future solvency. Indeed, the Congress has always taken the actions necessary to do this when faced with an immediate solvency crisis. While such an immediate crisis will not occur for many years, waiting until it is imminent would not be prudent. I would like to spend some time describing the nature, timing, and extent of Social Security's financing problem.

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## The Nature 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 to the system's financial condition. Now, however, people are living longer, and spending more time in retirement.

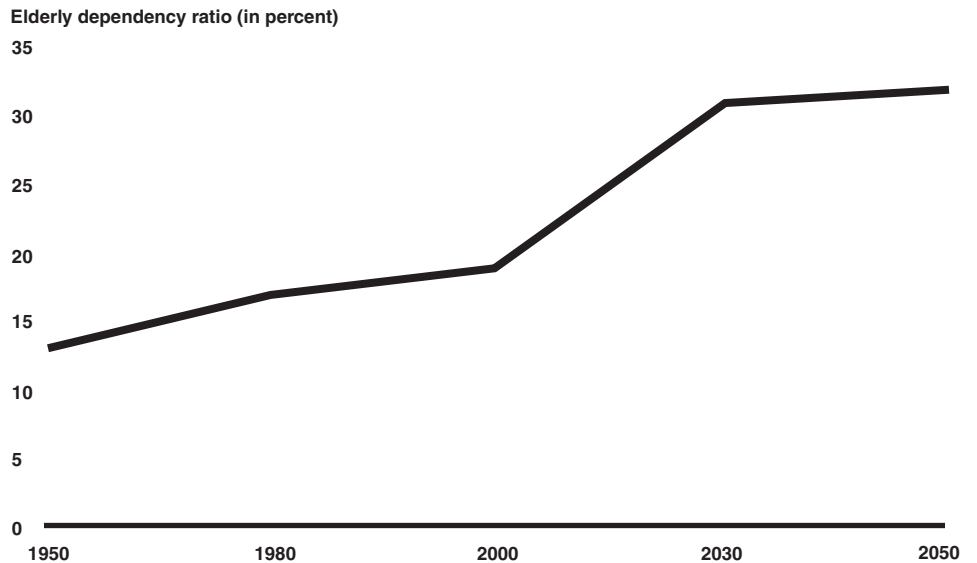
As shown in figure 1, the U.S. elderly dependency ratio is expected to continue to increase.<sup>4</sup> The proportion of the elderly population relative to the working-age population in the U.S. rose from 13 percent in 1950 to 19 percent in 2000. By 2050, there is projected to be almost 1 elderly dependent 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.

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<sup>4</sup>The elderly dependency ratio is the ratio of the population aged 65 years or over to the population aged 15 to 64.



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

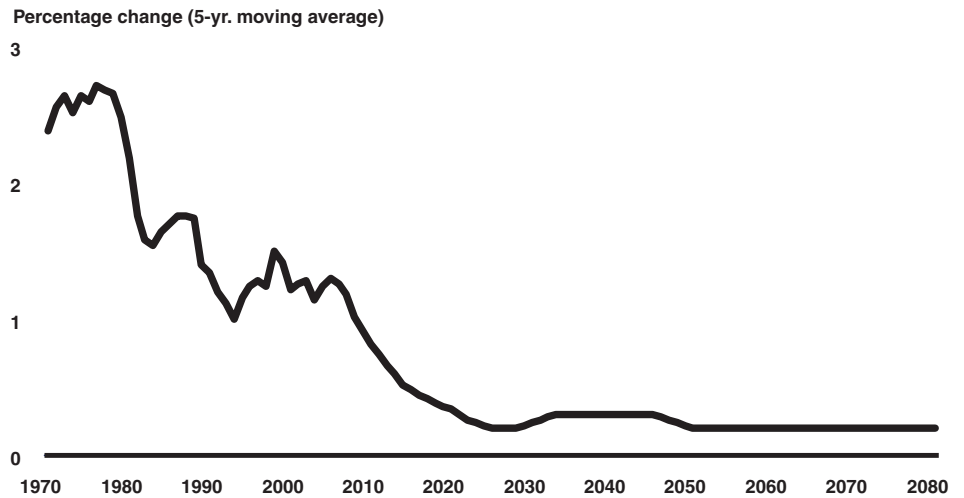


Source: Population Division of the Department of Economic and Social Affairs of the United Nations Secretariat, World Population Prospects: 2002 Revision, and World Urbanization Prospects: 2001 Revision.

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, which is the average number of children that would be born to women during their childbearing years, 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 what it takes to maintain a stable population. Taken together, these trends threaten the financial solvency and sustainability of Social Security.

The combination of these trends means that labor force growth will begin to slow after 2010 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 the goods and services that all will consume. Without a major increase in productivity or 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: Labor Force Growth Is Expected to Slow Significantly**



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

Note: Percentage change is calculated as a centered 5-yr 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.

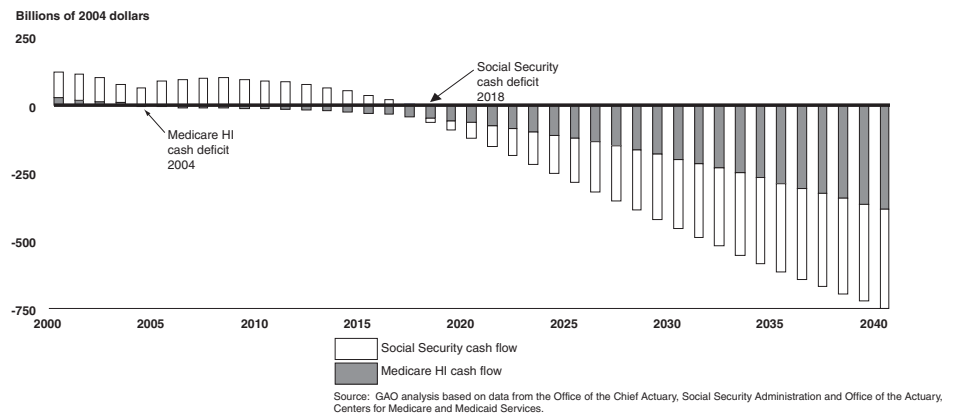
The Social Security program’s situation is one symptom of this larger demographic trend that will have broad and profound effects on our nation’s future in other ways as well. The aging of the labor force and the reduced growth in the number of workers will have important implications for the size and 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 a very different set of opportunities and challenges than that of previous generations. The slowdown in labor force growth can have very negative effects on our nation’s economic future, as relatively fewer workers will be producing the goods and services that everyone will consume. If people do choose to work longer this may mitigate the

expected slowdown in labor force growth, which could strengthen the nation's economic prospects.

## 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,<sup>5</sup> within the next few years, Social Security spending will begin to put pressure on the rest of the federal budget. 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 a permanent 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, 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**



In 2018, the combined OASDI Trust Funds will begin drawing on its

<sup>5</sup>Separately, the Disability Insurance (DI) fund is projected to be exhausted in 2029 and the Old-Age and Survivors' Insurance (OASI) fund in 2044. Using slightly different economic assumptions and model specifications, CBO estimated the combined Social Security trust fund will be solvent until 2052. See Congressional Budget Office, *The Outlook for Social Security* (Washington, D.C.: June 2004) and *Updated Long-Term Projections for Social Security* (Washington, D.C.: January 2005).

Treasury securities to cover the cash shortfall.<sup>6</sup> 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 Social Security’s long-term financing challenge, but they all illustrate a need for program reform sooner rather than later. A case can be made for a range of different measures, as well as different time horizons. For instance, the shortfall can be measured in present value, as a percentage of GDP, or as a percentage of taxable payroll. The Social Security Administration (SSA) has made projections of Social Security shortfall using different time horizons. (See table 1.)

**Table 1: Different Measures, Same Challenge**

Projection Horizon	SSA’s Projections of Unfunded OASDI Obligations		
	Present value	Percent of GDP	Percent of payroll
75 year	\$3.7 Trillion	0.7%	1.8%
Infinite horizon	\$10.4 Trillion	1.2%	3.5%

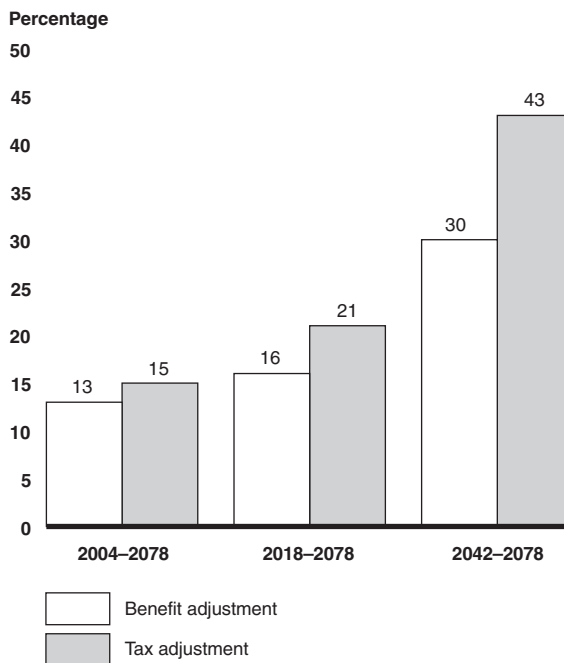
Sources: Social Security Administration, *The 2004 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds*. Washington, D.C., March 2004.

While the estimates vary due to different horizons, both identify 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 for the

<sup>6</sup> CBO estimates that OASDI cash flow will turn negative in 2020.

period 2042-2078. As figure 4 shows, earlier action shrinks the size of the necessary adjustment. However, these changes do not achieve sustainable solvency, they only achieve solvency through 2078.

**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 January 1st of the first year indicated to December 31, 2078.

## 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

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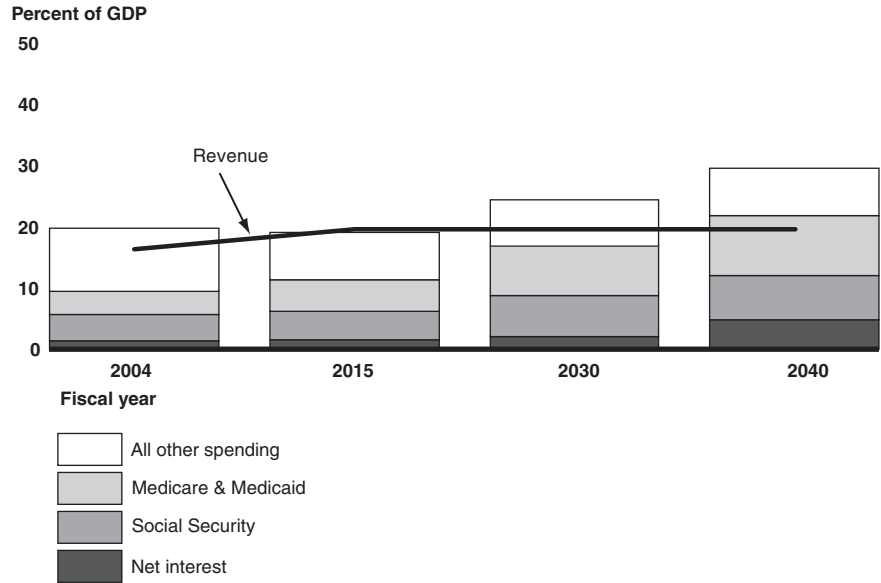
mandatory programs plus net interest accounted for about 33 percent of total federal spending. By 2004, this share had almost doubled to approximately 61 percent of the budget.

GAO's long-term simulations illustrate the magnitude of the fiscal challenges associated with an aging society and the significance of the related challenges the government will be called upon to address. Figures 5 and 6 present these simulations under two different sets of assumptions. In figure 5, we begin with CBO's January baseline – constructed according to the statutory requirements for that baseline.<sup>7</sup> Consistent with these requirements, discretionary spending is assumed to grow with inflation for the first 10 years and tax cuts scheduled to expire are assumed to expire. After 2015, discretionary spending is assumed to grow with the economy, and revenue is held constant as a share of GDP at the 2015 level. In figure 6 two assumptions are changed: discretionary spending is assumed to grow with the economy after 2005 rather than merely with inflation and the tax cuts are extended. For both simulations Social Security and Medicare spending is based on the 2004 Trustees' intermediate projections, and we assume that benefits continue to be paid in full after the trust funds are exhausted. Medicaid spending is based on CBO's December 2003 long-term projections under mid-range assumptions.

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<sup>7</sup>The Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2006 to 2015*, (Washington, D.C.: January 2005).

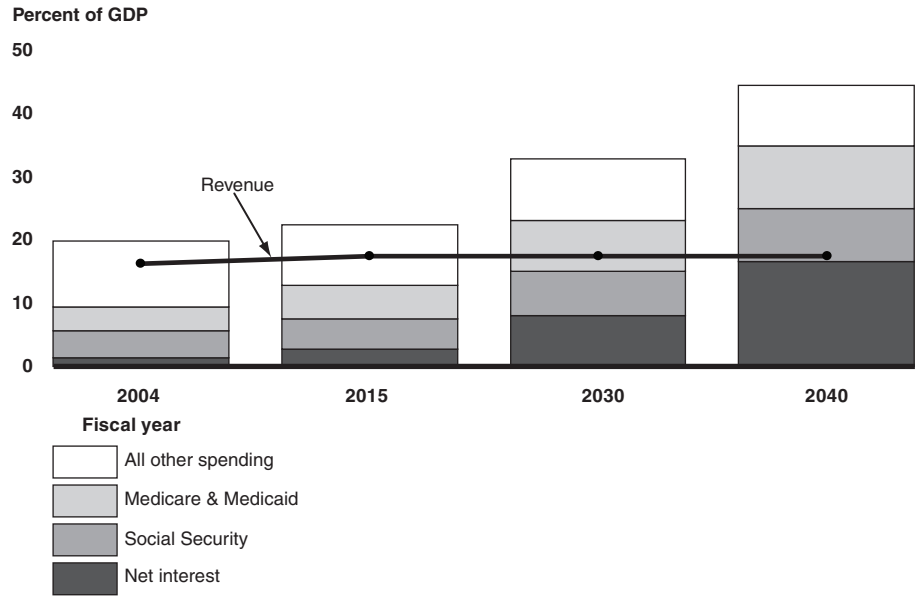
**Figure 5: Composition of Spending as a Share of Gross Domestic Product (GDP) Assuming Discretionary Spending Grows with GDP after 2005 and All Existing Tax Cuts Expire**



Source: GAO's January 2005 analysis.

Notes: In addition to the expiration of tax cuts, revenue as a share of GDP increases through 2015 due to (1) real bracket creep, (2) more taxpayers becoming subject to the AMT, and (3) increased revenue from tax-deferred retirement accounts. After 2015, revenue as a share of GDP is held constant.

**Figure 6: Composition of Spending as a Share of GDP Assuming Discretionary Spending Grows with GDP after 2005 and All Expiring Tax Provisions Are Extended**



Source: GAO's January 2005 analysis

Notes: Although expiring tax provisions are extended, revenue as a share of GDP increases through 2015 due to (1) real bracket creep, (2) more taxpayers becoming subject to the AMT, and (3) increased revenue from tax-deferred retirement accounts. After 2015, revenue as a share of GDP is held constant.

Both these simulations illustrate that, absent policy changes, the growth in spending on federal retirement and health entitlements will encumber an escalating share of the government's resources. Indeed, when we assume that recent tax reductions are made permanent and discretionary spending keeps pace with the economy, our long-term simulations suggest that by 2040 federal revenues may be adequate to pay little more than interest on the federal debt. Neither slowing the growth in discretionary spending nor allowing the tax provisions to expire—nor both together—would eliminate the imbalance. Although revenues will be part of the debate about our fiscal future, the failure to reform Social Security, Medicare, Medicaid, and other drivers of the long term fiscal gap would require at least a doubling of taxes—and that seems implausible. Accordingly, substantive reform of Social Security and our major health programs remains critical to recapturing our future fiscal flexibility.

Alternatively, taking action soon on Social Security would not only promote increased budgetary flexibility in the future and stronger



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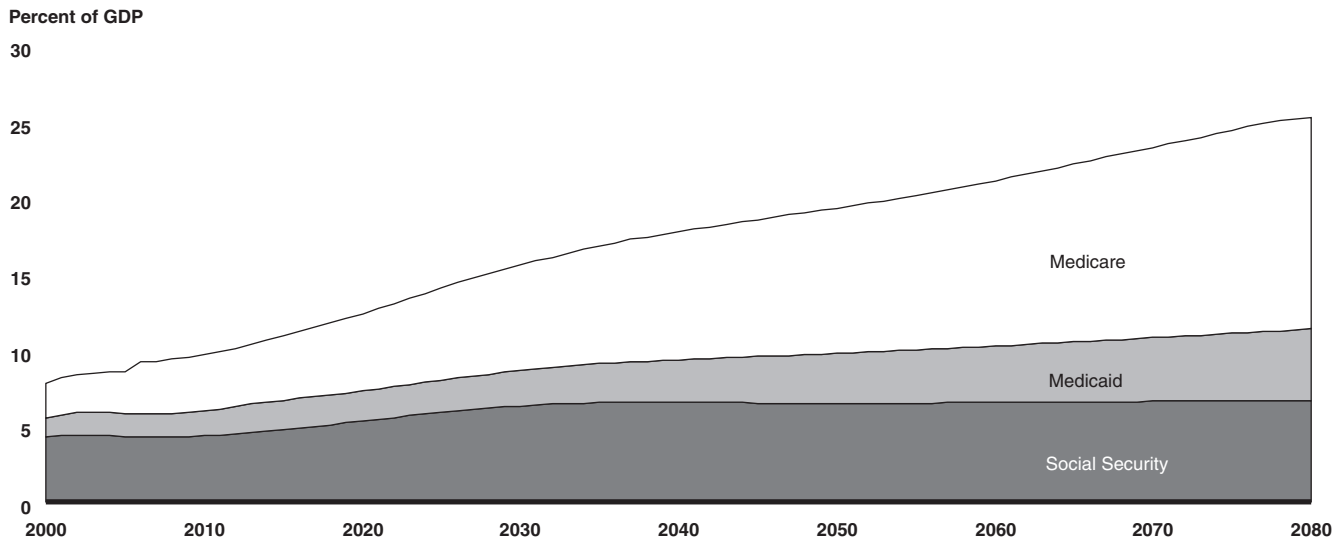
economic growth but would also make the necessary action less dramatic than if we wait. Indeed, long-term budget flexibility is about more than Social Security and Medicare. While these programs dominate the long-term outlook, they are not the only federal programs or activities that bind the future. 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.<sup>8</sup> Making government face and address 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, how it does it, and how it finances its operations is both needed and overdue.

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 7.) Taken together, Social Security, Medicare, and Medicaid represent an unsustainable burden on future generations of Americans.

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<sup>8</sup>GAO, *Fiscal Exposures: Improving the Budgetary Focus on Long-Term Costs and Uncertainties*, [GAO-03-213](#) (Washington, D.C.: Jan 24, 2003).

**Figure 7: Social Security, Medicare, and Medicaid Spending as a Percentage 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 projections based on CBO's January 2005 short-term Medicaid estimates and CBO's December 2003 long-term Medicaid projections under mid-range assumptions.

The government can help ease future fiscal burdens through spending or revenue actions that reduce debt held by the public, thereby saving for the future and enhancing the pool of economic resources available for private investment and long-term growth. Economic growth can help, but given the size of our projected fiscal gap we will not be able to simply grow our way out of the problem. Closing the current long-term fiscal gap would require sustained economic growth far beyond that experienced in U.S. economic history since World War II. Tough choices are inevitable, and the sooner we act, the better.

## 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

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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. Because the program is so deeply woven into the fabric of our nation, any proposed reform must consider the program in its entirety, rather than one aspect alone. To assist policymakers, GAO has developed a broad framework for evaluating reform proposals that considers solvency as well as other aspects of the program. Our criteria aim to balance financial and economic considerations with benefit adequacy and equity issues and the administrative challenges associated with various proposals.

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## GAO Framework For Evaluating Reform Proposals

GAO developed an analytic framework to assess reform proposals using three basic criteria:

- **Financing Sustainable Solvency** – the extent to which a proposal achieves sustainable solvency and how it would affect the economy, the federal budget, and national saving. 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 these two goals. From the beginning, Social Security benefits were set in a way that focused especially on replacing some portion of workers’ preretirement earnings. Over time other changes were made that were intended to enhance the program’s role in helping

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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. 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. While these issues may seem technical or routine on the surface, they are important. In particular, if these issues are not considered early enough for planning purposes, they could potential delay—if not derail—reform. 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 policymakers 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. As we have noted in the past, 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.

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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.<sup>9</sup> Currently promised benefits are not fully financed, and so any analysis that seeks to fairly evaluate reform proposals should include comparisons to 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.

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## Reform's Potential Effects on the Social Security Program

A variety of proposals have been offered to address Social Security's financial problems. Some of these proposals work within the current structure of Social Security and others would restructure the program. For instance, many proposals contain reforms that would alter benefits or revenues within the structure of the current defined benefits system. Also, a number of proposals seek to restructure the program through the creation of individual accounts. The discussion about examples of reform in this section are meant for illustrative purposes, and are by no means intended to be exhaustive of all the reform options proposed or the issues related to these approaches.

Some proposals would reduce benefits relative to scheduled benefits by modifying the benefit formula. For example, increasing the number of years used to calculate benefits or using price-indexing instead of wage-

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<sup>9</sup>GAO, *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).

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indexing would reduce the benefits individuals receive. Since wages generally grow faster than prices, indexing earnings to prices rather than wages would reduce the measure of average lifetime earnings used in the formula—reducing benefits. Changing the number of working years used to calculate benefits to include more than the highest 35 years of earnings would reduce the average lifetime earnings; thus, reducing benefits as compared to current levels. Other proposals include options to reduce cost-of-living adjustments (COLA) by lowering the COLA to less than the CPI, limiting the COLA to a specified threshold, or delaying the COLA; to raise the normal and/or early retirement ages or to reduce benefits more for workers who retire before the full retirement age; and to 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 options that would provide revenue increases. For example, raising the payroll tax or expanding the Social Security taxable wage base that finances the system would result in more revenue coming into the system. In 2005, earnings above \$90,000 are not subject to payroll taxes. If the cap were raised and the benefit formula remained the same, workers with earnings above the old cap would ultimately receive somewhat higher benefits as well as pay more taxes. Other options to increase revenues include increasing the taxation of benefits or covering those few remaining workers not currently required to participate in Social Security, such as some state and local government employees, although such new participants would increase future spending commitments as well. In addition to these proposals, Social Security can obtain revenues from sources outside of the program, such as by increasing the investment returns on Social Security holdings or by earmarking revenue from estate taxes or other sources.

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 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

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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—an increase in revenue, a decrease in benefits, or both will also be necessary. 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 these accounts are financed through borrowing, prefunding will not be achieved until the additional debt has been repaid.<sup>10</sup> 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 resources to make up the difference.

Some degree of implementation and administrative complexity arises in virtually all proposed changes to Social Security. 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. 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

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<sup>10</sup>After the accounts have been established and the transition costs have been repaid prefunding may be achieved, but this is likely not to happen for many decades.

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significantly larger and more complex than 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 through payroll deductions to millions of workers who currently lack private pension coverage.

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## Social Security Reform Should be Considered in the Context of Broader Challenges

Other broader concerns for Social Security reform include evaluating a proposal's effect on national saving and a proposal's implications for other sources of retirement income, access to long-term care and retirement security generally. An important economic consideration is assessing a proposal's effect on national saving. Individual account proposals designed as a carve-out that finance accounts through the 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. Individual accounts that are structured as "add-ons" may increase saving. However, this will depend on how the accounts are financed and how they are structured i.e. do they target low income workers who currently may not have high saving rates. Individual accounts that achieve prefunding without borrowing might increase government and individual saving. The effect of individual accounts on national saving will also be affected by other elements, such as benefit cuts or tax increases, that are part of the overall reform package.

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 higher deficits that result from redirecting payroll taxes to individual accounts could prompt changes in fiscal policy that reduce spending or increase revenue thereby resulting in lower deficits that would otherwise have been the case and increase net 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.



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Besides the effect on savings, Social Security reform proposals may also have implications for retirement security in general. Economic security in retirement requires both adequate retirement income—Social Security, pensions, personal savings, and earnings from continued employment—and affordable health care—Medicare and retiree health care; and long-term care coverage. In addition to the issues I have discussed regarding the financing challenges that Social Security, Medicare and Medicaid face, the nation also faces serious challenges associated with the private pension system and long-term care financing.

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 which provides a foundation of certain and secure retirement income.

In 2002, GAO reported that the total number of disabled elderly could be as high as 12.1 million, by 2040. Long-term care includes an array of health, personal care, and supportive services provided to persons with physical or mental disabilities. It relies heavily on financing by public payers, especially Medicaid, and has significant implications for state budgets as well as the federal budget.

Current problems with the provision and financing of long-term care could be exacerbated by the swelling numbers of the baby-boom generation needing care. These problems include whether individuals with disabilities receive adequate services, the potential for families to face financially catastrophic long-term care costs, and the burdens that heavy reliance on unpaid care from family members and other informal caregivers create coupled with possibly fewer caregivers available in coming generations.

Given the broader fiscal challenges that our nation faces and the potential future changes to Social Security, Medicare, and Medicaid, as well as the

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state of private pensions and long-term care trends, it is even more important that individuals are educated about what to expect in retirement. In this respect, 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.

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## 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 fiscal challenge that includes, among other things, the need to reform Medicare, Medicaid, and our overall health care system.

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. We have an opportunity to address Social Security as a first step toward improving the nation's long-term fiscal outlook. 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. As I have said before, the future sustainability of programs is the key issue policy makers should address—i.e., the capacity of the economy and budget to afford the commitment over time. Absent substantive reform, these important federal programs will not be sustainable. Furthermore, absent reform, younger workers will face dramatic benefit reductions or tax increases that will grow over time.

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Irrespective of when Social Security reform may occur and what form it may take, other Social Security related issues also need to be explored. These include, but are not limited to, the current accounting/reporting and budget treatment of Social Security and the related trust funds; its current investment options and strategy, and the current composition of the Social Security Board of Trustees.

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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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