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SOCIAL SECURITY REFORM

Analysis of a Trust Fund Exhaustion Scenario Illustrates the Difficult Choices and the Need for Early Action

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Highlights

Highlights of GAO-03-1038T, a testimony for the Special Committee on Aging, United States Senate

SOCIAL SECURITY REFORM

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Why GAO Did This Study

Social Security is an important social insurance program affecting virtually every American family. It is the foundation of the nation's retirement income system and also provides millions of Americans with disability insurance and survivors' benefits. Over the long term, as the baby boom generation retires, Social Security's financing shortfall presents a major program solvency and sustainability challenge.

The Chairman of the Senate Special Committee on Aging asked GAO to discuss Social Security's long-term financing challenges and the results of GAO's analysis of an illustrative "Trust Fund Exhaustion" scenario. Under this scenario, benefits are reduced proportionately for all beneficiaries by the shortfall in revenues occurring upon exhaustion of the combined Old-Age and Survivors Insurance and Disability Insurance Trust Funds. This scenario was developed for analytic purposes and is not a legal determination of how benefits would be paid in the event of trust fund exhaustion. GAO's analysis used the framework it has developed to analyze the implications of reform proposals. This framework consists of three criteria: (1) the extent to which the proposal achieves sustainable solvency and how it would affect the U.S. economy and the federal budget, (2) the balance struck between the twin goals of income adequacy and individual equity, and (3) how readily changes could be implemented, administered, and explained to the public.

www.gao.gov/cgi-bin/getrpt?GAO-03-1038T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Barbara Bovbjerg at (202) 512–5491 or Susan Irving at (202) 512-9142.

What GAO Found

Although the Trustees' 2003 intermediate estimates show that the combined Social Security Trust Funds will be solvent until 2042, program spending will constitute a growing share of the budget and the economy much sooner. Within 5 years, the first baby boomers will become eligible for Social Security. By 2018, Social Security's tax income is projected to be insufficient to pay currently scheduled benefits. This 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. In the long term, Social Security, together with rapidly growing federal health programs, will dominate our nation's fiscal outlook. Absent reform, the nation will ultimately have to choose between persistent, escalating federal deficits, significant tax increases, and/or dramatic budget cuts of unprecedented magnitude.

The Trust Fund Exhaustion scenario we analyzed dramatically illustrates the need for action sooner rather than later. (See *Social Security Reform: Analysis of a Trust Fund Exhaustion Scenario*. GAO-03-907. Washington, D.C.: July 29, 2003.) Under this scenario, after the combined trust funds had been fully depleted, benefit payments would be adjusted each year to equal annual tax income. Under this scenario, after trust fund exhaustion those receiving benefits would experience large and sudden benefit reductions. Additional smaller reductions in the following years would result in benefits equal to about two-thirds of currently scheduled levels by the end of the 75-year simulation period.

The Trust Fund Exhaustion scenario raises significant intergenerational equity issues. The timing of the benefit adjustments means the Trust Fund Exhaustion scenario places a much greater burden on younger generations. Lifetime benefits would be reduced much more for younger generations. In addition, under the Trust Fund Exhaustion scenario, benefits would be adjusted proportionately for all recipients, increasing the likelihood of hardship for lower income retirees and the disabled, especially those who rely on Social Security as their primary or sole source of retirement income.

Fundamentally, the Trust Fund Exhaustion scenario illustrates trade-offs between achieving sustainable solvency and maintaining benefit adequacy. The longer we wait to take action, the sharper these trade-offs will become. 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." Finally, 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.

Mr. Chairman and Members of the Committee:

Thank you for inviting me here to talk about 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 survivors' benefits. As a result, Social Security provides benefits that are critical to the current and future well-being of tens of millions of Americans. As I have said in congressional testimonies over the past several years,[1] this important program faces both solvency and sustainability challenges in the longer term that require our attention today.

Last January, I testified before this Committee on the need for early action to reform Social Security.[2] That testimony presented GAO's analysis of the reform models developed by the President's Commission to Strengthen Social Security. Since that time, the Social Security Trustees have issued their 2003 report, which showed that the program's financial condition remains virtually unchanged since last year. Under the Trustees' 2003 intermediate estimates, the actuarial balance of the combined trust funds[3] over the 75-year period deteriorated from last year's estimate of –1.87 percent of taxable payroll to this year's estimate of –1.92 percent of taxable payroll. The present value of this actuarial deficit is $3.8 trillion over the 75-year period. Absent legislative action, within 15 years projected Social Security outlays will begin to exceed projected tax receipts, and by 2042 the combined Old-Age and Survivors Insurance and Disability Insurance (OASDI) trust funds are projected to be exhausted. These new estimates once more underscore the program's unsustainability as Social Security continues to await reform.

Today we are issuing a report you requested using the same criteria and framework we used in our report on the Commission reform models to

[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); *Social Security: Long-Term Financing Shortfall Drives Need for Reform* GAO-02-845T (Washington, D.C.: June 19, 2002).

[2] U.S. General Accounting Office, *Social Security: Analysis of Issues and Selected Reform Proposals*, GAO-3-376T (Washington, D.C.: Jan. 15, 2003).

[3] In this testimony, the term "trust funds" refers to the combined Old-Age and Survivors Insurance and Disability Insurance (OASDI) Trust Funds.

analyze the potential effects over the long term if no program reform takes place. [4] For this analysis, we applied our criteria to a scenario in which the Trust Fund reaches exhaustion, after which only benefits equal to cash available from program income are paid. The scenario illustrates some potential outcomes of a lack of action to address the serious imbalance between Social Security's projected revenues and the costs of paying currently scheduled benefits.

Before I summarize the findings from this analysis, let me first highlight a number of important points in connection with the Social Security challenge.

- **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 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.[5]

- **Social Security reform is part of a broader fiscal and economic challenge**. If you look ahead in the federal budget, the combined Social Security or 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.

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[4] As in our report on the Commission reform models, we used the 2001 Trustees' intermediate assumptions in analyzing the Trust Fund Exhaustion scenario.

[5] In addition to assessing a proposal's likely effect on Social Security's actuarial balance, a standard of sustainable solvency involves looking at (1) the balance between program income and cost beyond the 75th year and (2) the share of the budget and economy consumed by Social Security spending.

- **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 46 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 over 68 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.

- **Acting sooner rather than later would help 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 in 2042. The program's annual cash flow is projected to be negative beginning in 2018. 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 to only those choices that are the most difficult. It could also contribute to further delay the really tough decisions on health programs (e.g., Medicare, Medicaid). 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." It would also help to assure that the "miracle of compounding" works for us rather than against us. Finally, 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.

  The Trust Fund Exhaustion scenario analyzed in our report[6] dramatically illustrates the need for action sooner rather than later. Under this scenario, once the combined trust funds had been fully depleted, benefit payments would be adjusted each year to equal annual tax income. [7] After

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[6] U.S. General Accounting Office, *Social Security Reform: Analysis of a Trust Fund Exhaustion Scenario*, GAO-03-907 (Washington, D.C.: July 29, 2003).

[7] The Trust Fund Exhaustion scenario is intended as an analytic tool, not a legal determination.

trust fund exhaustion, those receiving benefits would experience a large and sudden benefit reduction of about 27 percent (to 73 percent of currently scheduled levels) in 2039.[8] By the end of the 75-year period, smaller reductions in successive years after trust fund exhaustion would mean that benefits would be about two-thirds of what they would have been under current benefit formulas (or 67 percent of currently scheduled levels).

The Trust Fund Exhaustion scenario raises significant intergenerational equity issues. The timing of the benefit adjustments means the Trust Fund Exhaustion scenario places a much greater burden on younger generations. For example, those born in 1955 would receive currently scheduled benefits until they reached age 83, while those born in 1985 would always receive benefits in retirement lower than currently scheduled benefits. This means that lifetime benefits would be reduced more for younger generations. In addition, under the Trust Fund Exhaustion scenario, benefits would be adjusted proportionately for all recipients, increasing the likelihood of hardship for lower income retirees and the disabled, especially those who rely on Social Security as their primary or sole source of retirement income.

As we all know, 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. Social Security provides a foundation of retirement income for millions of Americans and has prevented many former workers and their families from living their retirement years in poverty. Proposals to restore the long-term financial stability and viability of the Social Security system must also be considered in terms of how potential changes affect different types of beneficiaries. The Trust Fund Exhaustion scenario illustrates trade-offs between the criterion of achieving sustainable solvency and the criterion of maintaining benefit adequacy and equity. The longer we wait to take action, the sharper these trade-offs will become. We need to put the

[8] In our analysis of the Trust Fund Exhaustion scenario, as in our January report on the Commission models, we used the Trustees' 2001 intermediate assumptions, under which the combined OASDI trust funds are projected to reach exhaustion in 2038. Under the 2001 intermediate assumptions, in 2038 the benefit reduction would be about 7 percent because trust fund assets would be available for part of the year to pay benefits. In 2039, the first full year after trust fund exhaustion, benefits would fall sharply, to about 27 percent (or 73 percent of currently scheduled levels). Under the Trustees' 2003 intermediate assumptions, the projected exhaustion date for the combined trust funds is 2042, and the overall drop is approximately the same.

program on a path toward sustainable solvency as soon as possible to assure that future policymakers would not have to face these difficult questions on a recurring basis.

I hope my testimony will help clarify some of the key issues in the debate about how to restructure this critically important program.

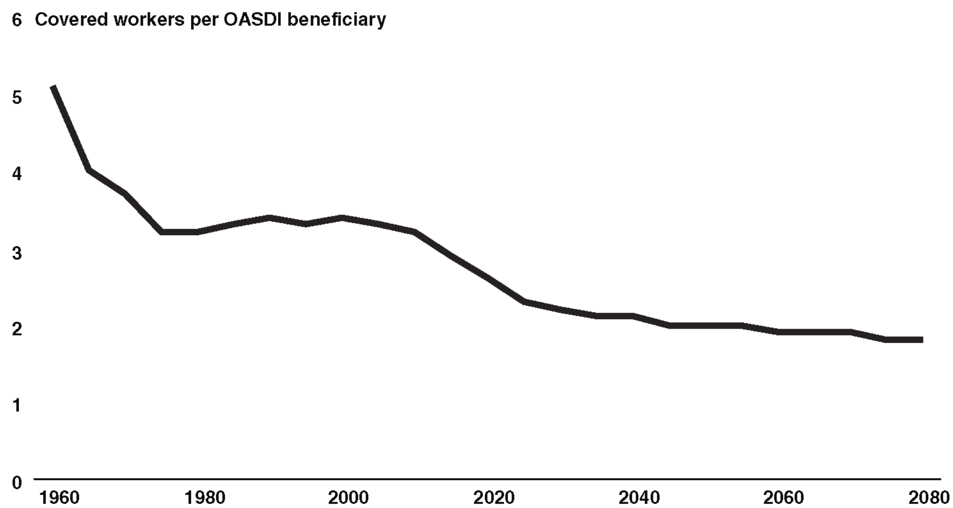
Social Security's Long-Term Financing Problem Is Truly Urgent

Today the Social Security program faces a long-range and 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. 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 1950, before the Social Security system was mature, the ratio was 16.5:1. In the 1960s, the ratio averaged 4.2:1. Today it is 3.3:1 and it is expected to drop to around 2.2:1 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

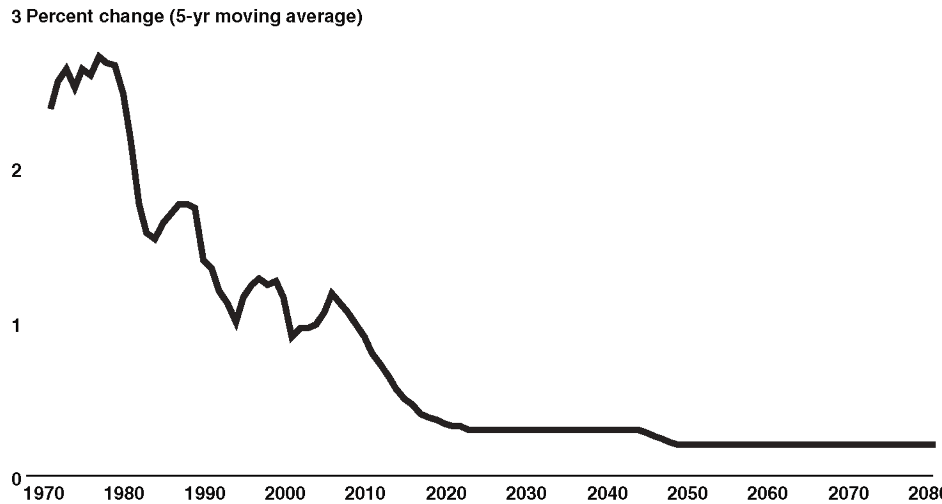


Source: *The 2003 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds.*

Note: Projections based on the intermediate assumptions of the *2003 Trustees' Report*.

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 third of what it is today. (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



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

Note: GAO analysis based on the intermediate assumptions of *The 2003 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and the Federal Disability Insurance Trust Funds*. Percentage change is calculated as a centered 5-year moving average.

This slowing labor force growth is not always recognized 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.

Social Security's Cash Flow Is Expected To Turn Negative in 2018

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. Although the Trustees' 2003 intermediate estimates project that the combined Social Security Trust Funds will be solvent until 2042,[9] program spending will constitute a rapidly growing share of the budget and the economy well before that

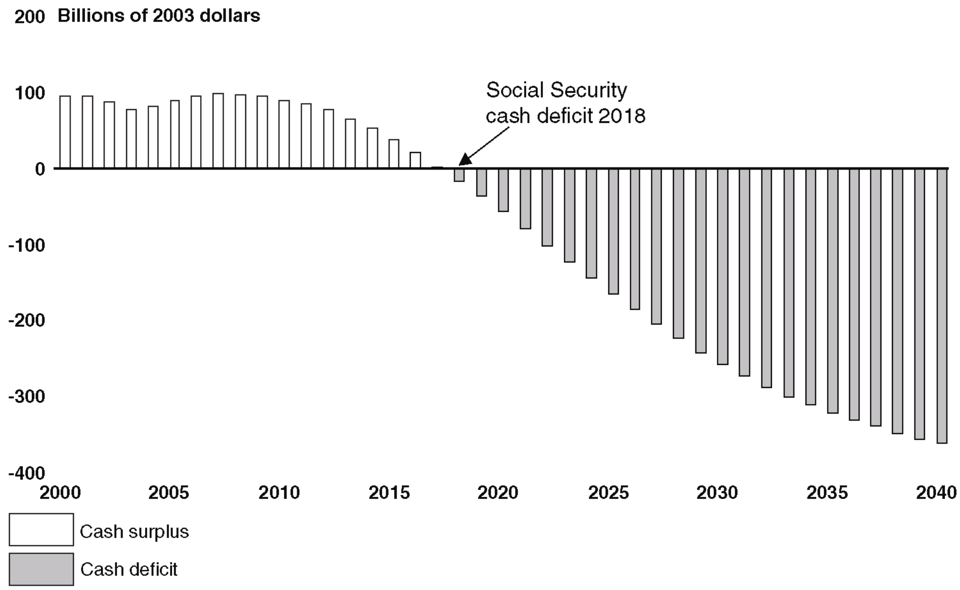
[9] Separately, the DI fund is projected to be exhausted in 2028 and the OASI fund in 2044.

date. In 2008, the first baby boomers will become eligible for Social Security benefits, and the future costs of serving them are already becoming a factor in the Congressional Budget Office's (CBO) 10-year projections. Under the Trustees' 2003 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 2009. To finance the same level of federal spending as in the previous year, additional revenues and/or increased borrowing will be needed.

By 2018, Social Security's tax income is projected to be insufficient to pay currently scheduled benefits. At that time, Social Security will join Medicare's Hospital Insurance Trust Fund (whose outlays are projected to begin to exceed revenues in 2013) as a net claimant on the rest of the federal budget. The combined OASDI 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. The Treasury will need to obtain cash for those redeemed securities either through increased taxes, and/or spending cuts, and/or more borrowing from the public than would have been the case had Social Security's cash flow remained positive.[10] Neither the decline in the cash surpluses nor the cash deficit will affect the payment of benefits. The shift from positive to negative cash flow, however, will place increased pressure on the federal budget to raise the resources necessary to meet the program's ongoing costs.

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

Figure 3: Social Security's (OASDI) Trust Funds Face Cash Deficits as Baby Boomers Retire



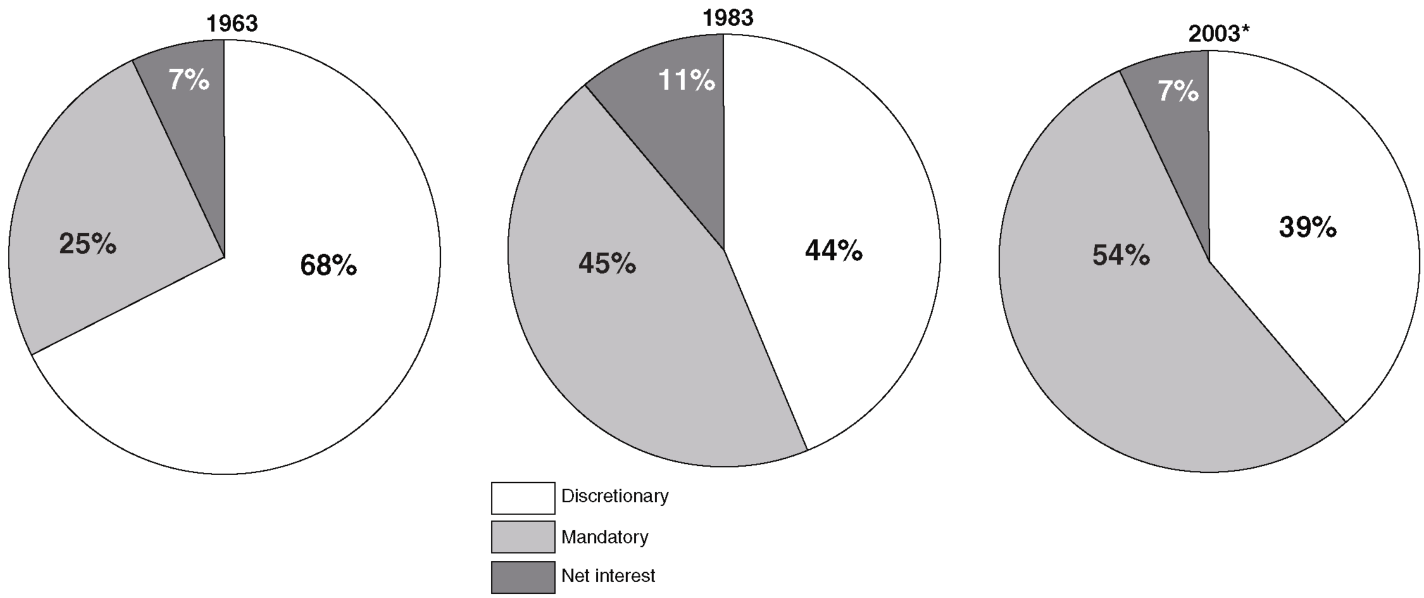
Source: GAO analysis of data from the Office of the Chief Actuary, Social Security Administration, based on the intermediate assumptions of *The 2003 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and the Federal Disability Insurance Trust Funds.*

Ultimately, the critical question is not how much a trust fund has in assets, but whether the government as a whole can afford the 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.

Decline in Budgetary Flexibility 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. In 1963, prior to the creation of the Medicare and Medicaid programs, spending for mandatory programs plus net interest accounted for about 32 percent of total federal spending. By 2003, this share had almost doubled to approximately 61 percent of the budget. (See fig. 4.)

Figure 4: Federal Spending for Mandatory and Discretionary Programs, Fiscal Years 1963, 1983, and 2003



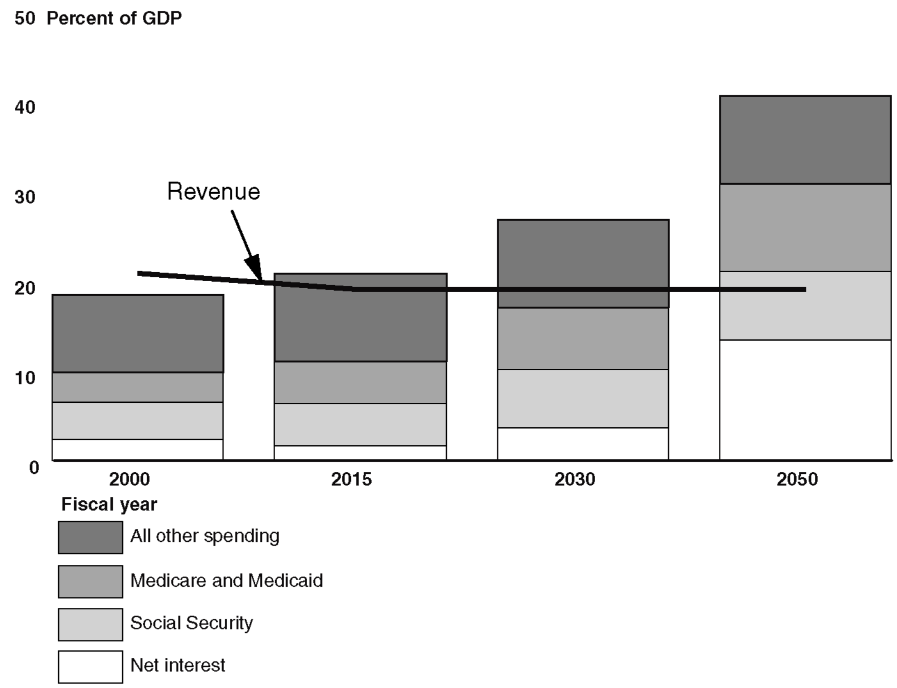
Source: *Budget of the United States: Fiscal Year 2004*, Office of Management and Budget, and GAO analysis of data from the Congressional Budget Office for FY2003.

*Estimate for 2003 includes $41 billion in discretionary spending and about $1 billion in mandatory spending for the Iraq war supplemental. Includes $11 billion in mandatory spending for the Jobs and Growth Tax Relief Reconciliation Act of 2003.

In much of the last decade, reductions in defense spending helped accommodate the growth in these entitlement programs. Even before the events of September 11, 2001, however, this ceased to be a viable option. Indeed, spending on defense and homeland security will grow as we seek to combat new threats to our nation's security.

GAO prepares long-term budget simulations that seek to illustrate the likely fiscal consequences of the coming demographic tidal wave and rising health care costs. These 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 in 2001 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.[11] To obtain balance, massive spending cuts, tax increases, or some combination of the two would be necessary. (See fig. 5.) Neither slowing the growth of discretionary spending nor allowing the tax reductions to sunset eliminates the imbalance.

Figure 5: Composition of Spending as a Share of Gross Domestic Product (GDP) Assuming Discretionary Spending Grows with GDP, the 2001 Tax Cuts Do Not Sunset, and Payment of Currently Scheduled Social Security Benefits



Source: GAO's March 2003 analysis.

Note: Assumes currently scheduled Social Security benefits are paid in full throughout the simulation period. Social Security and Medicare projections are based on the Trustees' 2003 intermediate assumptions.

Although this figure assumes payment of currently scheduled Social Security benefits, the long-term fiscal imbalance would not be eliminated even if Social Security benefits were to be limited to currently projected

[11] This simulation assumes that all currently scheduled benefits would be paid in full throughout the 75-year projection period. The simulation does not reflect the effects of any legislation enacted after March 2003, e.g., the tax reductions in the Jobs and Growth Tax Relief Reconciliation Act of 2003.

trust fund revenues. This is because Medicare (and Medicaid)—spending for which is driven by both demographics and rising health care costs—present an even greater problem.

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. 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. GAO is developing a health care framework to help focus additional attention on this important area and to help educate key policymakers and the public on the current system and related challenges.

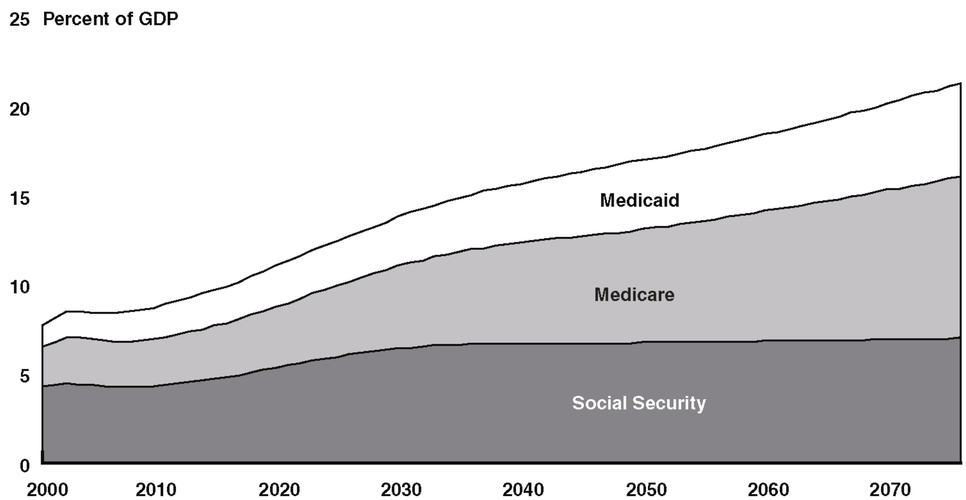
Indeed, long-term budget flexibility is about more than Social Security and Medicare. While these programs dominate the long-term outlook, they are not the only federal programs or activities that bind the future. The federal government undertakes a wide range of programs, responsibilities, and activities that obligate it to future spending or create an expectation for spending. A recent GAO report describes 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.[12] Making government fit the challenges of the future will require not only dealing with the drivers—entitlements for the elderly—but also looking at the range of federal activities. A fundamental review of what the federal government does and how it does it will be needed.

At the same time it is important to look beyond the federal budget to the economy as a whole. Figure 6 shows the total future draw on the economy represented by Social Security, Medicare, and Medicaid. Under the 2003 Trustees' intermediate estimates and CBO's long-term Medicaid estimates, spending for these entitlement programs combined will grow to 14 percent

[12]U.S. General Accounting Office, *Fiscal Exposures: Improving the Budgetary Focus on Long-Term Costs and Uncertainties*, GAO-03-213 (Washington, D.C.: Jan. 24, 2003).

of GDP in 2030 from today's 8.4 percent. Taken together, Social Security, Medicare, and Medicaid represent an unsustainable burden on future generations.

Figure 6: Social Security, Medicare, and Medicaid Spending as a Percent of GDP



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

Note: Projections based on the intermediate assumptions of the *2003 Trustees' Reports*, CBO's March 2003 short-term Medicaid estimates, and CBO's June 2002 long-term Medicaid projections under midrange assumptions.

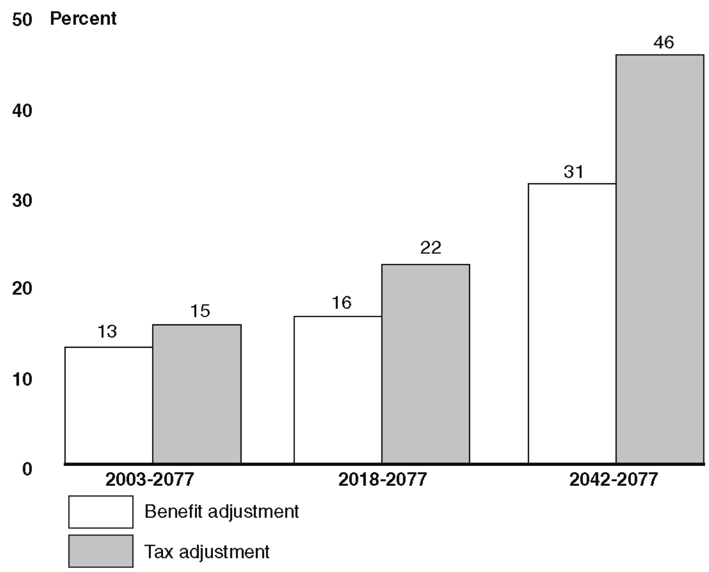
When Social Security redeems assets to pay benefits, the program will constitute a claim on real resources in the future. As a result, taking action now to increase the future pool of resources is important. To echo Federal Reserve Chairman Greenspan, the crucial issue of saving in our economy relates 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, i.e., as the economy returns to a higher growth path, a much more balanced and disciplined fiscal policy that recognizes our long-term challenges can help provide a strong foundation for future economic growth and can enhance future budgetary flexibility. In the short term, we need to realize that we

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

are already facing a huge fiscal hole (gap). The first thing that we should do is stop digging.

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. Some of the benefits of early action—and the costs of delay—can be seen in figure 7. This compares what it would take to achieve actuarial balance at different points in time by either raising payroll taxes or reducing benefits.[14] If we did nothing until 2042—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 46 percent. As figure 7 shows, earlier action shrinks the size of the adjustment.

Figure 7: Size of Action Needed to Achieve Social Security Solvency



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

Note: Based on the intermediate assumptions of the *2003 Trustees' Report*. The benefit adjustments in this graph represent a one-time, permanent change to all existing and future benefits beginning in the first year indicated.

[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 7.

Thus both sustainability concerns and solvency considerations drive us to act sooner rather than later. Trust Fund exhaustion may be almost 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 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 $454 billion in benefits to more than 46 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

Our sustainable solvency standard encompasses several different ways of looking at the Social Security program's financing needs. While 75-year actuarial balance is generally 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 cost beyond the 75th year and (2) the share of the budget and economy consumed by Social Security spending.

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' preretirement 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

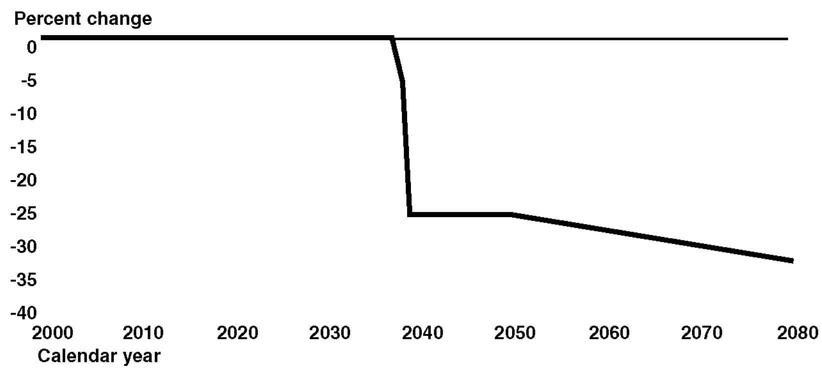
Program complexity makes implementation and administration both more difficult and harder to explain to the public. Some degree of implementation and administrative complexity arises in virtually all proposed changes to Social Security, even those that make incremental changes in the already existing 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. 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.

Social Security's Long-Term Financing Shortfall Requires Action Sooner Rather Than Later

As you requested, we applied our criteria to a scenario of Trust Fund Exhaustion. This scenario dramatically illustrates the need to take action sooner rather than later to address the program's long-term fiscal imbalance. Under this scenario, currently scheduled benefits would be paid in full until the combined OASDI Trust Funds are exhausted. After exhaustion, monthly benefit checks are reduced in proportion to the annual shortfall. In effect, after trust fund exhaustion, all beneficiaries would experience a sharp drop in benefits. Additional reductions in the following years would result in benefits equal to about two-thirds of currently scheduled levels by the end of the 75-year simulation period. (See fig. 8.)

Figure 8: Change in Currently Scheduled Benefits under the Trust Fund Exhaustion Scenario



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

We used our long-term economic model in assessing the Trust Fund Exhaustion scenario against the first criterion, that of financing sustainable solvency. To examine how the Commission reform models balance adequacy and equity concerns, we used the GEMINI model, a dynamic microsimulation model for analyzing the lifetime implications of Social Security policies for a large sample of people born in the same year. Our analysis examined the effects of the reform models for the 1955, 1970, and 1985 birth cohorts. For this analysis, as in our report on the Commission reform models, we used the 2001 Trustees' intermediate assumptions. Under these assumptions, the combined trust funds are projected to reach exhaustion in 2038.

Our analysis of the scenario used the same three benchmarks as in our January report on the Commission reform models:[15]

- The "benefit reduction benchmark" assumes a gradual reduction in the currently scheduled Social Security defined benefit beginning with those newly eligible for retirement in 2005. Current tax rates are maintained.
- The "tax increase benchmark" assumes an increase in the OASDI payroll tax beginning in 2002 sufficient to achieve an actuarial balance over the 75-year period. Currently scheduled benefits are maintained. [16]
- The "baseline extended benchmark" is a fiscal policy path developed in our earlier long-term model work that assumes payment in full of currently scheduled Social Security benefits and no other changes in current spending or tax policies. [17]

The use of our criteria in evaluating the Trust Fund Exhaustion scenario underscores the need to take action sooner rather than later to address Social Security's financing shortfall. In so doing, it illustrates trade-offs that exist between efforts to achieve sustainable solvency for the OASDI Trust Funds and efforts to maintain adequate retirement income for current and future beneficiaries.

By definition this scenario would achieve sustainable solvency because after the combined trust funds had run out of assets, benefit payments would be adjusted each year to equal annual tax income. Before 2038, the Trust Fund Exhaustion scenario would result in lower unified surpluses and higher unified deficits compared to the tax increase benchmark by the same amounts as the baseline extended benchmark. Subsequently the Trust Fund Exhaustion scenario would result in unified fiscal results increasingly similar to both the tax increase benchmark and the benefit reduction scenario over the 75-year period. Before 2038, the Trust Fund Exhaustion scenario would require the same amounts of cash as the tax increase or baseline extended benchmarks; subsequently, the Trust Fund

[15] From the perspective of analyzing benefit adequacy, the tax increase and baseline extended benchmarks are identical because both assume payment in full of scheduled Social Security benefits over the 75-year simulation period.

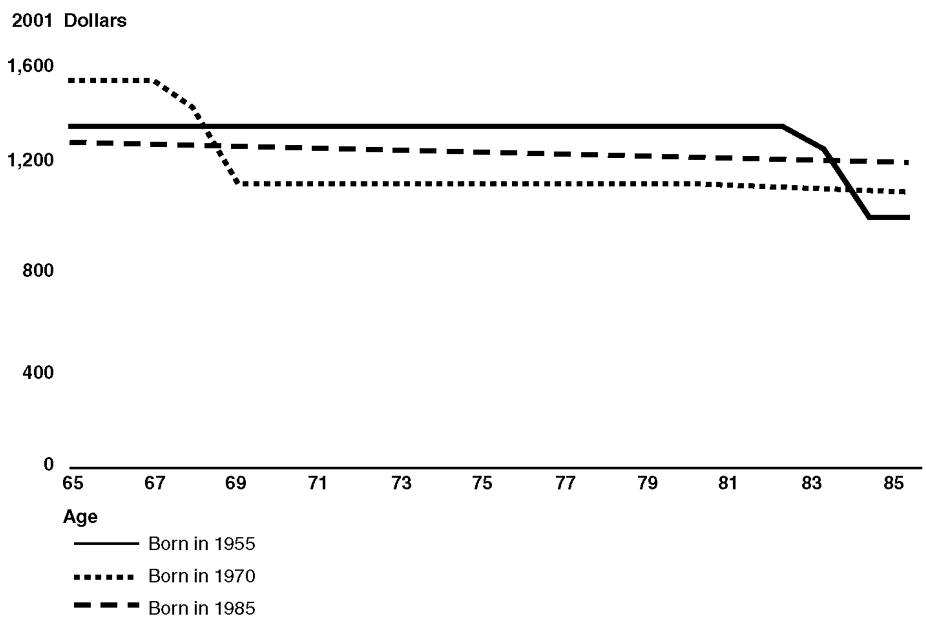
[16] Our benchmarks are solvent for the 75-year projection period commonly used by the Social Security Administration's (SSA) Office of the Chief Actuary, but they do not achieve sustainable solvency. Both the benefit reduction and tax increase benchmarks are explicitly fully funded and we worked closely with SSA's Chief Actuary in their design.

[17] Implicitly, therefore, after exhaustion benefits are paid in part by increased borrowing from the public.

Exhaustion scenario would require less cash each year than any of the three benchmarks.

Under the Trust Fund Exhaustion scenario, the effect on benefits would differ sharply before and after exhaustion took place. Before exhaustion, benefits would be the same as those currently scheduled, reflected in both the tax increase and baseline extended benchmarks. Once the combined trust funds had run out, benefits for all would be reduced across the board and remain below currently scheduled levels. Accordingly, those receiving benefits at the time of trust fund exhaustion would experience a sharp drop in benefits; under the Trustees' 2001 intermediate estimates, this drop is estimated at 27 percent (to 73 percent of currently scheduled levels) in 2039. Small further reductions would need to be taken in successive years such that by 2076 benefits would be only two-thirds of currently scheduled levels (i.e., to 67 percent of currently scheduled levels). (See fig. 9.)

Figure 9: Monthly Benefits Under the Trust Fund Exhaustion Scenario for an Illustrative Individual by Selected Birth Year



Source: GAO analysis using GEMINI model.

Note: Illustrative workers retire at age 65 and receive benefits equal to the median for the appropriate GEMINI cohort under the Trust Fund Exhaustion scenario. In years after 2038, real benefits are reduced according to the Trust Fund Exhaustion scenario. In GEMINI, the median age of death for those living to age 65 years and receiving a retired workers benefit is 84, 85, and 86, for the 1955, 1970, and 1985 cohorts, respectively.

Due to the timing of the reductions under the Trust Fund Exhaustion scenario, younger generations would bear greater benefit reductions. Those born in 1955 would not experience benefit reductions until they reached age 83, while those born in 1985 would receive lower benefits than under either GAO's benefit reduction or tax increase benchmarks in all years of retirement. Consequently, lifetime benefits would be reduced more for younger generations. Under the Trust Fund Exhaustion scenario we used, benefits would be adjusted proportionately for all recipients, increasing the likelihood of hardship for lower income retirees and the disabled.

Given a lack of historical precedent and legislative clarity on how SSA would proceed in the event of trust fund exhaustion, the nature and scope of SSA's administrative challenges under the scenario are difficult to describe or assess. At a minimum, a focus on cash management would be needed for SSA to calculate and implement the ongoing benefit adjustments required under the scenario.

Conclusion: Choices and Trade-Offs Will Be Part of Any Social Security Reform—Acting Soon Would Help

It is likely that the structural changes required to restore Social Security's long-term viability generally will require some combination of reductions from currently scheduled benefits, revenue increases, and may include the use of some general revenues. The proposals we have examined, both this year and earlier, generally reflect this. Proposals employ possible benefit modifications within the current program structure, including modifying the benefit formula, reconsidering current eligibility criteria, and reducing cost-of-living adjustments. Revenue increases might take the form of increases in the payroll tax rate, expanding coverage to include the relatively few workers who are still not covered under Social Security, or allowing the trust funds to be invested in potentially higher-yielding securities such as stocks.[18] Similarly, some proposals rely on general revenue transfers to increase the amount of money going towards the Social Security program. Reforms that include individual accounts would also involve Social Security benefit reductions and/or revenue increases, and the use of general revenues. Whatever approach is taken to reform, we must be able to continue to finance ongoing benefits to retirees in the

[18] About 4 percent of the workforce remains uncovered, which mostly includes some state and local government employees and federal employees hired before 1984.

short term. The longer we delay reform, the larger the “transition costs” and the more disruptive the actions will be.

In evaluating Social Security reform proposals, the choice among various benefit reductions and revenue increases will affect the balance between income adequacy and individual equity. Benefit reductions could pose the risk of diminishing adequacy, especially for specific subpopulations. Both benefit reductions and tax increases that have been proposed could diminish individual equity by reducing the implicit rates of return the workers earn on their contributions to the system. In contrast, increasing revenues by investing retirement funds in the stock market could improve rates of return but potentially expose individuals to investment risk and losses of expected retirement income.

Similarly, the choice among various benefit reductions and revenue increases—for example, raising the retirement age—will ultimately determine not just how much income retirees will have but also how long they will be expected to continue working and how long their retirements will be. Reforms will determine how much consumption workers will give up during their working years to provide for more consumption during retirement.

The use of our criteria to evaluate approaches to Social Security reform highlights the trade-offs that exist between efforts to achieve sustainable solvency and to maintain adequate retirement income for current and future beneficiaries. These trade-offs can be described as differences in the extent and nature of the risks for individuals and the nation as a whole.

At the same time, the defined benefit under the current Social Security system is also uncertain. The primary risk is that a significant funding gap exists between currently scheduled and funded benefits which, although it will not occur for a number of years, is significant and will grow over time. Other risks stem from uncertainty in, for example, future levels of productivity growth, real wage growth, and demographics. The Congress has revised Social Security many times in the past, and future Congresses could decide to revise benefits in ways that leave those affected little time to adjust. As the Congress deliberates various approaches to Social Security, the national debate also needs to include discussion of the various types of risk implicit in each approach and in the timing of reform.

Early action to change these programs would yield the highest fiscal dividends for the federal budget and would provide a longer period for prospective beneficiaries to make adjustments in their own planning.

Waiting to build economic resources and reform future claims entails risks. First, we lose an important window where today's relatively large workforce can increase saving and enhance productivity, two elements critical to growing the future economy. We lose the opportunity to reduce the burden of interest payments, thereby creating a legacy of higher debt as well as elderly entitlement spending for the relatively smaller workforce of the future. Most critically, we risk losing the opportunity to phase in changes gradually so that all can make the adjustments needed in private and public plans to accommodate this historic shift. Unfortunately, the long-range challenge has become more difficult, and the window of opportunity to address the entitlement challenge is narrowing.

As the baby boom generation retires and the numbers of those entitled to these retirement benefits grow, the difficulties of reform will be compounded. Accordingly, it remains more important than ever to deal with these issues over the next several years. In their March 2003 report, the Trustees emphasized the need for action sooner rather than later, stating that the sooner Social Security's financial challenges are addressed, the more varied and less disruptive can be their solutions.

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 have said before, I believe it is possible to structure a Social Security reform proposal that will exceed the expectations of all generations of Americans. In my view 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, Members of the Committee, that concludes my statement. I’d be happy to answer any questions you may have.

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