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LONG-TERM FISCAL ISSUES

The Need for Social Security Reform

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Highlights

Highlights of GAO-05-318T, a testimony before the Budget Committee, House of Representatives

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The Need for Social Security Reform

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, providing millions of Americans with disability insurance and survivors' benefits. As the baby boom generation retires and given longer life spans and lower birth rates, Social Security's financing shortfall will grow. The current gap between promised and funded benefits is $3.7 trillion and is growing daily.

The Chairman of the House Budget 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 is preferable 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.

www.gao.gov/cgi-bin/getrpt?GAO-05-318T.

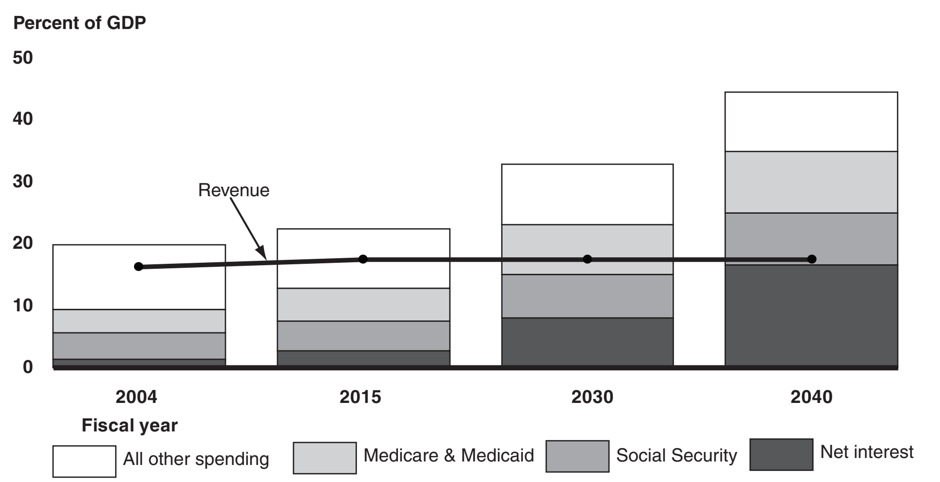
To view the full product, including the scope and methodology, click on the link above. For more information, contact Susan Irving at (202) 512-9142 or irvings@gao.gov.

What GAO Found

Although the Social Security system is not in crisis today, it faces a serious and growing solvency and sustainability challenge that is growing as time passes. If we did nothing until 2042, achieving actuarial balance would require a 30-percent reduction in benefits or a 43-percent increase in payroll taxes. Furthermore, Social Security's problems are a subset of our nation's overall fiscal challenge. Absent reform, the nation will ultimately have to choose among escalating federal deficits and debt, huge tax increases and/or dramatic budget cuts. 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 fiscal future. Taking action soon would also serve to reduce the amount of change needed to ensure that Social Security is solvent, sustainable, and secure for current and future generations. Acting sooner would also serve to improve the federal government's credibility with the markets and the confidence of the American people in the government's ability to address long-range challenges before they reach crisis proportions.

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

Composition of Spending as a Share of Gross Domestic Product (GDP) Assuming Discretionary Spending Grows with GDP after 2005 and All Expiring Tax Provisions Are Extended



Source: GAO's January 2005 analysis

Mr. Chairman and Members of the Committee:

I appreciate the opportunity to talk with you about our nation's Social Security program[1] and how to address the challenges presented in ensuring the long-term viability of this important social insurance system. 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. 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 both solvency and sustainability challenges in the longer term.[2] While the Social Security program does not face an immediate crisis, it does have a $3.7 trillion gap between promised and funded benefits in current dollar terms. This gap is growing daily 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 country, children, and grandchildren.

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

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

[2]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); and *Social Security: Long-Term Challenges Warrant Early Action*, GAO-05-303T (Washington, D.C.: Feb. 3, 2005).

the survivors of deceased workers. The number of individuals receiving benefits is expected to grow to almost 69 million by 2020. The program has been highly effective at reducing the incidence of poverty among the elderly, and the disability and survivor benefits have been critical to the financial well-being of millions of others.

- **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) will dominate the federal government's future fiscal outlook. While this hearing is not about the complexities of Medicare, it is important to note that Medicare presents a much greater, more complex, and more urgent fiscal challenge than Social Security. Medicare growth rates reflect not only a burgeoning beneficiary population, but also the escalation of health care costs at rates well exceeding general rates of inflation. Taken together, Social Security, Medicare, and Medicaid represent an unsustainable burden on future generations. Furthermore, any changes to Social Security should be considered in the context of the problems currently facing our nation's private pension system. These include the chronically low level of coverage of the private workforce, the continued decline in defined benefit plans coupled with the termination of large underfunded plans by bankrupt firms, and the shift by employers to defined contribution plans, where workers face the potential for greater return but also assume greater financial risk.

- **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. 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 government expenses, or increasing debt held by the public. 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.

- **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. Social Security's cash shortfall 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 trust fund 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 federal health programs. Acting sooner rather than later would allow changes to be more modest while also being phased in so that future 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 package will have pluses and minuses, and no plan will satisfy everyone on all dimensions. If we focus on the pros and cons of each element of reform by itself, we may find it impossible to build the bridges necessary to achieve consensus. Analyses of reform proposals should reflect the fact that the program faces a long-term actuarial deficit and that benefit reduction and/or revenue increases will be necessary to restore solvency. This requires looking at proposed reforms from at least two perspectives or 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).

Today, the Social Security program does not face an immediate crisis, but rather a long-range financing problem driven by 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 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.

Today we have an opportunity to address the relatively easier part of the overall entitlement challenge before the baby boom generation begins to retire and the challenge begins to compound. Medicare represents a much larger driver of the long-term fiscal outlook, but this does not mean that Social Security reform should be postponed until after it is addressed. On the contrary, it argues for moving ahead on Social Security soon. Unlike the case in health care, potential approaches to Social Security reform have already been articulated in various proposals in recent years. These approaches can serve as a starting point for deliberations. Since health care will be much harder to address, there is a significant danger that if we do not move ahead on Social Security now, we could end up reforming neither. Successful Social Security reform could also help build both trust and confidence and thereby facilitate consideration of the needed structural changes in the health care system.

The Social Security system has required changes in the past to ensure its future solvency. Congress took action to address an immediate solvency crisis in 1983. While such an immediate crisis will not occur for many years, waiting until it is imminent will not be prudent. Furthermore, 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 there for future generations. I believe that it is possible to reform Social Security in a way that will assure the program's solvency and sustainability while exceeding the expectations of all generations of Americans.

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

In my role as lead partner on the audit of the U.S. government's consolidated financial statements and the de facto Chief Accountability Officer of the United States government, I have become increasingly concerned about the state of our nation's finances. In speeches and presentations over the past several years, I have called attention to our large and growing long-term fiscal challenge and the risks it poses to our nation's future.[3] Simply put, our nation's fiscal policy is on an unsustainable course, and our long-term fiscal imbalance worsened significantly in 2004. GAO's simulations—as well as those of the Congressional Budget Office (CBO) and others—show that over the long term we face a large and growing structural deficit due primarily to known demographic trends and rising health care costs. Continuing on this unsustainable fiscal path will gradually erode, if not suddenly damage, our economy, our standard of living, and ultimately our national security. Our current path also will increasingly constrain our ability to address emerging and unexpected budgetary needs.

Regardless of the assumptions used, all simulations indicate that the problem is too big to be solved by economic growth alone or by making modest changes to existing spending and tax policies. Nothing less than a fundamental reexamination of all major spending and tax policies and priorities is needed. This reexamination should also involve a national discussion about what Americans want from their government and how much they are willing to pay for those things. This discussion will not be easy, but it must take place.

In fiscal year 2004 alone, the nation's fiscal imbalance grew dramatically, primarily due to enactment of the new Medicare prescription drug benefit, which added $8.1 trillion to the outstanding commitments and obligations of the U.S. government. The near-term deficits also reflected higher defense, homeland security, and overall discretionary spending which exceeded growth in the economy, as well as revenues which have fallen below historical averages due to policy decisions and other economic and technical factors.

[3] *Saving Our Nation's Future: An Intergovernmental Challenge*, Outlook 2005 Conference, The National Press Club (Washington D.C.: Feb. 2, 2005). This product can be found on GAO's web site, www.gao.gov.

While the nation's long-term fiscal imbalance grew significantly, the retirement of the baby boom generation has come closer to becoming a reality. In fact, the cost implications of the baby boom generation's retirement have already become a factor in CBO's baseline projections and will only intensify as the boomers age. According to CBO, total federal spending for Social Security, Medicare, and Medicaid is projected to grow by about 25 percent over the next 10 years—from 8.4 percent of gross domestic product (GDP) in 2004 to 10.4 percent in 2015. Given these and other factors, it is clear that the nation's current fiscal path is unsustainable and that tough choices will be necessary in order to address the growing imbalance.

There are different ways to describe the magnitude of Social Security's long-term financing challenge, but they all show 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 the 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%

Source: SSA.

Note: Data from Social Security Administration, *The 2004 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Fund* (Washington, D.C., March 2004).

While estimates vary due to different horizons, both identify the same long-term challenge: The Social Security system is unsustainable in 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.

Although the Trustees' 2004 intermediate estimates project that the combined Social Security Trust Funds will be solvent until 2042,[4] within the next few years, Social Security spending will begin to put pressure on the rest of the federal budget. (See table 2.) 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. (See fig. 1.) To finance the same level of federal spending as in the previous year, additional revenues and/or increased borrowing will be needed in each subsequent year.

Table 2: Key Dates Highlight Long Term Challenges of the Social Security System

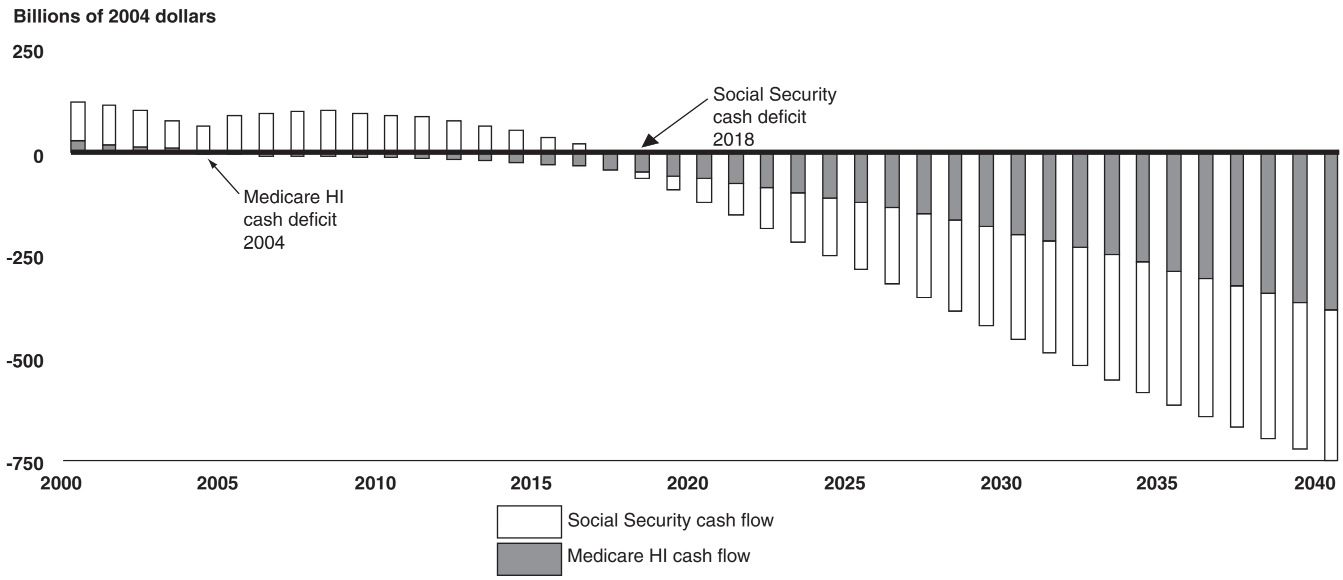
Date	Event
2008	Social Security cash surplus begins to decline
2018	Annual benefit costs exceed cash revenue from taxes
2028	Trust fund ceases to grow because even taxes plus interest fall short of benefits
2042 (SSA) 2052 (CBO)	Trust fund exhausted, annual revenues sufficient to pay about 73% – 81% of promised benefits

Sources: SSA and CBO.

Note: Data from 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) and Congressional Budget Office, *The Outlook for Social Security: Potential Range of Social Security Outlays and Revenues Under Current Law* (Washington, D.C., June 2004).

[4]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).

Figure 1: Social Security and Medicare's Hospital Insurance Trust Funds Face Cash Deficits



Source: GAO analysis based on data from the Office of the Chief Actuary, Social Security Administration and Office of the Actuary, Centers for Medicare and Medicaid Services.

Note: Projections based on the intermediate assumptions of the 2004 Trustees' Reports.

By 2018,[5] Social Security's cash income (tax revenue) is projected to fall below program expenses. At that time, Social Security will join Medicare's Hospital Insurance Trust Fund, whose outlays exceeded cash revenues in 2004, 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. At this point, 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.

Today Social Security spending exceeds federal spending for Medicare and Medicaid, but that will change. While Social Security is expected to grow about 5.6 percent per year on average over the next 10 years, Medicare and Medicaid combined are expected to grow at 8.5 percent per year. As a result, CBO's baseline projects Medicare and Medicaid spending will be

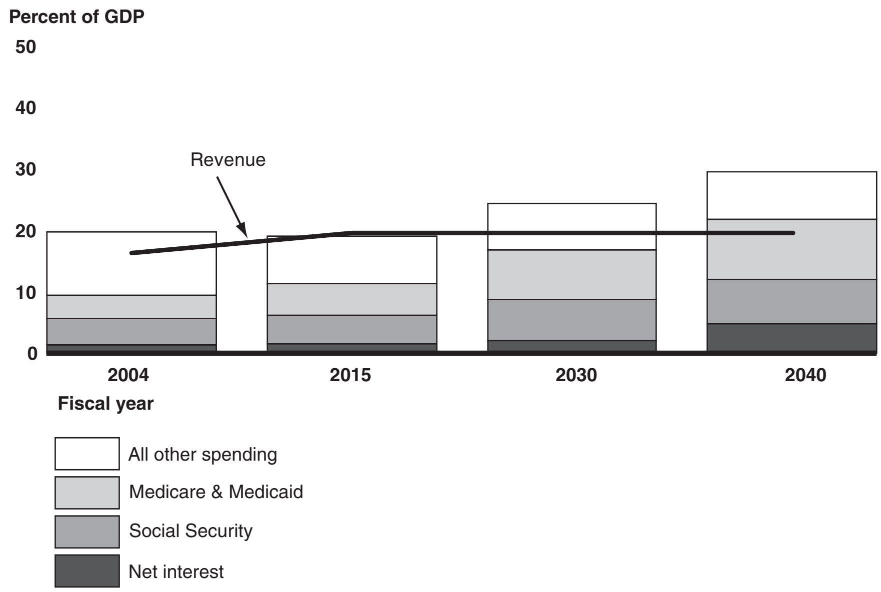
[5] CBO estimates that this will occur in 2020. See CBO's *Updated Long-Term Projections for Social Security* (January 2005).

about 30 percent higher than Social Security in 2015. According to the Social Security and Medicare trustees, Social Security will grow from 4.3 percent of GDP today to 6.6 percent in 2075, and Medicare's burden on the economy will quintuple—from 2.7 percent to 13.3 percent of the economy.

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 2 and 3 present these simulations under two different sets of assumptions. In figure 2, we begin with CBO's January baseline, constructed according to the statutory requirements for that baseline.[6] 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 3 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.

[6]The Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2006 to 2015*, (Washington, D.C.: January 2005).

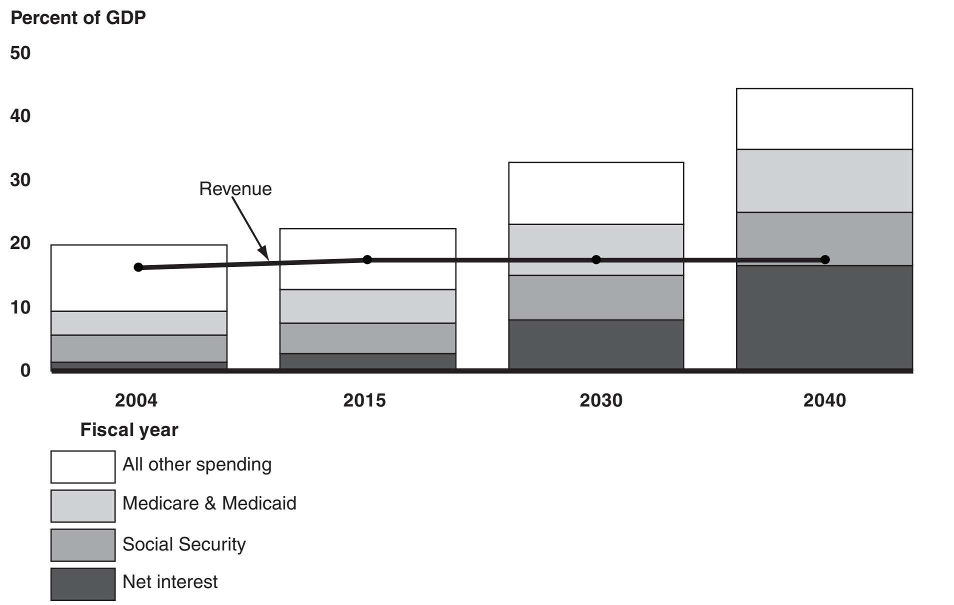
Figure 2: Composition of Spending as a Share of Gross Domestic Product (GDP) under Baseline Extended



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



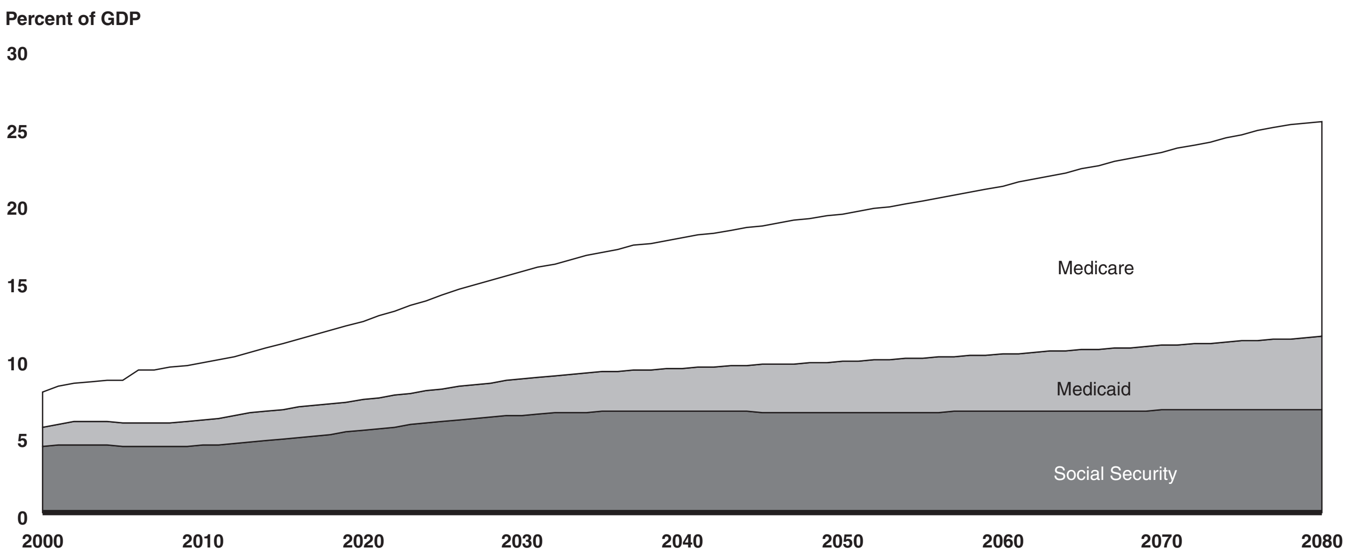
Source: GAO's January 2005 analysis

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.

Although considerable uncertainty surrounds long-term budget projections, we know two things for certain: the population is aging and the baby boom generation is approaching retirement age. The aging population and rising health care spending will have significant implications not only for the budget but also for the economy as a whole. Figure 4 shows the total future draw on the economy represented by Social Security, Medicare, and Medicaid. Under the 2004 Trustees' intermediate estimates and CBO's long-term Medicaid estimates, spending for these entitlement programs combined will grow to 15.6 percent of GDP in 2030 from today's 8.5 percent. It is clear that, taken together, Social Security, Medicare, and Medicaid represent an unsustainable burden on future generations.

Figure 4: Social Security, Medicare, and Medicaid Spending as a Percentage of GDP



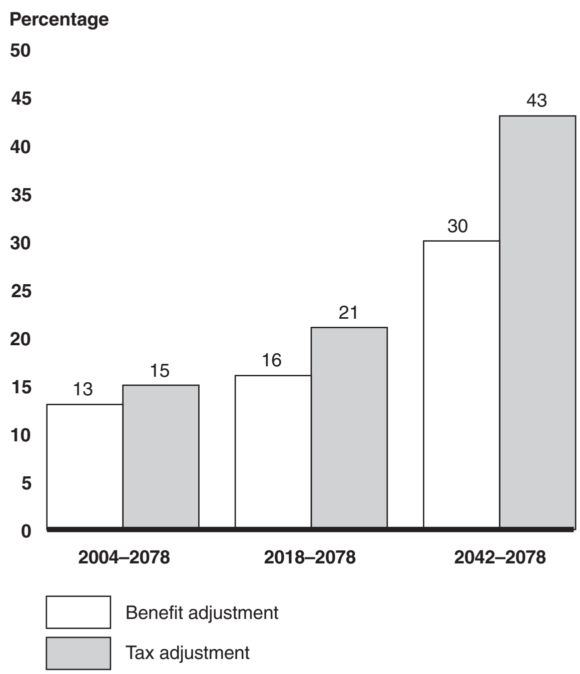
Source: GAO analysis based on data from the Office of the Chief Actuary, Social Security Administration, Office of the Actuary, Centers for Medicare and Medicaid Services, and the Congressional Budget Office.

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 reductions 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.

Some of the benefits of early action—and the costs of delay—can be illustrated using the 2004 Social Security Trustees' intermediate projections. Figure 5 compares what it would take to keep Social Security solvent through 2078 by either raising payroll taxes or reducing benefits. If we did nothing until 2042—the year SSA estimates the Trust Funds will be exhausted—achieving actuarial balance would require changes in benefits of 30 percent or changes in taxes of 43 percent. As figure 5 shows, earlier action shrinks the size of the necessary adjustment.

Figure 5: Size of Action Needed to Achieve Social Security Solvency



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

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

Both sustainability concerns and solvency considerations drive us to act sooner rather than later. Trust Fund exhaustion may be nearly 40 years away, but the squeeze on the federal budget will begin as the baby boom generation begins 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.

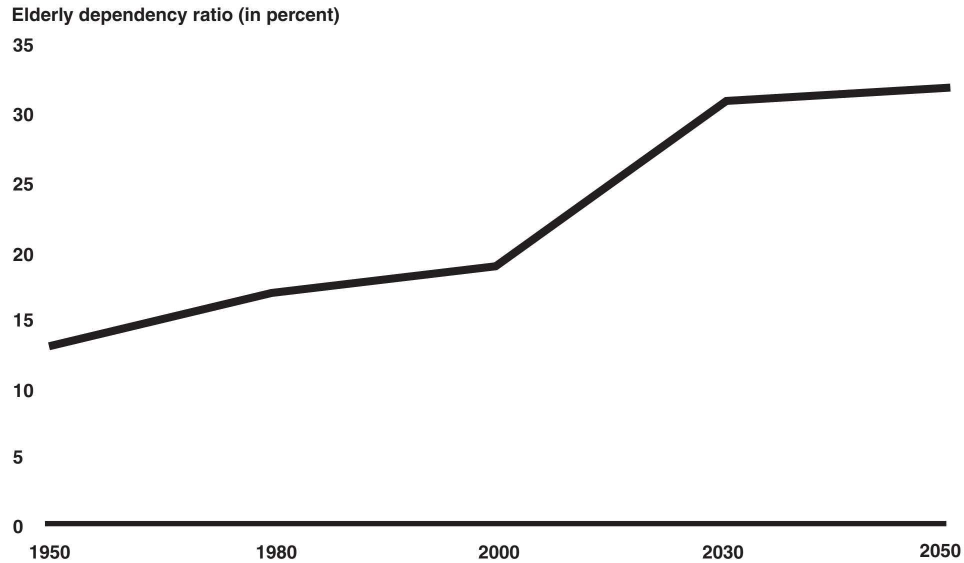
Demographic Trends Drive Both the Long-term Fiscal Outlook and Social Security's Financing Challenge

The Social Security program's situation is but one symptom of larger demographic trends that will have broad and profound effects on our nation's future in other ways as well. As you are aware, 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 6, the U.S. elderly dependency ratio is expected to continue to increase.[7] 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 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.

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

Figure 6: U.S. Elderly Dependency Ratio Is Expected to Continue to Increase

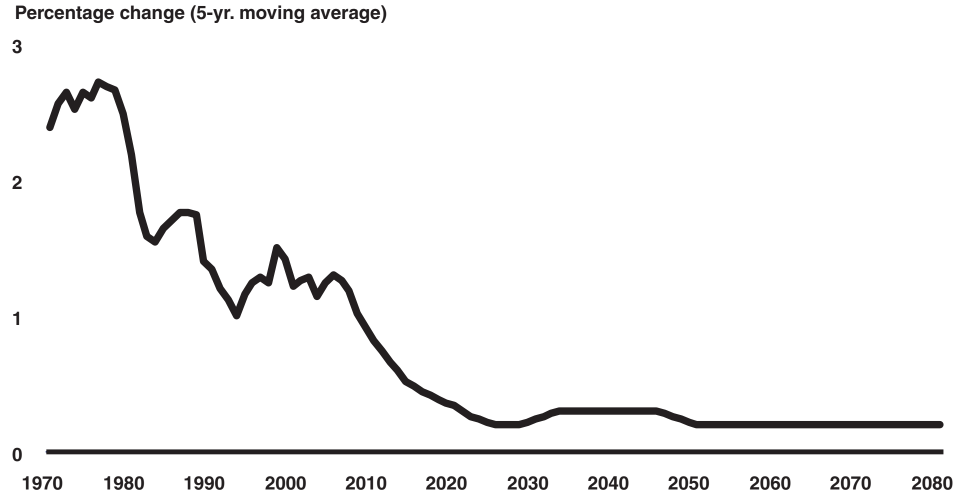


Source: Population Division of the Department of Economic and Social Affairs of the United Nations Secretariat, World Population Prospects: 2002 Revision, and World Urbanization Prospects: 2001 Revision.

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 factors means that annual 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. (See fig. 7.) Relatively fewer workers will be available to produce the goods and services that all will consume. Without a major increase in productivity or increases in immigration, low labor force growth will lead to slower growth in the economy and to slower growth of federal revenues. This in turn will only accentuate the overall pressure on the federal budget.

Figure 7: Labor Force Growth Is Expected to Slow Significantly



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

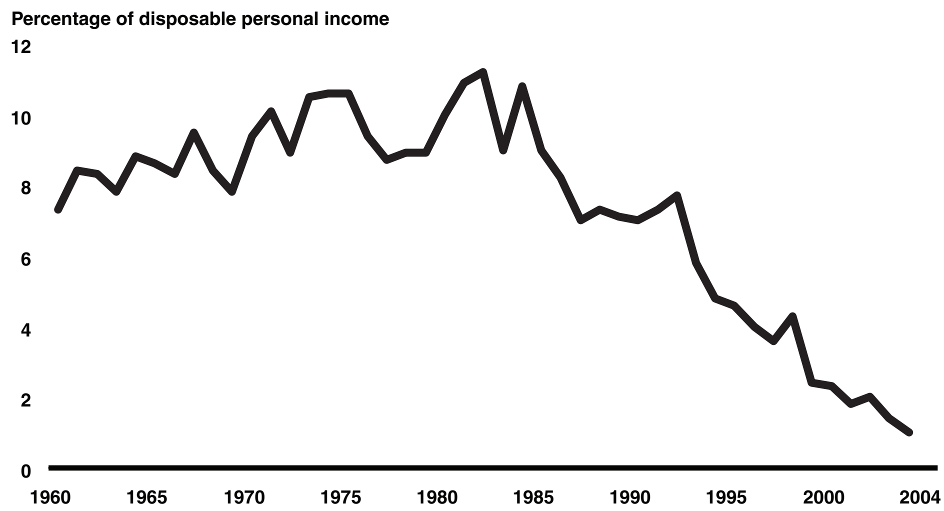
Note: Percentage change is calculated as a centered 5-yr. moving average of projections based on the intermediate assumptions of the 2004 Trustees Reports.

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, 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.

Increased investment could increase the productivity of workers and spur economic growth. However, increasing investment depends on national saving, which remains at historically low levels. Historically, the most direct way for the federal government to increase saving has been to reduce the deficit (or run a surplus). Although the government may try to increase personal saving, results of these efforts have been mixed. For example, even with the preferential tax treatment granted since the 1970s to encourage retirement saving, the personal saving rate has steadily declined. Even if economic growth increases, the structure of retirement programs and historical experience in health care cost growth suggest that higher economic growth results in a generally commensurate growth in spending for these programs in the long term.[8]

In recent years, personal saving by households has reached record lows while at the same time the federal budget deficit has climbed. (See fig. 8.) Accordingly, national saving has diminished but the economy has continued to grow in part because more and better investments were made. That is, each dollar saved bought more investment goods and a greater share of saving was invested in highly productive information technology. The economy has also continued to grow because the United States was able to invest more than it saved by borrowing abroad, that is, by running a current account deficit. However, a portion of the income generated by foreign-owned assets in the United States must be paid to foreign lenders. National saving is the only way a country can have its capital and own it too.

Figure 8: Personal Saving Rate Has Steadily Declined



Source: Bureau of Economic Analysis.

In general, saving involves trading off consumption today for greater consumption tomorrow. Our budget decisions today will have important

[8]Initial Social Security benefits are indexed to nominal wage growth resulting in higher benefits over time.

consequences for the living standards of future generations. The financial burdens facing the smaller cohort of future workers in an aging society would most certainly be lessened if the economic pie were enlarged. This is no easy challenge, but in a very real sense, our fiscal decisions affect the longer-term economy through their effects on national saving.

The persistent U.S. current account deficits of recent years have translated into a rising level of indebtedness to other countries. However, many other nations currently financing investment in the United States also will face aging populations and declining national saving, so relying on foreign savings to finance a large share of U.S. domestic investment or federal borrowing is not a viable strategy in the long run.

Health Care Is a Larger and More Difficult Challenge Than Social Security

As figure 4 showed, over the long term Medicare and Medicaid will dominate the federal government's future fiscal outlook. 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. Health care generally presents not only a much greater but a more complex challenge than Social Security. The structural changes needed to address health care cost growth will take time to develop, and the process of reforming health care is likely to be an incremental one.

While the long-term fiscal challenge cannot be successfully addressed without addressing Medicare and Medicaid, federal health spending trends should not be viewed in isolation from the health care system as a whole. For example, Medicare and Medicaid cannot grow over the long term at a slower rate than cost in the rest of the health care system without resulting in a two-tier health care system. This, for example, could squeeze providers who then in turn might seek to recoup costs from other payers elsewhere in the health care system. Rather, in order to address the long-term fiscal challenge, it will be necessary to find approaches that deal with health care cost growth in the overall health care system.

Although health care spending is the largest driver of the long-term fiscal outlook, this does not mean that Social Security reform should be postponed until after health is addressed. On the contrary, it argues for moving ahead on Social Security now. The outlines of Social Security reform have already been articulated in many Social Security reform proposals. These approaches and the specific elements of reform are well known and have been the subject of many analyses, including GAO reports and testimonies. Reform approaches already put forward can serve as a starting point for deliberations.

Considerations In Assessing Reform Options

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

GAO Framework For Evaluating Reform Proposals

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

- **Financing Sustainable Solvency**—the extent to which a proposal achieves sustainable solvency and how it would affect the economy and the federal budget. Our sustainable solvency standard encompasses several different ways of looking at the Social Security program's financing needs. While a 75-year actuarial balance has generally been used in evaluating the long-term financial outlook of the Social Security program and reform proposals, it is not sufficient in gauging the program's solvency after the 75th year. For example, under the trustees' intermediate assumptions, each year the 75-year actuarial period changes, and a year with a surplus is replaced by a new 75th year that has a significant deficit. As a result, changes made to restore trust fund solvency only for the 75-year period can result in future actuarial imbalances almost immediately. Reform plans that lead to sustainable solvency would be those that consider the broader issues of fiscal sustainability and affordability over the long term. Specifically, a standard of sustainable solvency also involves looking at (1) the balance between program income and costs beyond the 75th year and (2) the share of the budget and economy consumed by Social Security spending.

- **Balancing Adequacy and Equity**—the relative balance struck between the goals of individual equity and income adequacy. The current Social Security system's benefit structure attempts to strike a balance between 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 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. Although these issues may appear technical or routine on the surface, they are important issues because they have the potential to delay—if not derail—reform if they are not considered early enough for planning purposes. Moreover, issues such as feasibility and cost can, and should, influence policy choices. Continued public acceptance of and confidence in the Social Security program require that any reforms and their implications for benefits be well understood. This means that the American people must understand why change is necessary, what the reforms are, why they are needed, how they are to be implemented and administered, and how they will affect their own retirement income. All reform proposals will require some additional outreach to the public so that future beneficiaries can adjust their retirement planning accordingly. The more transparent the implementation and administration of reform, and the more carefully such reform is phased in, the more likely it will be understood and accepted by the American people.

The weight that different 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 before this committee and elsewhere, a comprehensive evaluation is needed that considers a range of effects together. Focusing on comprehensive packages of reforms will enable us to foster credibility and acceptance. This will help us avoid getting mired in the details and losing sight of important interactive effects. It will help build the bridges necessary to achieve consensus.

Reform's Potential Effects on the Social Security Program

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

A number of proposals also seek to restructure the program through the creation of individual accounts. Under a system of individual accounts, workers would manage a portion of their own Social Security contributions to varying degrees. This would expose workers to a greater degree of risk in return for both greater individual choice in retirement investments and the possibility of a higher rate of return on contributions than available under current law. There are many different ways that an individual account system could be set up. For example, contributions to individual accounts could be mandatory or they could be voluntary. Proposals also differ in the manner in which accounts would be financed, the extent of choice and flexibility concerning investment options, the way in which benefits are paid out, and the way the accounts would interact with the existing Social Security program—individual accounts could serve either as an addition to or as a replacement for part of the current benefit structure.

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

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

Also, some degree of implementation and administrative complexity arises in virtually all proposed changes to Social Security. The greatest potential implementation and administrative challenges are associated with proposals that would create individual accounts. These include, for example, issues concerning the management of the information and money flow needed to maintain such a system, the degree of choice and flexibility individuals would have over investment options and access to their accounts, investment education and transitional efforts, and the mechanisms that would be used to pay out benefits upon retirement. The federal Thrift Savings Plan (TSP) could serve as a model for providing a limited amount of options that reduce risk and administrative costs while still providing some degree of choice. However, a system of accounts that spans the entire national workforce and millions of employers would be significantly larger and more complex than TSP or any other system we have in place today.

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

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

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

Conclusions

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

Today we have an opportunity to address Social Security as a first step toward improving the nation's long-term fiscal outlook. Steps to reform our federal health care system are likely to be much more difficult. They are also likely to require a series of incremental actions over an extended period of time. 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.

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.

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