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SOCIAL SECURITY: WHOSE TRUST WILL BE BROKEN?

HEARING

BEFORE THE

SPECIAL COMMITTEE ON AGING UNITED STATES SENATE

ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

WASHINGTON, DC

JULY 29, 2003

Serial No. 108–18

Printed for the use of the Special Committee on Aging

U.S. GOVERNMENT PRINTING OFFICE

90–050 PDF WASHINGTON : 2003

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
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SOCIAL SECURITY: WHOSE TRUST WILL BE BROKEN?

TUESDAY, JULY 29, 2003

U.S. SENATE,
SPECIAL COMMITTEE ON AGING,
Washington, DC.

The committee met, pursuant to notice, at 10 a.m., in room SD–628, Dirksen Senate Office Building, Hon. Larry E. Craig (chairman of the committee) presiding.

Present: Senators Craig and Stabenow.

OPENING STATEMENT OF SENATOR LARRY E. CRAIG, CHAIRMAN

The CHAIRMAN. Good morning, everyone. The U.S. Senate Special Committee on Aging will convene.

I was just chatting with BNA's correspondent, Mr. Wyand, and he tells me that his uncle turned 100 yesterday. He mentioned he was coming down here on a Social Security hearing, and he instructed his nephew to make sure that Social Security is going to be OK and left alone. I can tell your uncle personally that the system will be stable and long-lived for him. [Laughter.]

Well, thank you all very much for being with us this morning. Today we do something that is really the primary responsibility of this committee, and that is, oversight, review, and record building, information gathering, for the purposes of senatorial use, especially as the appropriate committees begin to look at Social Security in the coming years and deal with the realities of the trust funds.

Last year, Senator Chuck Grassley, Chairman of the Finance Committee, and I asked the GAO to use its analytical framework to evaluate a Social Security Trust Fund exhaustion scenario or what might be called the status quo option. This option reflects the idea that we do not need to act soon to strengthen Social Security. Critics of the models developed by the President's Commission to Strengthen Social Security suggest that we wait until the trust fund is exhausted before we act to improve the system.

Today's GAO trust fund exhaustion study builds on a report requested by Aging Committee Ranking Member Senator Breaux and presented in January to this committee by the Comptroller General. The January report used GAO's analytical framework to evaluate the models developed by the President's Commission to Strengthen Social Security. Today's GAO study will help us compare the Commission's models with the status quo or the trust fund exhaustion scenario.

Many of us in Congress have a strong concern for the future of Social Security and the impact on future beneficiaries of the status quo option. It is important to emphasize that the trust fund exhaustion scenario does not affect seniors currently receiving Social Security benefits or those about to retire. This scenario is really about America's youth, in other words, looking forward into the future.

Representing them here today will be a panelist by the name of Brad Smith, who will be on our second panel, a 20-year-old college student who will testify before us. We are here today to receive first the GAO's report and listen to additional testimony on the trust fund exhaustion scenario, but before we begin, I am compelled to mention recent action taken by several lawmakers in Congress.

Last Wednesday, I signed a bipartisan letter with several lawmakers, including my good friend, the ranking member of this committee, John Breaux. The letter was addressed to leaders of the Democrat and the Republican Campaign Committees. The letter called for a political cease-fire on Social Security.

In signing the letter, we pledged to defend candidates running for public office, Republican or Democrat, who support, and I quote, "Social Security modernization and are willing to make the tough choices to address the fiscal challenges facing Social Security."

This hearing is convened in the spirit of a cease-fire on Social Security and to point this Congress in the direction of facing up to the tough choices ahead on Social Security.

With that, I am pleased to welcome the distinguished witnesses to the Aging Committee. Our first witnesses on panel one are David Walker, who is the Comptroller General of the General Accounting Office. James Lockhart, Deputy Commissioner for the Social Security Administration, will also testify before us today on panel one.

Panel two I mentioned. We will hear from Dr. Thomas Saving, Public Trustee for the Social Security/Medicare Trust Funds, and Brad Smith of Knoxville, TN, President and co-founder of an organization called Social Good Through Politics at Harvard University, where he will be a junior this fall.

So I look forward to all of your testimony. Now let us turn to our first panel, Mr. Walker and Mr. Lockhart. David, if you would start.

STATEMENT OF HON. DAVID M. WALKER, COMPTROLLER GENERAL, UNITED STATES GENERAL ACCOUNTING OFFICE, WASHINGTON, DC

Mr. WALKER. Thank you, Chairman Craig. It is a pleasure to be here to speak about the important issue of our Nation's Social Security program. As you know, today we are issuing the report that Senator Grassley and you requested dealing with the trust fund exhaustion scenario, or the so-called "do nothing" scenario. But before I end up getting into summarizing the key parts of that report, I would like to talk about a few framework issues that I think are important to put this subject in context.

I think it is important to keep in mind that in looking at Social Security reform, 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.

Second, as this next graphic will show, Social Security reform is part of a broader fiscal challenge, and the combined Social Security and OASDI program will end up taking an increasingly large part of the overall Federal budget. If you look into the future, you can see that we are in for some very tough decisions because of the large and growing gap between projected revenues and projected expenditures based upon these assumptions. Absent reform, the Nation will ultimately have to choose between persistent and escalating Federal deficits, significant tax increases, and/or dramatic budget cuts.

Solving Social Security's long-term financing problem is more important and complex, as you know, Mr. Chairman, than simply making the numbers add up. Acting sooner rather than later would clearly help to ease the difficulty of change. Social Security will begin to constrain the budget long before the trust funds are exhausted in 2042. In fact, as you can see from this graphic, the program's annual cash-flow is projected to become negative in 2018.

Social Security's annual cash deficit will place increasing pressure on the rest of the Federal budget to raise resources necessary to meet program costs. Waiting until Social Security faces an immediate solvency crisis will limit the scope of feasible solutions and could reduce the option only to those choices that are the most difficult and dramatic options.

Acting soon reduces the likelihood that Congress will have to choose between imposing severe budget cuts and benefit cuts or unfairly burdening future generations, as the next chart will show. This chart shows the sooner you act, the less dramatic changes you have to make, whether it be on the revenue side or the expenditure side because we get the power of compounding working for us rather than as it is right now, namely working against us.

The trust fund exhaustion scenario or the "do nothing" scenario analyzed in our report dramatically illustrates the need for action sooner rather than later. Under this scenario, once the combined trust funds have been fully depleted, benefit payments would be adjusted each year to match the annual tax revenue that will be coming into the trust funds.

Under the trust fund exhaustion, scenario those receiving benefits would experience a large and sudden benefit reduction of about 27 percent, or, in other words, they would receive about 73 percent of currently scheduled benefits in 2039. By the end of the 75-year period, smaller reductions that would occur in successive years after 2039 would mean that individuals would only be receiving about two-thirds of what otherwise they would have been receiving under the current benefit formulas, or about 67 percent of their currently scheduled benefits. As you can see, a dramatic decline would occur between 2037 and 2039 and then a gradual decline beyond that.

As the next graphic shows, the trust fund exhaustion scenario raises significant intergenerational equity issues. The timing of the benefit adjustments means that the trust fund exhaustion scenario would place much greater burdens on younger generations. For example, those born in 1955 would receive currently scheduled benefits until they reach age 83, while those born in 1985 would always receive benefits in retirement lower than currently scheduled benefits. This means that the lifetime benefits would be reduced for younger generations. So, therefore, their return on investment would also be reduced.

In addition, under the trust fund exhaustion scenario, benefits would be adjusted proportionally for all recipients, increasing the likelihood of hardship for lower-income retirees and the disabled, those who rely on Social Security as their primary or sole source of retirement income.

In summary, Mr. Chairman, the Social Security challenge is a significant one. We do not have an immediate solvency problem. We do not have an immediate crisis with regard to this program. We do, however, have a large and growing imbalance. Acting sooner rather than later is the responsible approach. Candidly, solving the Social Security problem is easy lifting compared to Medicare and some of the other challenges we face. We have an opportunity to exceed the expectations of all generations of Americans if we take timely and prudent actions. Thank you, Mr. Chairman, for holding this hearing. It is incredibly important.

[The prepared statement of Mr. Walker follows:]

United States General Accounting Office

GAO

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

For Release on Delivery
Expected at 10:00 a.m. EDT
Tuesday, July 29, 2003

SOCIAL SECURITY REFORM

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

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

GAO-03-1038T

July 29, 2003

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Highlights

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

SOCIAL SECURITY REFORM

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

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.

[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

[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.

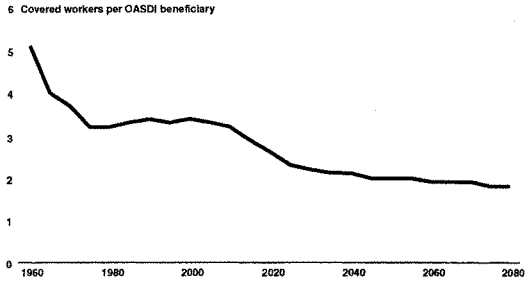
Social Security's Long-Term Financing Problem Is Truly Urgent

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

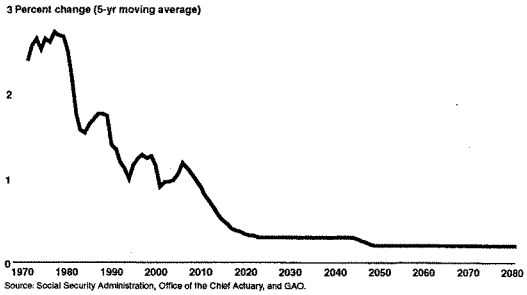


Source: *The 2003 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds.*

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

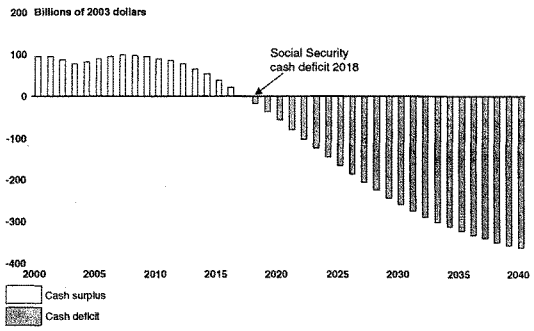
[9] Separately, the DI fund is projected to be exhausted in 2028 and the OASI fund in 2044.

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.*

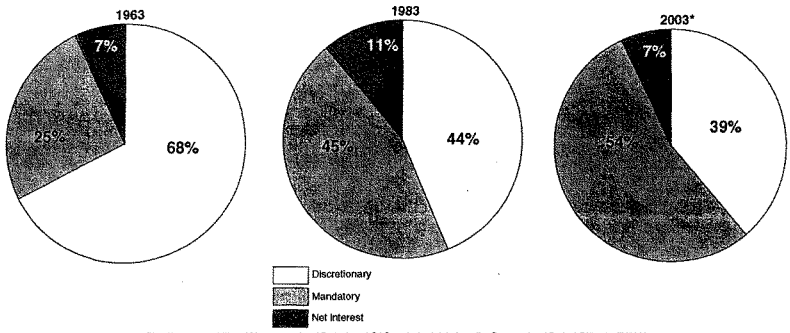
Ultimately, the critical question is not how much a trust fund has in assets, but whether the government as a whole can afford the benefits in the future and at what cost to other claims on scarce resources. As I have said before, the future sustainability of programs is the key issue policymakers should 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.

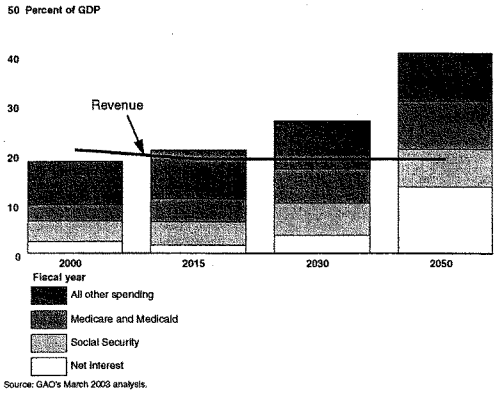
*Estimate for 2003 includes $41 billion in discretionary spending and about $1 billion in mandatory spending for the Iraq war supplemental. Includes $11 billion in mandatory spending for the Jobs and Growth Tax Relief Reconciliation Act of 2003.

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.

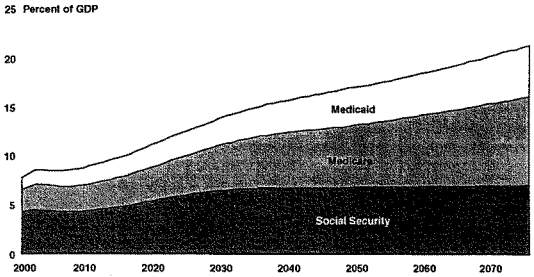
Indeed, long-term budget flexibility is about more than Social Security and Medicare. While these programs dominate the long-term outlook, they are not the only federal programs or activities that bind the future. The federal government undertakes a wide range of programs, responsibilities, and activities 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.

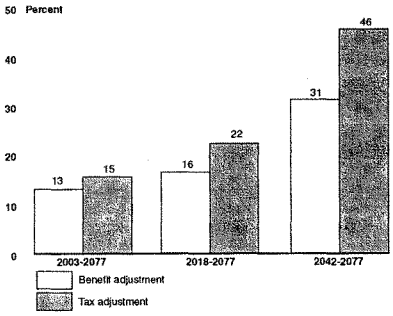
When Social Security redeems assets to pay benefits, the program will constitute a claim on real resources in the future. As a result, taking action now to increase the future pool of resources is important. To echo Federal Reserve Chairman Greenspan, the crucial issue of saving in our economy relates 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

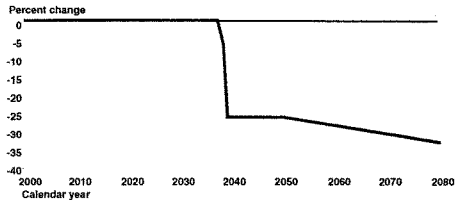
Program complexity makes implementation and administration both more difficult and harder to explain to the public. Some degree of implementation and administrative complexity arises in virtually all proposed changes to Social Security, even those that make incremental changes in the already existing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

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.

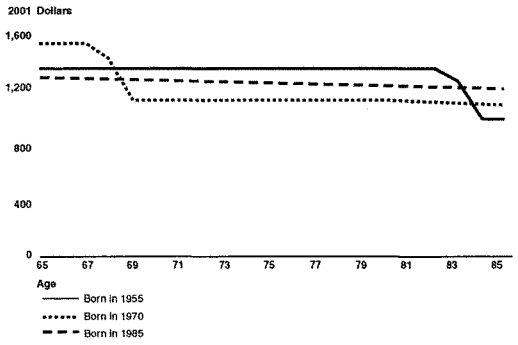
[16] Our benchmarks are solvent for the 75-year projection period commonly used by the Social Security Administration's (SSA) Office of the Chief Actuary, but they do not achieve sustainable solvency. Both the benefit reduction and tax increase benchmarks are explicitly fully funded and we worked closely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

The CHAIRMAN. Well, David, thank you very much. You are not the first to compare the difficulties between Medicare prescription drugs and Social Security and those kinds of adjustments. We had Chairman Greenspan before the committee some months ago, and he made the same reflection. It was really the first time I had actually begun to focus on the reality of the differences between a dynamic activity like health care versus being able to effectively calculate, shall I say, relatively static figures or predictable outcomes. So thank you very much.

Now let us turn to Jim Lockhart, Deputy Commissioner, Social Security Administration. Thanks for being with us.

STATEMENT OF JAMES B. LOCKHART, III, DEPUTY COMMISSIONER, SOCIAL SECURITY ADMINISTRATION

Mr. LOCKHART. Thank you, Mr. Chairman, for holding this hearing on the very important topic, the future of Social Security. Commissioner Jo Anne Barnhart has made achieving sustainable solvency a major goal of the agency.

Both the Trustees' Annual Report and GAO's report confirm that the Social Security program as currently financed is unsustainable. However, I want to make it clear, as you did, that the benefits of current retirees and those nearing retirement are safe.

Social Security is one of the most successful Government programs, last year paying out over $450 billion to 46 million people. Only 70 percent were retirees, with the rest being survivors and disabled. The 154 million American workers paying Social Security taxes last year and the millions joining the system every year are relying on Social Security for a major portion of their financial future.

Turning to the first chart—America is aging rapidly. In the next 30 years, the number of Americans aged 65 and older will double. Lower birth rates and increased life expectancies have reduced the ratio of workers to beneficiaries from over 8:1 in 1955 to 3.3:1 today. By 2031, we will reach an unsustainable level—in fact, well before 2031 we will reach an unsustainable level.

As the Trustees point out, the pressure on the trust funds will begin in 5 years, when the first baby boomers reach retirement age. In 2018, the cash-flow will turn negative. By 2042, the trust fund will be exhausted.

As David Walker pointed out, and as shown in this next chart, when the trust fund is exhausted there would be a 27-percent reduction in scheduled benefits. Benefits would continue to decrease every year thereafter, and by 2077, the reduction would be 35 percent.

Today's younger workers such as my 26-year-old son, who is here today, would be particularly hurt. After paying into Social Security for well over 40 years, his scheduled benefits would be drastically cut at retirement and every year thereafter. In contrast, based on my life expectancy, leading-edge baby boomers like myself would never see a benefit cut.

An alternative, as the next chart shows, is to raise taxes to maintain solvency. The payroll tax rate would have to start increasing in 2042, reaching 18.9 percent by 2077. That is more than a 50-percent payroll tax increase from today's 12.4 percent rate. The

GAO report reinforces the Trustees' position in their annual report, and I quote, "The sooner adjustments are made the smaller and less abrupt they will have to be."

Another way to look at this shortfall over just the 75-year period is its present value of $3.5 trillion. What present values means is the trust funds would need the equivalent of that amount today plus earning interest on that amount today to pay for the shortfall over the 75-year period. To achieve sustainable solvency, which is our goal, the present value is actually $10.5 trillion. That is triple the public national debt of today. Absent any action, the shortfall will continue to compound every year thereafter.

Clearly, achieving sustainable solvency will be no easy task, but delay only makes the task more difficult. As David Walker just said, "if we wait we will have to make benefit reductions even deeper or tax increases even steeper."

The unattractiveness of relying exclusively on tax increases and benefit reductions has led a number of Republicans and Democrats to propose Social Security personal accounts among other changes. Some of those proposals have significantly less costs than the current system.

In March, Social Security's Trustees presented their annual report to President Bush personally. At the meeting, the President said, ". . . the Trustees confirmed that benefits for today's seniors are safe and secure . . . also once again have delivered a sobering message—Social Security . . . is unsustainable for the long term. . . . We need to explore new ways to ensure that Social Security remains strong and financially secure for America's children and grandchildren."

He continued: "I am encouraged by the unprecedented level of bipartisan interest in . . . proposals . . . to strengthen Social Security. . . . Although these proposals differ in details, they are consistent in showing that if we give workers the opportunity to invest a portion of their wages in personal accounts, Social Security will be able to offer high benefits than would otherwise be the case."

He continued: "I hope that Members of Congress will join with the Social Security Administration and other interested parties in a national dialog about how best to strengthen and protect Social Security. I look forward to working with Congress to see that Social Security remains sound and strong for today's and tomorrow's retirees."

This hearing is part of that process of working together to fulfill our obligations to the hundreds of millions of Americans we serve. There is really no other program that impacts the lives of so many Americans.

Mr. Chairman, thank you, and I look forward to working with you and other Members of Congress to reach a bipartisan consensus on how best to protect and strengthen Social Security for future generations.

[The prepared statement of Mr. Lockhart follows:]

For Release on Delivery

SOCIAL SECURITY: WHOSE TRUST WILL BE BROKEN?

SENATE SPECIAL COMMITTEE
ON AGING

JULY 29, 2003

TESTIMONY OF

JAMES B. LOCKHART, III
DEPUTY COMMISSIONER
OF SOCIAL SECURITY

Testimony of
James B. Lockhart III
Deputy Commissioner of Social Security
Hearing before the Special Committee on Aging
United States Senate
July 29, 2003

Mr. Chairman, Members of the Committee, thank you for inviting me here today to discuss GAO's report entitled "Social Security Reform: Analysis of a Trust Fund Exhaustion Scenario." I would like to take this opportunity to commend the Chairman and the Committee for holding this hearing, and keeping the important issue of Social Security reform before the public. We at Social Security think it is an extremely important issue. Commissioner Jo Anne Barnhart has made achieving sustainable solvency one of Social Security's four major strategic goals.

I would like to begin by discussing the current and future financial status of the Social Security program. The figures I will cite are taken from the recent 2003 Annual Report of the Board of Trustees and will therefore differ somewhat from the figures contained in the GAO report, which used data from the 2001 Trustees Report. However, the qualitative conclusions drawn from both are the same: that the Social Security program as currently financed is unsustainable for the long term.

I must place some stress on the phrase "long term." Today Social Security is running surpluses, and I want to make it clear that the benefits of current retirees and those nearing retirement are safe. Social Security's

future financing shortfalls or changes proposed to address those shortfalls will not result in benefit reductions for retirees or near retirees.

Social Security continues to be one of the most successful government programs. Last year SSA paid over $450 billion in benefits to 46 million retirees, survivors, and disabled individuals. Social Security is much more than a retirement program. Thirty percent of our beneficiaries are disabled or survivors -- widows, widowers and children. About 154 million American workers paid Social Security taxes last year. They, and the millions joining the system every year, are relying on Social Security for a major portion of their future financial security.

Moreover, the combined old age and disability trust funds are growing; last year the funds grew to $1.4 trillion—an increase of 14 percent over the prior year. It should be noted, however, that half of that growth was from bonds issued to the fund to pay interest on existing assets.

The Trustees point out that pressure on the trust funds will begin in 2008, when the first baby boomers reach early retirement age and Social Security tax surpluses begin to decline. Beginning in 2018 the trust funds are projected to begin paying out more in benefits than is collected in taxes. At that time the funds will begin redeeming their assets, consisting of government bonds. By 2042, it is projected that all of the Treasury bonds that make up the trust fund assets will have been cashed in, and the Social Security trust fund assets will be exhausted. Over the long term, as the Trustees' Report says, the trust funds would be capable of paying less than 73 percent of scheduled benefits.

The trust funds would need the equivalent of an additional $3.5 trillion today to be able to pay all scheduled benefits for the next 75 years. $3.5 trillion is the present value of the Social Security program's unfunded benefit obligations over the next 75 years. That means that a lump sum of $3.5 trillion today, earning interest at the Treasury bond rate, could be drawn down to pay annual revenue shortfalls over the next 75 years. This $3.5 trillion is a figure roughly equal to the total public portion of the national debt. This measure of unfunded benefit obligations is up $200 billion over last year and $600 billion over 2000. Absent any action to address this situation, this steady growth in the shortfall will continue, year after year.

Traditionally, the Trustees have measured the long-term financial health of the Social Security system by evaluating the system's operations over a 75 year period. However, to achieve sustainable solvency, which the Trustees have defined as not only meeting the 75 year test of solvency but also assuring that at the end of that 75 year period the trust fund is stable or rising – that is, to make Social Security solvent permanently – the trust funds would need an additional present value $10.5 trillion today. Absent any action the shortfall will continue to grow at a compounding rate.

If this remaining $10.5 trillion shortfall were divided up among current workers – that is, if they decided to leave to future generations a program free of unfunded obligations – it would equal over $99,000 per average family of 1.5 workers. For the average family, Social Security's unfunded obligations almost equal the family's net worth of $107,000. Even if spread among future workers not yet entered into the program, the price for making the current Social Security program sustainable is large.

At your request, Mr. Chairman, the GAO has today issued a report detailing what may occur in the event that the trust fund exhaustion date is reached without any Congressional action being taken. The scenario GAO analyzed—a proportional reduction in benefits—is a very possible outcome in such a situation.

At the point of trust fund exhaustion, in 2042, tax income would cover only 73 percent of scheduled benefits, which means a 27 percent across the board reduction in scheduled benefits. Benefits would continue to decrease thereafter and by 2077, there would be a 35 percent reduction in scheduled benefits. Younger workers would be particularly hurt in a trust fund exhaustion scenario, as they would spend much or all of their retirement years in a post-trust fund exhaustion world.

It would be very hard to explain that to the younger generation. My 26 year old son who is here today, and who will reach the then normal retirement age of 67 in 2044, after paying into Social Security for well over 40 years will have his scheduled benefits drastically cut and every year in retirement they would continue to be cut. In contrast, based on life expectancy, we leading edge baby boomers will not see a benefit cut.

Congress has never allowed the finances of the Social Security program to reach the point that full promised benefits could not be paid, and I would not expect it to do so in the future. If benefits were not reduced and only tax increases were used to address solvency, the payroll tax rate would have to increase from the current 12.4% to 15.9% in 2043 and would continue to increase each year thereafter rising in 2077 to a rate of 18.9% of covered wages, more than 50 percent higher than it is today. The GAO

report only reinforces the position that action to strengthen Social Security should be taken sooner rather than later to assure that the events outlined in the report never take place.

The President has pledged that trust fund exhaustion will never take place. Social Security's insolvency must be prevented and it will be prevented, through the bipartisan cooperation of Congress, the Administration, and the American people.

As the Trustees said in their Annual Report, "The sooner adjustments are made, the smaller and less abrupt they will have to be." Changes can be phased in more gradually, reducing the need for any sudden and severe impact on American workers and their families. The effect upon each individual can be decreased through early action because the cost of fixing Social Security can be more evenly spread among generations of American workers. For example, the changes enacted for the retirement age in 1983 were phased in over many years; individuals reaching normal retirement this year were the first to have their retirement age increased. For this year's retirees the age is 65 years and 2 months.

Early action will also allow current workers plenty of time to properly plan for their retirement. And finally, the sooner action is taken, the sooner confidence can be restored to the Social Security program and the sooner the burdens of future economic and retirement uncertainties faced by the American public can be relieved.

The goal of strengthening Social Security is not simply to make the Social Security program solvent at the end of the 75 year long-range period but rather to achieve sustainable solvency, that is, to maintain solvency

beyond the 75-year period. Under the scenario developed in the GAO report, sustainable solvency, by definition, would be achieved. Although this scenario--a large and abrupt benefit cut beginning in 2042, followed by continuing benefit reductions--would achieve sustainable solvency, I think we can agree that this is not a desirable outcome.

Clearly, achieving sustainable solvency will be no easy task. However, delay only makes the task more difficult. It is not suggested that taxes be increased or benefits cut, especially for retirees or near retirees, but, solely as an illustration of the costs involved to reach solvency just through 2077, there would need to be either an immediate 15 percent increase in payroll taxes or a 13 percent reduction in benefits. By 2018, there would need to be a 22 percent increase in payroll taxes or a 16 percent reduction in benefits. And by 2042, if nothing is done, payroll taxes would have to be increased by 46 percent, or benefits cut by nearly one-third.

The unattractiveness of relying exclusively on tax increases and benefit reduction to bring Social Security to balance, has led Republicans and Democrats to look for additional options. A number of them, including a majority of each of the last two presidential advisory commissions, as well as President Bush himself, have proposed that this be accomplished through Social Security personal accounts.

One of the Social Security Administration's key roles is for our actuaries to provide a non-partisan costing of any reform proposals. To that end, they reviewed all three of President Bush's Commission to Strengthen Social Security's proposals and have reviewed a number of plans

introduced or developed by both Democratic and Republican Members of the House and Senate. These proposals contain a wide range of provisions; many include personal retirement accounts, and the plans use a variety of means to restore Social Security to 75-year solvency, including changes to benefit growth, the retirement age, cost of living adjustments, and inclusions of transfers of general tax revenue to Social Security. Some of these proposals would ultimately have significantly less costs to the trust funds and to general revenues than the current system in order to offer the same projected total benefit levels.

With bipartisan commitment, informed discussion, creative thinking, and timely legislative action, we will ensure that Social Security continues to protect future generations.

As we all know, this century will see a rapidly aging America, which will bring about changes in many areas of national life, including the Social Security program. Just in the next 30 years the number of Americans aged 65 and older will double. Lower birth rates and increased life expectancies have reduced the ratio of workers to beneficiaries from over 8-to-1 in 1955 to around 3-to-1 today. By 2031 there will be only around 2 workers supporting each Social Security beneficiary.

In March of this year, Social Security's Board of Trustees presented its annual report to President Bush personally. At this meeting, the President reiterated his support for action to strengthen Social Security, saying;

> "...the Trustees confirmed that benefits for today's seniors are safe and secure. Promises made can and will be kept. The Trustees also

once again have delivered a sobering message—Social Security, in its present form, is unsustainable for the long term. I share the Trustees' view that we need to explore new ways to ensure that Social Security remains strong and financially secure for America's children and grandchildren.

"I am encouraged by the unprecedented level of bipartisan interest in Social Security modernization. Many comprehensive proposals have been put forward to strengthen Social Security for the long term. Although these proposals differ in details, they are consistent in showing that if we give workers the opportunity to invest a portion of their wages in personal accounts, Social Security will be able to offer higher benefits than would otherwise be the case.

"...I hope that Members of Congress will join with the Social Security Administration and other interested parties in a national dialogue about how best to strengthen and protect Social Security. I look forward to working with Congress to see that Social Security remains sound and strong for today's and tomorrow's retirees."

This hearing, I hope, will be part of that process of working together to fulfill our obligations to the Social Security program and the hundreds of millions of Americans it serves, today and in the future. The Social Security Administration will continue to work with this committee, other Members of Congress and outside groups to build this national dialogue into a bipartisan consensus on how to strengthen Social Security for future generations.

There is no other Federal program that impacts the lives of so many Americans. And as important as the program is today, it will become even more important in the next few decades, when today's boomers become tomorrow's aged. We must find a way to financially provide for these older Americans without unduly burdening succeeding generations.

In conclusion, I would like to just quote the old seafaring wisdom that I found applicable in my Navy days, which is "the world isn't interested in the storms you encountered, but whether or not you brought in the ship."

I believe that this will be the true test of our own work. Storms of controversy often surround the issue of how to provide retirement security. My son's and future generations will care primarily that we have been able to protect and strengthen the Social Security program so that it can remain a safe harbor for them and their children.

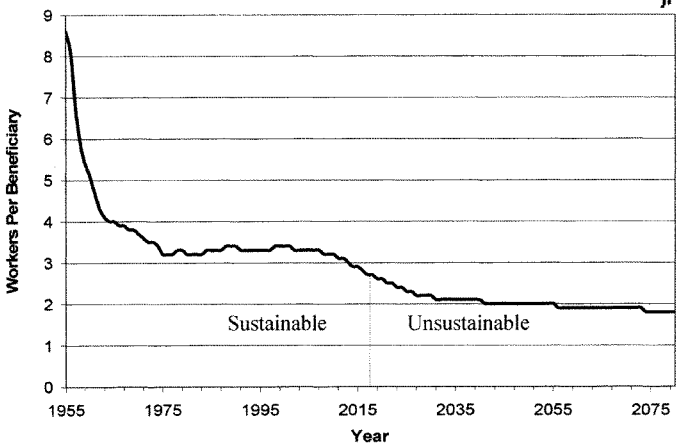
Mr. Chairman, thank you again for inviting me to discuss the GAO report and the future of Social Security. I look forward to working with you, and other Members of Congress and the Administration to reach a bipartisan consensus on how best to reform Social Security for the future.

Social Security: Whose Trust Will Be Broken?

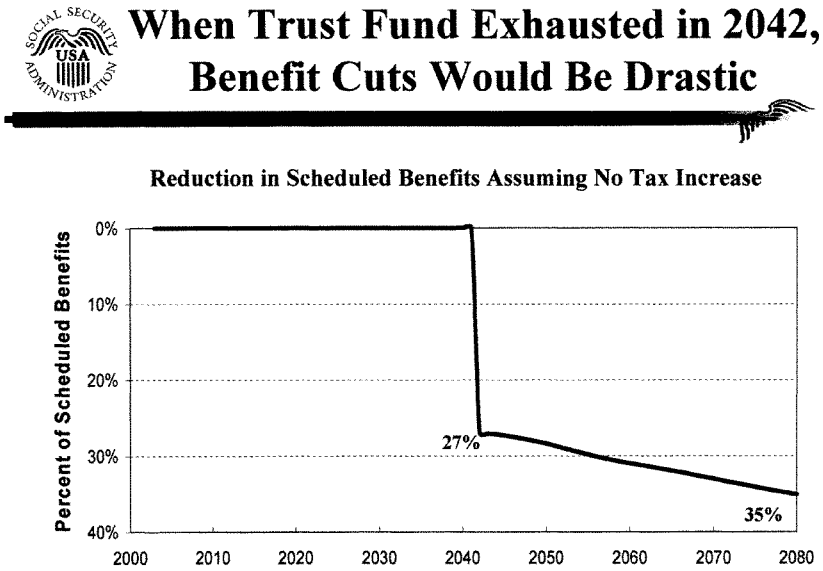
Testimony by James B. Lockhart
The Deputy Commissioner of Social Security

Hearing Before the Special Committee on Aging
July 29, 2003

Ratio of Workers to Beneficiaries Is Falling Rapidly to Unsustainable Levels

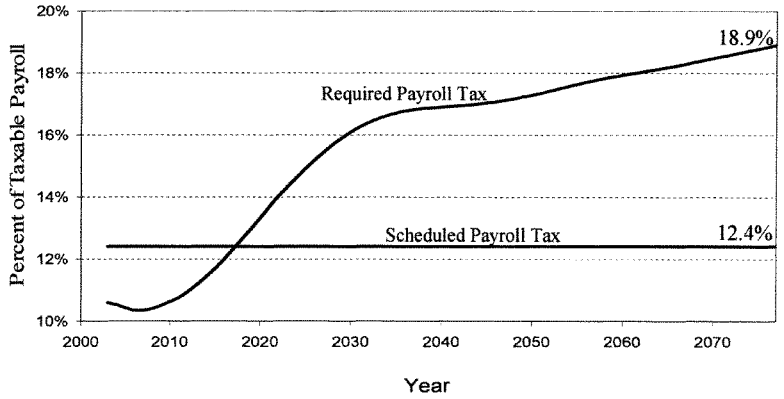


Based on Current Tax and Scheduled Benefit Rates

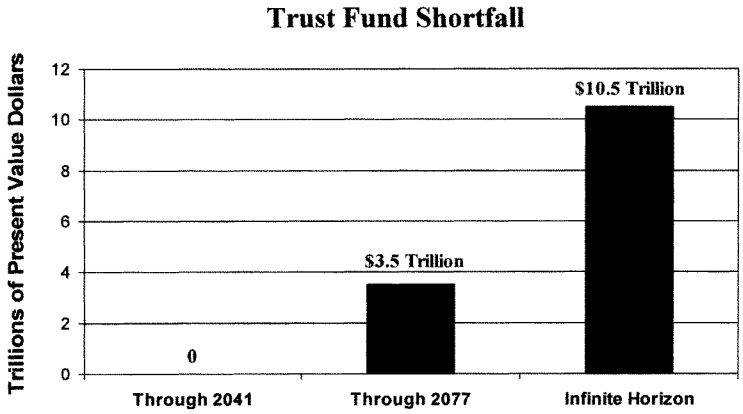

When Trust Fund Exhausted in 2042,
Benefit Cuts Would Be Drastic
Reduction in Scheduled Benefits Assuming No Tax Increase
Percent of Scheduled Benefits
0%
10%
20%
30%
40%
27%
35%
2000
2010
2020
2030
2040
2050
2060
2070
2080

To Pay Scheduled Benefits, Payroll Taxes Would Have to Increase Over 50%

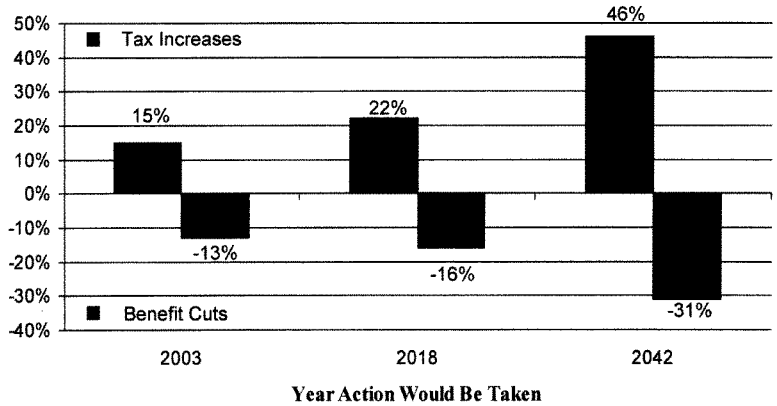
Payroll Tax Required for Scheduled Benefits



To Achieve Sustainable Solvency, the Challenge Is Even Larger



Delay Increases the Cost to Fix Social Security



The CHAIRMAN. Well, Commissioner Lockhart, thank you very much. Let me thank both of you for your testimony this morning and the consistency and I think the responsibility you have brought in discussing this issue. I think all of us recognize the value of the program and the phenomenal impact it has on seniors.

I am always made aware of that. I hold a good number of town meetings in my State on an annual basis, and I have a fair number who attend who will tell me that it is their single largest source of income in their senior years or that it is a substantial or only source of income, depending on their particular condition and situation of disability.

That is a fairly sobering statement, at least to me, when I realize the level of dependency that these individuals place on the program itself. So there is no question that not only is it important for the healthy, the most vulnerable in our society are dramatically impacted and would be, I suggest, by this proposal.

A 30-percent reduction, or near that, in payment by the late 2030 to 2040 timeframe, both of you agree with that scenario. I see your charts are very similar.

Mr. LOCKHART. Yes, they are.

Mr. WALKER. That is correct.

The CHAIRMAN. Of course, that is making the assumption that those who are the recipients at that time are the ones who have paid in at consistently higher levels throughout their productive years. Is that not correct?

Mr. WALKER. That is correct.

The CHAIRMAN. You know, outside of economists and actuaries, most folks—and, Mr. Lockhart, you dealt with explaining this. Most folks do not really understand what present value means. Can you briefly clarify for us the difference between present value and common ways of thinking about spending? For example, in normal dollar terms, about how big would the 75-year deficit be? Both of you can respond to that if you wish.

Mr. LOCKHART. Well, let me start with that. It is a concept we introduced this year in the Trustees' Report for the first time. It is not only actuaries and economists who use it, but financial folk like myself use it all the time.

Really, to look at it in its simplest way, it means that we would need that amount of money today, earning interest today, to cover the shortfall over the 75-year period. So if you look at the numbers, the interest on that amount of money is well over $200 billion a year. That is just to cover the shortfall over the 75-year period. As David Walker pointed out, what our goal has to be is sustainable solvency. The other point of that number is it does include our present trust fund.

But if you look at the longer term, that $10.5 trillion that I had in that chart—if you would put that back up—if you look at that, it is triple that amount. Every year there is interest of about $650 billion. So the numbers are very, very large. The point is you need that money today earning interest. Or if you get it later, you have to even put in more money.

Yes, there are other ways to look at it, and one of the ways is to say how much in today's dollars we need for the 75-year period.

Again, including the trust fund, that is about $21 trillion in constant 2003 dollars.

If you look at nominal dollars and assume, say, a 3-percent inflation rate——

The CHAIRMAN. I was going to say, how do we adjust for inflation here? If we choose to do that, obviously.

Mr. LOCKHART. The Trustees' Report assumes a 3-percent inflation rate. If you use that number and look at nominal dollars, future dollars, if you will, that is about $120 trillion. I mean, all these numbers are so large it is hard to come to grips with. But one way to look at the $10.5 trillion number is it is $100,000 for every American family. The net worth of the average American family is just about that.

Mr. WALKER. The bottom line, Senator Craig, is how much money you would have to have today invested at Treasury rates in order to fund the gap between projected revenues and projected expenses. As Mr. Lockhart said, for the 75-year period, which is historically what the Trustees have done for a number of years, you would need $13.5 trillion today invested at Treasury rates.

But if you look in perpetuity, recognizing that things are getting worse every year after the trust fund goes insolvent, including at the end of the 75-year period, you would have to have $10.5 trillion today invested at Treasury rates. Guess what? We don't have $10.5 trillion today. That is almost the size of the U.S. economy for a year.

The CHAIRMAN. Very close.

Mr. Walker, in your testimony you state that slowing labor force growth is not always recognized as part of the Social Security debate. One of the possibile items you mentioned for addressing the financial gap includes raising payroll taxes. What would be the effect on wages and employment of increasing the payroll tax to close the Social Security financing gap?

Mr. WALKER. Well, it is a complex factor, but I will say this: to the extent that you end up raising the payroll tax, that obviously has a negative effect on employment opportunities. It also happens to be the most regressive tax that we have. As you know, the payroll tax gets imposed on all individuals up to the taxable wage base, and so raising it is obviously going to have a negative effect on what employment opportunities and represents an increase in a regressive tax.

I think one of the things we need to think about, Senator, is what can we do to encourage people to work longer. We have a problem whereby we face slow workforce growth and we need to try to encourage seasoned Americans, especially in a knowledge-based economy with longer life spans, to work longer. This can help us not only on the revenue side, it can help us on the expenditure side. Other than that, we can look at immigration policy and what, if anything, might need to be considered in order to deal with these dependency ratios.

The CHAIRMAN. OK. Today, the worker-to-retiree ratio is about 3.3:1. By the time of the trust fund exhaustion in 2042, there will be only two workers to support each retiree. At least that is the current projection. This happens because our labor force growth drops to what your testimony terms "negligible growth." In what

ways can lawmakers address labor shortages in the next couple of decades? You probably have already addressed that in the tail end of your last question about working longer. Are there other factors?

Mr. WALKER. Well, immigration policy—which is obviously complicated now because, while our country is comprised to a great extent of immigrants, with new security threats there is obviously a new dimension associated with immigration policy. Other than that, it is trying to find ways, as I mentioned, to encourage people to work longer.

Now, the interesting thing is that if you look at average life spans, if you consider the fact that we have moved from the industrial age to the knowledge age, where it is brain power rather than brawn; if we recognize the fact, as medical science has shown, that to the extent that people stay mentally and physically active for a longer period of time, they are likely to live longer and have a more productive life, all things being relatively equal; I would argue that we need to look at what can be done not only with regard to Federal entitlement program policies but also private pension and other employee benefit policies and practices to encourage people to work longer, even if it is just on a part-time basis.

The CHAIRMAN. It appears to be starting to happen almost voluntarily because of certain needs and certain desires and lifestyles and health and niches with the workforce that need that kind of experience. But as a part of policy, it isn't there yet.

Mr. Lockhart, from the Social Security Administration standpoint, can you tell us why sustainability is so important?

Mr. LOCKHART. We have set sustainability as one of our four major strategic goals, and the reason really simply is that we think it is important to strengthen Social Security not just for a short-term period or some arbitrary period, but for the long term, for our children and our grandchildren.

There are obviously a lot of ways to define "sustainability," but it really means that we eventually start creating a positive cash-flow; that if you look at the $3.5 trillion and the $10.5 trillion numbers, that they are equal, if you will, that it doesn't grow after the 75-year period.

If you don't have sustainable solvency, you are going to fall off the cliff, just like they are falling off the cliff in 2042. Reform should really be addressed to achieve sustainable solvency, not just a 75-year period.

The CHAIRMAN. OK. Can you explain what you mean by saying in your testimony that some of the reform proposals, despite significant transition costs, are less costly than the present system?

Mr. LOCKHART. Yes, Mr. Chairman. It is our belief that reforms should be judged against the cost and benefits of the present system, and that cost over the very long-term future is $10.5 trillion. In contrast, some of the personal account proposals, with other changes besides personal accounts as well, have a cost to general revenues in the $1 to $3 trillion range, and they have been graded by GAO, some of them, and by our actuaries as sustainable.

So by that transition investment, one could actually reduce or eliminate that $10.5 trillion number. So from our standpoint, it is not a transition cost. It is a transition investment. The return on investment is excellent.

Mr. WALKER. Mr. Chairman, if I might?

The CHAIRMAN. Please.

Mr. WALKER. One of the problems that we have is that if you look at how we keep score in the Federal Government, it can lead to some very perverse decisions. For example, from a budgeting standpoint, we look at 10-year cash-flows. We don't look at discounted present value concepts.

It is very important that we start considering discounted present value, not only for Social Security and Medicare and related obligations, but also any major spending and tax decisions. Because if we don't do that, then we may end up taking actions that arguably make sense in the short term, but are unsustainable in the long term. This is part of our fiduciary and stewardship obligation to future generations, to our children and grandchildren.

The CHAIRMAN. Mr. Lockhart, what is the Social Security Administration doing or what efforts are you making at this moment to educate the public about the consequence of inaction in strengthening Social Security? Is there any outreach of communicative effort now based on the information that is being accumulated?

Mr. LOCKHART. Certainly. As, again, one of our four strategic objectives, a big part of that objective is solvency education. We have started that. We have a lot farther to go in that. We have our communications group, our policy group, our actuaries all working on it.

One of the things we do is that we send out every year a statement to American workers, anybody who is over 25. I think my son just got his first this year. It is trying to lay out the future of Social Security as well as project future benefits. Unfortunately, too many people just look at the numbers, and they don't look at the message. The message in there is the same that we have been talking about today, that there is a serious long-term issue. So we put that out.

Certainly our website is one of the most looked at websites in Government. We have frequently asked questions on there about Social Security's future. We have communications people throughout the country. We, as you know, have 1,300 field offices. We are involved in a lot of local events. We are working with interested interest groups and hope to do a lot more of that. Our policy and actuarial groups do papers, have forums.

But we can do more, and we will do more.

The CHAIRMAN. Mr. Walker?

Mr. WALKER. Mr. Chairman, I was part of a concerted national dialog effort in the 1997 to 1998 timeframe prior to becoming Comptroller General of the United States. As you know, I used to be a Trustee of Social Security and Medicare, and Assistant Secretary for Pensions and Health at the Labor Department in an earlier part of my life. That effort showed, quite frankly, that the American people get it; that if they are provided with the information, that they can be moved to recognize that there is a need for reform.

At the same point in time, I would respectfully suggest that if we are going to engage in such a dialog, we need to recognize that we have a broader challenge. As on one of the charts that I showed, we have a large and growing fiscal imbalance. We have a struc-

tural deficit. This is a subset of that broader challenge, and so people need to understand that we need to make some tough choices in a range of areas. This is just one. Health care is one that is much greater than this.

So I would respectfully suggest that while we need a national dialog, we need to dialog on the overall imbalance, we need to talk about Social Security, but we also need to talk about health care, because, frankly, that is a lot bigger problem and a lot tougher challenge than Social Security.

The CHAIRMAN. Well, I agree with both of you. The American people get it today. I sense that in my experience over the last 20 years, that when it comes to a dialog on Social Security—there was an old line that I remember as a freshman in Congress: "Don't you touch Social Security. You leave that alone, Congressman." To a much more thoughtful line today, and that is, "How do we fix it?" Or "How do we make sure that it is there for our children and our grandchildren?" Most importantly—and I think I am increasingly surprised, and I spend a lot of time in high schools. The No. 1 question asked of me by high school seniors is: What are you going to do about Social Security? All of a sudden they got their first paycheck. They saw what was taken out of it. They know the importance of it to their grandparents. But all of a sudden it has dawned on them that they are going to be large payers into it. There is an informational base that they are looking at out there.

So it is interesting to see that dialog beginning at a very early age in the workforce, and I think that is tremendously valuable.

Mr. WALKER. If I might, Mr. Chairman, follow up, you mentioned before something that is very important—Mr. Lockhart did as well—that from a practical standpoint, today's seniors and those that are nearing retirement aren't going to be affected.

The CHAIRMAN. Exactly.

Mr. WALKER. So, therefore, it means that the sooner we act so that we can end up structuring reforms to where they affect younger people more than the current seasoned Americans, if you will, and retirees, then they have time to be able to make the necessary adjustments. They will have an opportunity to make the adjustments. So we can structure reforms, if we get on with it, that will exceed the expectation of every generation of Americans.

One of the things that many younger workers and young people don't understand is that even when the trust fund goes insolvent, they still will get 73 cents of their benefits but declining thereafter many think it means that there is no money at all. That is not true. So we really have an opportunity to exceed the expectations of all generations. We just need to get on with it.

The CHAIRMAN. Well, thank you. We have been joined by my colleague from Michigan. Senator, welcome, and you are certainly welcome to make an opening statement and ask questions of either of these gentlemen. Thank you.

Senator Stabenow. Thank you, Mr. Chairman, and——

The CHAIRMAN. Turn your mike on, please?

Senator Stabenow. Rather than making an opening statement, welcome. We appreciate both of you and your leadership roles and information that you provide. I think rather than an opening statement, I would like to ask some questions.

I noticed that the hearing really talked about—and the chairman, our distinguished chairman of the committee, has asked you to look at the "do nothing" strategy related to Social Security. I guess I would challenge the "do nothing" title of this because I believe we have done something. What we have done is pass a series of tax cuts on two different occasions now that have placed us in a much more serious situation in order to meet our obligations long term, it would certainly appear by the numbers.

Mr. Chairman, there is a Center on Budget and Policy Priorities study that I would ask be placed in the record that is called "Social Security and the Tax Cut." The 75-year cost of the tax cut is more than twice as large as the long-term deficit in Social Security. I would ask that that be placed as part of the record.

The CHAIRMAN. Certainly. It will be a part of the record.

Senator Stabenow. Thank you.

[The study follows:]

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Revised April 11, 2002

SOCIAL SECURITY AND THE TAX CUT
The 75-year Cost of the Tax Cut Is More than Twice As Large as the Long-Term Deficit in Social Security

by Richard Kogan, Robert Greenstein, and Peter Orszag

Restoring long-term solvency to Social Security and ensuring a sustainable long-run fiscal policy for the United States are issues of major importance. To help illuminate these issues, this analysis examines and compares the fiscal dimensions of two major items: the projected long-term deficit in Social Security and the long-term cost of the tax cut enacted last June (assuming that the provisions of the tax cut are extended beyond their scheduled expiration dates).

From listening to various pundits and policymakers, many Americans may believe that the tax cut is modest in size while the long-term Social Security shortfall is enormous. Senator Phil Gramm, for example, has said: "This is not a huge, irresponsible tax cut, this is a modest tax cut....this is a prudent, responsible tax cut." Last year's interim report of the President's Social Security commission stated that the Social Security shortfall is of a magnitude that threatens "astronomical levels of borrowing." Michael Tanner of the Cato Institute, one of the most ardent and most widely quoted privatization proponents, has likened Social Security's condition to that of the Titanic, while David John of the Heritage Foundation has written that Social Security faces a "monsoon."

Over the next 75 years – the period used to measure Social Security's financing gap – the revenue loss from the tax cut will be $5 trillion larger than the entire Social Security shortfall.

As this analysis shows, the long-term size of the tax cut is *more than double* the entire long-term Social Security shortfall. The tax cut is not as modest as its proponents often claim, while the Social Security shortfall — although a significant problem that must be addressed — is not as gargantuan as often portrayed by those seeking radical changes in Social Security.

When this analysis was first issued on August 2, 2001, the Administration attempted to refute its findings on the relative magnitude of the tax cut and the Social Security shortfall. The Administration's arguments were unpersuasive (see box on page 3). Moreover, even the Administration's "refutation" conceded that over the next 75 years, the revenue loss from the tax cut is fully as large as the shortfall in Social Security.

Because of the tax cut — and because the projections of large and growing surpluses made last spring have turned out to be too optimistic for other reasons as well — resources no longer exist outside of Social Security that could assist in restoring solvency to this program. Cancelling some provisions of the tax cut before they take effect in future years could help to provide such resources.

The Size of the Tax Cut and the Social Security Shortfall

According to the official estimates that the Social Security actuaries and trustees issued in March 2002, the projected long-term deficit in Social Security over the next 75 years — the period used for measuring long-term solvency — equals

Cost of Tax Cut and Size of Social Security Shortfall Over 75 Years

	As Share of GDP	Present Value
Social Security Shortfall	0.72%	$3.7 trillion
Tax Cut	1.68%	$8.7 trillion

1.87 percent of the wages, salaries, and self-employment income that will be subject to the payroll tax during this period, or $3.7 trillion in present value. (Present value is the amount today that, with interest, would exactly cover these future costs.) The trustees' report also shows that, measured as a share of the economy, the Social Security shortfall equals 0.72 percent of the Gross Domestic Product over the next 75 years.[1]

To measure the long-term cost of the tax cut, we take the Congressional Budget Office's most recent estimate of the cost of the tax cut in 2011 if all of its provisions are extended, and assume that these costs will remain constant as a share of GDP after 2011. Assuming that the cost of tax cuts will remain constant as a share of GDP once the tax cuts are fully in effect is the standard approach that the Congressional Budget Office, the Office of Management and Budget, and the General Accounting Office all use when preparing long-term fiscal projections. In this case, such an approach is likely to understate long-term revenue losses because the costs of several provisions of the tax bill, such as the estate tax repeal and the introduction of "Roth 401(k) pension plans," are virtually certain to grow faster than GDP for a number of years after 2011.[2] For this reason, our estimates of the long-term costs of the tax cut are likely to be conservative.

These figures highlight the inconsistency in the rhetoric of those who portray Social Security as facing an enormous financial chasm while touting the tax cut as modest and prudent.

The projected cost of the tax cut over 75 years amounts to 1.68 percent of GDP, or $8.7 trillion in present value. Thus, the cost of the tax cut over the next 75 years is more than twice as large as the long-term deficit in Social Security, as shown in the table above.[3]

In other words, if the tax cut takes full effect as scheduled and continues after 2010, its long-term costs will substantially exceed the 75-year deficit within Social Security. In fact, if the tax cut were scaled back so that three-fifths of it took effect while the funds from the other two-fifths of the tax cut were used instead to strengthen Social Security, the entire 75-year deficit in Social Security could be eliminated.

The figures on the relative size of the Social Security shortfall and the tax cut also show the fundamental inconsistency in the rhetoric of policymakers, interest groups, and others (including some Administration officials) who portray Social Security as facing an enormous financial chasm that threatens the nation's long-term fiscal health while touting the tax cut as modest and prudent.

We should emphasize that we would not recommend canceling 40 percent of the tax cut and placing all of the freed-up resources in Social Security. The nation will face serious financial strains when the baby boomers retire in large numbers. The long-term financing shortfall in Medicare is larger than that in Social Security, and the nation also is likely to face needs in the decades ahead that will require resources in other areas, including areas relating to children, the environment, the large number of Americans without health insurance, the lack of a Medicare

The Administration's Refutation Is Not Convincing

When this analysis was first issued on August 2, 2001, the Bush Administration responded by saying that the cost of the tax cut is only one percent of GDP (rather than 1.68 percent) while the Social Security shortfall is, likewise, close to one percent of GDP (rather than 0.7 percent). Although the Administration itself thus acknowledged that the revenue loss from the tax cut is fully as large as the Social Security shortfall, the 1.0 percent of GDP figure that it used for both estimates is not valid — its Social Security estimate differed from the traditional measure issued by the Social Security Trustees, while its tax cut estimate failed to include the cost of at least three provisions of the tax-cut law.

Under the intermediate projection prepared by the highly respected Chief Actuary at the Social Security Administration and published in the 2001 Social Security Trustees report, the Social Security shortfall was projected to equal 0.7 percent of GDP, virtually identical to the trustees' current estimate of 0.72 percent. The Center relies on these published figures. The Administration, by contrast, claimed that the Social Security shortfall equaled about one percent of GDP. It did so primarily by ignoring the assets of the Social Security Trust Fund. Such an assumption contradicts the long-established practice of the Social Security actuaries and trustees in evaluating the long-term imbalance within Social Security; the actuaries and trustees appropriately count the Trust Fund's $1.2 trillion in assets, since these assets clearly are available to help finance Social Security benefits. But even if one adopts the assumption the Administration did and ignores the Trust Fund's assets, the resulting restatement of the Social Security imbalance over the next 75 years (at 1.0 percent of GDP) is still much smaller than the cost of the tax cut (at 1.68 percent of GDP).

As noted, the Administration estimated the cost of the tax cut to be only 1.0 percent of GDP. It did so by looking solely at the cost of the tax cut, as enacted, *in 2010*, rather than at the cost of the tax cut when fully phased in and with all of its provisions extended. Under the Administration's estimating approach, the provisions of the tax cut that are artificially slated to expire in 2004, 2005, and 2006 are assumed to die rather than to be extended — including a provision scheduled to expire in 2004 that protects millions of taxpayers from being subject to the mushrooming individual Alternative Minimum Tax. The Administration's estimate that the tax cut would cost 1.0 percent of GDP thus assumed that 35.5 million taxpayers would be subject to the AMT in 2010, as compared with 1.4 million in 2001, and that the AMT would cancel out significant parts of the tax cut for large numbers of taxpayers. No credible observer believes Congress will simply allow this AMT-relief provision to expire in 2004. Similarly, the Administration's approach excluded the large cost of repealing the estate tax, a cost that only shows up in years *after* 2010. Under the tax-cut legislation enacted last year, the estate tax is not repealed until 2010. As tax estimators know, the cost of repealing the estate tax shows up only a year or two *after* the year in which it is repealed because there is normally a lag of a year or so between the time an individual dies and the time the estate is settled and tax is paid on it. (Even when ignoring the real costs of the tax cut, the Administration massaged its figures; CBO estimates that if all the provisions of the tax cut expire on schedule, it will still cost 1.2 percent of GDP in 2010.)

In short, the Administration's estimate that the cost of the tax cut is 1.0 percent of GDP relied upon gimmicks embedded in the tax bill to make the bill's cost appear lower than it actually is. Paul Krugman, the Princeton economist, wrote in the August 21 *New York Times* that the Administration's attempts to counter these Center estimates were deceptive and unsuccessful and that "the [C]enter's estimate matches those of the I.M.F. and other independent organizations." (For a more complete analysis of the weaknesses of the Administration's claims, see "Administration Critique of Center Analysis Does Not Withstand Scrutiny," Center on Budget and Policy Priorities, August 3, 2001.)

prescription drug benefit, and the uncertain costs of homeland security, as well as other problems that inevitably will arise in the future but that we cannot foresee today. A balanced long-term fiscal policy is likely to entail some changes in Social Security to reduce its future claims on the budget, rather than simply providing it with whatever resources are needed from the rest of the budget to close its entire long-term financing shortfall.

Providing resources from the rest of the budget to close a *portion* (rather than all) of the Social Security shortfall, however — in conjunction with other Social Security reforms — is likely to be essential if any reform plan to restore long-term solvency is to have hope of being enacted. Otherwise, the Social Security benefit cuts and payroll tax increases that will be required as part of any solvency plan are likely to be too large for such a plan to be politically viable.

The recommendations adopted by the President's Social Security commission illustrate this point. One of the three proposals advanced by the commission did little to restore 75-year solvency to the Social Security program. The other two did, but only with substantial cuts in guaranteed Social Security benefits and major adverse consequences for the rest of the budget. These other two proposals would cause a deterioration in the unified budget of more than $1 trillion over the next decade and between $1.9 trillion and $2.2 trillion during the decade from 2013 to 2022 (assuming that all eligible workers participate in the individual accounts). Moreover, the adverse budgetary consequences would persist for decades. Members of the commission were asked where these vast budgetary resources would come from, especially since surpluses outside of Social Security have now been replaced by deficits for the foreseeable future. They were unable to identify a way to finance the provision of these large sums. We do not concur with the commission's proposals, but we would note that scaling back some provisions of the tax cut that have not yet taken effect could help provide the sizeable general-fund resources the commission counts on.

The relative magnitudes of the long-term deficit in Social Security and the long-term revenue loss resulting from the tax cut highlight an important question: Given the demographic and other challenges that lie ahead, is a tax cut that ultimately will provide approximately 35 percent of its benefits to the most affluent one percent of the population the best use of the bulk of the surplus that had been projected outside Social Security and Medicare Hospital Insurance?

General Fund Assistance to Social Security

As alluded to above, the tax cut is likely to make Social Security reform considerably more difficult, if not impossible, for the foreseeable future. The tax cut consumes non-Social Security resources that are likely to be essential to the development of a politically viable package of reforms to restore Social Security solvency.

Transfers from the non-Social Security budget are likely to be crucial to the political viability both of Social Security plans that include individual accounts and of plans that do not. Without such transfers, individual accounts will have to be financed from existing Social Security revenue. Diverting revenue from the Social Security Trust Fund into individual accounts, however, would exacerbate Social Security's projected long-term deficit by reducing the revenue available to the system. Restoring long-term balance to the Social Security system while shifting revenue from the Trust Fund to individual accounts requires larger reductions in Social Security benefits (relative to the benefits that would be paid under the benefit formula in current law) than otherwise would be needed.

An analysis by one of the authors of this analysis and three leading economists and Social Security experts — Henry Aaron, Alan Blinder, Alicia Munnell, and Peter Orszag — found that if payroll tax revenues equaling two percent of wages were shifted from Social Security to individual accounts and Social Security benefits were maintained at current-law levels for people currently 55 and older, guaranteed Social Security benefits for workers 30 and under would have to be cut more than 50 percent.[4] Including the income

projected from individual accounts, the overall retirement income for such workers (their reduced Social Security benefits plus the retirement income they would receive from the individual accounts) would average 20 percent below current-law levels, with some workers losing considerably more than that, *if* stock market returns were as high in future decades as promoters of private accounts predict. As these figures suggest, the magnitude of the reductions in Social Security benefits that would be necessitated by action to create individual accounts without securing additional revenue from the non-Social Security budget is likely to doom individual account plans that lack another revenue source.

The tax cut is likely to make Social Security reform more difficult because it consumes resources likely to be essential to the development of a politically viable reform plan that restores long-term solvency.

In short, regardless of whether Social Security reform includes individual accounts, transfers from the non-Social Security budget are almost certain to be essential to the development of a politically acceptable reform plan. Such transfers are not likely to be possible without creating or increasing deficits outside the Social Security and Medicare Hospital Insurance trust funds, unless the tax cut is scaled back rather than extended in its current form.

The remainder of this analysis presents in greater detail the projections of the relative sizes of the long-term deficit in Social Security and the revenue loss from the tax cut.

The 75-year Deficit Within Social Security

As is well known, Social Security currently owns assets — Treasury bonds backed by the full faith and credit of the U.S. government — totaling more than $1 trillion. In addition, Social Security is currently running annual surpluses of roughly $150 billion, and these surpluses are expected to increase in size for a decade. According to the current projections of the Social Security Trustees, annual Social Security tax revenue (which does not include interest on the bonds the Trust Fund holds) will fall below Social Security benefit expenditures starting in 2017, but Social Security as a whole will run a surplus of more than $310 billion in 2017 because it will earn interest income on the bonds it holds. The Trustees expect Social Security to remain in surplus until 2027, even with the increase in the cost of benefits that will occur as the "baby boom" generation retires. At that time, the Trust Fund's assets will total $7.2 trillion (or $3.5 trillion if measured in today's dollars).

The Social Security actuaries calculate, however, that those assets, along with the interest on them and future Social Security revenue, will be insufficient to cover all of Social Security's future costs. Over the 75-year period used for long-term Social Security planning, the shortfall is projected to be $3.7 trillion.[5] In other words, if Social Security currently had $4.9 trillion in assets rather than the $1.2 trillion it now holds, projected Social Security revenues plus the expanded trust fund reserves (and the interest the reserves would earn) would cover projected costs for the next 75 years.

An equivalent measure of the long-term deficit under Social Security is the actuaries' projection that the system faces a projected 75-year imbalance equal to 0.72 percent of the Gross Domestic Product. In other words, if Social Security had additional revenue equal to 0.72 percent of GDP each year, its 75-year deficit would be eliminated. While this shortfall is far from trivial, it is not insurmountable. Last June, the International Monetary Fund concluded that "the long-term financing problems of Social Security are not large, especially compared with those in several other industrial countries, and could be addressed through relatively small adjustments in the program's parameters provided they are implemented quickly."[6]

The Deficit Within Social Security and the Cost of the Tax Cut, Measured in Perpetuity

It is possible to examine the size of the deficit in Social Security in perpetuity (rather than over 75 years) and the cost of the tax cut in perpetuity. Such a comparison can be made by using the same methodology as described here to estimate the permanent cost of the tax cut, and by using figures from the Social Security actuaries to estimate the permanent Social Security deficit. In both cases, the projection horizon is extended far beyond 75 years.

Calculations of costs in perpetuity are subject to even more uncertainty than the already uncertain estimates for 75 years, or even for 10 years. Birth, death, and productivity rates a century or several centuries from now are highly speculative. We would not recommend basing analyses or making policy decisions on specific estimates of costs in perpetuity.

The present value of the cost of the tax cut in perpetuity, estimated as above but extending the analysis beyond 75 years, equals $11.8 trillion (in 2002 dollars). Last year, the Social Security actuaries estimated that the present value of the cost of transforming Social Security from a primarily pay-as-you-go system to a fully funded system would amount to $11.7 trillion (in 2001 dollars).* This cost is approximately equal to the projected deficit in Social Security in perpetuity.** (This $11.7 trillion figure also is the cost that would have to be paid to transform Social Security fully into a system of individual accounts.) With the Social Security trustees' new projection of the Social Security shortfall over the next 75 years (1.87 percent of payroll) being nearly identical to the shortfall they projected a year ago (1.86 percent of payroll), an updated estimate of the size of the shortfall in perpetuity would yield a number very close to last year's $11.7 trillion figure, plus one year of inflation (to express the estimate in 2002 dollars).

In other words, the projected cost of the tax cut in perpetuity and the projected cost of the Social Security shortfall in perpetuity are about the same — close to $12 trillion in present value. Shifting the focus beyond 75 years consequently does not alter the basic finding of this analysis that the long-term cost of the tax cut is at least as large as the long-term deficit in Social Security.

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* Office of the Chief Actuary, "Unfunded Obligations and Selected Transition Costs for the Combined Old-Age and Survivors Insurance and Disability Insurance (OASDI) Programs," April 5, 2001.

** For further discussion of the connection between the cost of transforming Social Security to a fully funded system and the deficit in Social Security in perpetuity, see John Geanakoplos, Olivia S. Mitchell, and Stephen P. Zeldes, "Social Security's Money Worth,"in Olivia S. Mitchell, Robert J. Myers, and Howard Young, *Prospects for Social Security Reform* (University of Pennsylvania Press: Philadelphia, 1999).

The 75-year Cost of the Tax Cut

Budget policies are not commonly discussed in terms of their costs over 75 years, in part because the resulting figures would be mind-numbing. But it is instructive to do so, given the concerns over the long-term health of the federal budget that are being emphasized in the Social Security debate.

To calculate the long-term costs of the tax cut, we use estimates of the tax cut supplied by the Joint Committee on Taxation (JCT), the official tax estimator for Congress. The tax cut includes several provisions that expire before 2010, and all of its other provisions expire in 2010. Administration officials and other prominent supporters of the tax cut have made clear that they expect the tax cut to continue — and that those

who oppose its continuation will be portrayed as seeking to impose hefty tax increases on the American people. The CBO estimates used here show the costs that will occur in 2011 if the provisions are made permanent law. The CBO included these estimates in its annual report of January, 2002.[7]

To project the cost of the tax cut beyond 2011 (the last year for which JCT estimates are available), we assume it will remain a constant share of the economy thereafter. Based on the conservative assumption that the tax cut will remain a constant share of the economy from 2011 on, the cost of the tax over the next 75 years amounts to 1.68 percent of GDP over that period.[8] In dollar terms, the long-term cost of the tax cut amounts to $8.7 trillion in present value.[9] The cost of the tax cut thus is more than twice as large as the long-term deficit in Social Security, which amounts to 0.72 percent of GDP, or $3.7 trillion in present value.

Conclusions

Measured over the next 75 years, the costs of the tax cut, if extended permanently, are more than twice as large as the shortfall in Social Security. While the Administration recently wrote that it is "impossible to afford" the current Social Security system "without large tax increases," this analysis makes clear that what the Administration calls large tax increases are less than half the size of the tax cut the Administration pushed through last year.[10] Policymakers concerned about both the long-term fiscal health of the nation and the restoration of long-term Social Security solvency would do well to examine options for canceling some of the scheduled tax cuts before they take effect (particularly provisions narrowly targeted on those with the highest incomes) and using a portion of the resources as a down-payment in restoring solvency to the Social Security system. Canceling part of the tax cut could, if all goes well, provide the resources for transferring some general revenues to Social Security. Such transfers are likely to be an essential ingredient of a sound Social Security reform package that makes changes in the Social Security program.

Without the resources consumed by the tax cut, the Administration and Congress are likely to have an exceedingly difficult time in fashioning Social Security proposals that both avoid very large benefit cuts and achieve solvency over 75 years. In addition, if the tax cuts take effect as scheduled and are continued after 2010, as the Administration proposes in its current budget, the long-term drain on the budget will exceed the long-term benefit to the budget of eliminating the entire Social Security shortfall.

Notes:

1. Under the Social Security actuaries' intermediate projections, the projected 75-year deficit amounts to 1.87 percent of taxable payroll. Over this 75-year-period, taxable payroll will amount to 38.4 percent of the Gross Domestic Product when both are expressed in present value. As a result, the 75-year imbalance amounts to 0.72 percent of GDP, which is equal to 1.87 percent of taxable payroll multiplied by 38.4 percent. The figure of 0.72 percent of GDP appears in Table VI.E5 on page 164 of the Trustees Report of March 26, 2002.

2. The assumption that the tax cut will remain a constant share of GDP after 2011 is likely to be conservative. Before the tax cut was enacted, both income tax revenues and estate tax revenues were projected to grow somewhat faster than the economy. This growth was projected to occur primarily because national income is projected to grow faster than inflation (with the resulting income growth pushing some taxpayers into higher marginal tax brackets even though the brackets are indexed to inflation), and because the amount that was exempt from the estate tax was not indexed for inflation. In addition, some provisions of the tax legislation, such as the creation of Roth 401(k) accounts and the increase in the amount that can be contributed to a Roth IRA, are substantially more costly in the long run than in the short run.

3. Another indication of the conservative nature of the estimate used in this paper — that the tax cut has a present value equal to 1.68 or of GDP — is that in a forthcoming Brookings Institution paper, Alan Auerbach, William Gale, and Peter Orszag estimate that cost at 1.85 per of GDP. Alan J. Auerbach, William G. Gale, and Peter R. Orszag, "The Budget Outlook and Fiscal Policy Options," Brookings Institution, forthcoming. The difference between the two estimates primarily reflects differences in estimating the costs of the interaction between the tax cut and the Alternative Minimum Tax.

4. Henry J. Aaron, Alan S. Blinder, Alicia H. Munnell, and Peter R. Orszag, "Governor Bush's Individual Account Proposal: Implications for Retirement Benefits," The Century Foundation and the Social Security Network, June 6, 2000.

5. The $3.7 trillion is the net present value of the 75-year Social Security deficit. (This figure can be calculated using the year-by-year data backing up table V1.E7 in the trustees' report. Those data allow the calculation of the present value of GDP over 75 years, which totals $519 trillion under the trustees' projections. The $3.7 trillion figure — the present value of the Social Security shortfall — equals 0.72 percent of $519 trillion.

6. International Monetary Fund, "Staff Report for the 2001 Article IV Consultation," June 28, 2001, page 30.

7. Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2003-2012*, January 2002, pp. 47, 65. This analysis also makes use of Joint Committee on Taxation estimates of the cost of addressing problems related to the individual Alternative Minimum Tax that were caused by last year's tax-cut legislation. These JCT estimates, provided last year at the request of Rep. Charles Rangel, reflect costs related to extending a provision of last year's tax-cut legislation scheduled to expire in 2004 that provides relief from the AMT. Through 2004, this provision holds the number of taxpayers subject to the AMT to roughly the number that would have been subject to the AMT under the law in place prior to enactment of the tax-cut legislation. In preparing these estimates of the cost of the tax-cut legislation in 2011 if its provisions are extended, the JCT assumed continuation of this AMT-relief provision in such a manner that the number of taxpayers subject to the AMT would continue to track closely the number of taxpayers who would have been subject to the AMT under prior law. (This approach is likely to understate the cost of addressing problems in the AMT, since under the prior law — and hence under the JCT estimates used here — the number of taxpayers subject to the AMT still would rise from about 1.5 million in 2001 to more than 20 million in 2011.)

The CBO and JCT figures show that with the AMT and other provisions extended, the tax-cut legislation would cost $1.7 trillion through 2011 (before accounting for additional debt service costs). This figure, which forms the basis for the estimates in this analysis, is lower than a comparable estimate made by the IMF, which concluded that "the total cost of the tax cuts is likely to be higher than the $1.35 trillion estimate. Extending the tax cuts through 2011 and extending the AMT provisions would raise the cost of the package to an estimated $1.9 trillion." (*Op. cit.*, p. 28)

The estimate used here for the cost of the tax cut does *not* include the cost of extending an array of popular tax credits that are regularly extended for a few years at a time and are virtually certain to continue being renewed. That cost is not included here because the recently enacted tax law does not address the issue of extending these credits.

8. In conducting this analysis, we used the actuaries' estimates of GDP in calculating the amount of the tax cut to assure consistency in our cost estimates.

9. The $8.7 trillion figure is the net present value of the tax cut over the next 75 years, discounted at the same discount rate as the Social Security actuaries use to calculate the 75-year deficit in Social Security.

10. Council of Economic Advisers, *Economic Report of the President,* February 2002, p. 79.

It seems to me, if we are looking at all options—and it is always a question of values and priorities—that we certainly cannot look at tax policy separately or in isolation from this debate, that this is all part of the same debate in terms of the revenues that are available, the way the trust funds are used, what the deficit is, as well as our obligations and so on.

So I am wondering—Mr. Walker, I would ask you first—if you would agree that the decisions we have made on tax policy will make it tougher to meet our Social Security obligations in the long run.

Mr. WALKER. I think you have to look from a macro and micro perspective. Macro is the overall fiscal situation, and then micro would be individual programs such as Social Security.

As my testimony points out on one of the figures, we face a large and growing fiscal imbalance due to decisions that have been made both on the spending side and the tax side. Frankly, we have been increasing spending at a much more dramatic rate than historically has been the case and was expected. There have also been actions taken on the tax side. The combined effect is that the bottom line is much worse as a result.

As we show on Figure 5 that is in the testimony, based upon the assumptions laid out, we face a large and growing fiscal imbalance, a structural deficit. Tough decisions are going to have to be made dealing with entitlement programs, discretionary spending, and tax policy. Ultimately that is a policy decision for the Congress to make, but it is not just one issue. It is looking at all three dimensions in order to solve the problem.

Senator Stabenow. I appreciate that. The reality is, as you have just indicated, that we make decisions every day. It is really not "do nothing." We make decisions every day that impact what will happen in terms of Social Security.

Mr. Lockhart, I don't know if you would like to respond to that question.

Mr. LOCKHART. Certainly if you just look from the Social Security standpoint, for all payroll taxes that are not used, to pay benefits or administrative expenses, we get a Treasury bond. We also receive bonds to pay for the interest on trust fund assets every year. So from the trust standpoint, there is no impact.

I think what I would like to do is really look at the $3.5 trillion, and picking up a comment that Mr. Walker made about looking at the net present value of the cost of these programs, one of the things one can do with reform is to reduce those numbers pretty dramatically. You can stop some of the growth on those charts that he has there. Social Security is slated to grow from about 4.4 percent of GDP to about 7 percent by 2077. By reforms, you can actually level that off in a way that is fair to present and future generations. That is, I think, what we should be looking for, and that is why I think we should be doing reform sooner rather than later because it is a lot easier if we do it sooner.

Senator Stabenow. Well, I guess to go back to my original premise, when I look at as a member of the Budget Committee at decisions like—I was fortunate to come on that committee 2 years ago. We were debating what to do with the $5.7 trillion surplus, I believe the largest or one of the largest surpluses that our Fed-

eral Government has been fortunate to have. Then 2 years later, now we have seen, I believe, the largest swing ever in our history to over a $2 trillion deficit. So over a $7 trillion swing as we just look 10 years out, the largest single year deficit possibly ever in our country that we are facing right now.

The reality is that we are making decisions that impact that. Some of that is the slowed economy. The largest single piece of that is tax policy, the tax cuts that were given. Then we have spending, and I believe it is somewhere in the range of 96 percent of the increases we have seen in 2 years are defense, homeland security, and restoration of the 9/11 targets, particularly in New York. So 96 percent is something that the people of our country certainly believe needs to happen for our basic safety and security. All of those things, again, combine back to having an impact.

When we were debating the $5.7 trillion surplus, a number of us, including at that time the chairman of the Budget Committee, suggested because of your presentations, the numbers you have, that we actually put dollars aside to go into—to essentially put money in the bank in terms of the trust fund for future generations to address these issues of solvency so we would not be in a situation of looking at raising payroll taxes or cutting benefits or so on.

That choice was not made. So it is not that we are doing nothing. We are making choices that impact where we are today, which I think is just very important for the American people to understand—not that that takes the place of the baby boomers retiring, not that it negates any of what you are talking about, but we are making choices.

Now we have the economy, and the unemployment rate for June jumped from 6.1 percent to 6.4 percent, the highest level in 9 years, the highest number of people on unemployment benefits since 1983. In a macro sense, I guess I would ask you: Shouldn't we be focusing very much on job creation, not only for individual families, where it is absolutely critical, but doesn't the weakened economy undermine our ability to provide benefits for future generations? Our economic policies now, how we stimulate the economy to create jobs, doesn't that have an impact on your numbers as well when we look at the strength of the economy?

Mr. WALKER. Well, first, let me clarify that the "do nothing" phrase only deals with Social Security. Clearly, you are correct that Congress has been doing a lot of things in many different areas, and many of which were good things. I mean, some are good and some are not so good, depending upon where you sit.

I do think, however, whether it be on the tax side or the spending side, that when Congress is debating significant legislation that could have significant costs not just over the next 10 years, but also beyond the 10 years, many times Congress debates both tax and spending proposals that the costs balloon after 10 years, and we act like the world is going to end in 10 years. Well, it isn't.

As a result, we need to consider discounted present value concepts as part of the discussion and debate on both the tax side and the spending side, and one of the things that we need to start doing, quite frankly, is to quit digging because we are already in a huge hole. For Part A of Medicare alone, we have a $6 trillion unfunded discounted present value obligation. For Social Security,

we have got $3.5 trillion. That is only for 75 years. If you look for perpetuity, Social Security is $10.5 trillion, according to the latest calculations, and Medicare may be more like $30 trillion. So we need to recognize reality.

By the way, I have been testifying on this issue for several years, and we have had a long-range structural imbalance even when we had surpluses. We had a long-range problem then. Even if the tax cuts didn't happen, we still would not solve our problem. But you are right to say you have got to look at both sides. You have got to look at both sides of the equation.

Mr. LOCKHART. Senator.

Senator Stabenow. Yes, go ahead.

Mr. LOCKHART. Excuse me, Senator. The only point I would like to make is, in the case of Social Security, I think there is still time to make some choices here. If we do it relatively soon, we have the opportunity to stop those numbers growing. That is critical. Every year that $10.5 trillion will grow by about $650 billion. That is more than the present deficit.

So to the extent we can start looking at solutions, start evaluating them, and, as the President asked, do it on a bipartisan basis, I think we can really make a great choice for America's children and grandchildren.

Senator Stabenow. Well, I certainly agree with that and believe that we need to make choices. I would also suggest that, Mr. Walker, when you talk about stopping digging, that around here we just continue to dig, and without looking at the situation. The vast majority of—I mean, if we asked the American people do we have the option of not focusing on homeland security or rebuilding the Pentagon and New York or defense, or, on the other side, reducing revenue through a supply side strategy on tax cuts, people understand that we had to come forward with those dollars in terms of protecting safety and security. The option, in my judgment, was on the other side, and we have chosen as a Congress to keep diggings. My guess is we are going to see more digging and more and more undermining revenue that just adds to the problem that you are talking about right now.

Thank you, Mr. Chairman. I would just add one thing as a positive note on Social Security. Social Security is not just about income for people, which we know the vast majority of people receive income from, and many of them, many of our constituents or possibly family members rely on Social Security. But it is also a life insurance and disability policy for people of this country. I remind young people of that when I speak to them in schools that if they were to become disabled or if there would be a loss of life of their parents or themselves with minor children, it also is a part of a safety net that I believe has been a great American success story. It is our job to be responsible about making sure it is there for the future.

Thank you.

The CHAIRMAN. Senator, thank you very much.

One of the reasons Chairman Grassley and I asked the GAO to do the audit and look at the "do nothing" is because we—you know, while you are concerned, and responsibly so, about actions taken this year and next year, what is critical to Social Security is actions

we take now to impact us out 40 and 50 years. If you will notice, even with what we did this year, the line of revenue on Social Security is still flatlined, relatively speaking, as growth patterns occur.

Of course, out there in late 2030 or early 2040, a precipitous drop begins in Social Security's ability unless we do one of a couple of things at that time, and that is why we thought it was important, if you will, to look at the cliff, because we don't function well, you or I, at that cliff level. We really have to think in actuarial terms long term on Social Security and its impact. The idea of raising payroll taxes by 50 percent would be as precipitously negative on your workforce and mine as it would be to cut benefits by anywhere from 30 to 35 percent. Those are the "do nothing" scenarios that both GAO and Social Security agree on.

So what we are trying to do is build a record so that you and I can look outward and in the coming years make those kinds of decisions. I personally think that is critically important.

Senator Stabenow. Mr. Chairman, if I might, I absolutely agree with the need to do that. I would just urge that we do that within the context of all of the decisions we make, not just in the context of raising benefits—lowering benefits or raising the payroll tax, but that we do this in the context of the broader issue. If we, in fact, had now a $5 trillion surplus and were able to take a large part of that and pre-fund the liability outward on Social Security, I would dare say that would help a great deal. It wouldn't solve the problem, but it would allow us to make different decisions.

So that is all that I guess I wanted to say, is that we have—as we make decisions responsibly about where we go, I don't think going back into huge deficits, the largest deficit possibly in the history of the country, helps any of these numbers. That should be of a big concern to all of us.

The CHAIRMAN. Thank you.

Gentlemen, thank you very much for your work and your testimony before us. As you know, this is ongoing as we work to build a record from which decisions will be made by Members of this Congress, so I thank you both very, very much.

Mr. LOCKHART. Thank you, Senator.

Mr. WALKER. Thank you, Senator.

The CHAIRMAN. Now I would ask our second panel to come forward, if you would please: Dr. Thomas Saving, Public Trustee of the Social Security and Medicare Trust Funds; and Brad Smith, the President and co-founder of Social Good Through Politics at Harvard University.

Gentlemen, welcome to the committee. Mr. Saving, if you would proceed, please. Pull that mike as close as is comfortable, and we thank you for being here.

STATEMENT OF THOMAS R. SAVING, PUBLIC TRUSTEE, SOCIAL SECURITY AND MEDICARE TRUST FUNDS, COLLEGE STATION, TX

Mr. SAVING. Thank you, Mr. Chairman, and I would like to present some things about Social Security. A few of those—this is a chart that comes right from the Trustees' Report, and mainly what I would like to do is—if I can figure out how to do it. That is where I want to be, right here at Figure 1.

As Congress considers legislation to reform Social Security, it is important to understand the program's financial condition, and I think there are a lot of ways to speak about this, and I am going to say some things that may be somewhat different than we have just heard but are related to it in a way that I will make very clear as we go along.

In less than a decade, the combined Social Security and Medicare programs—and I am going to briefly comment on both of them because I think they are both important. In fact, they are part of the same kind of a program, and that is, transfers from the young to the old. One of those programs, as we have already heard from both witnesses, is in much more dire straits, but is much more difficult to solve. So that means that the reason we are concentrating on Social Security is it is something that we can do something about. We can solve at least perhaps a fourth of the problem that these two programs represent in an easy way, and then we can try to solve the other three-fourths of that problem.

But in less than a decade, the combined Social Security and Medicare programs will go from a position of providing net revenue to the Treasury, which is what they have been doing up until—forecasts for this year will be the first year in which Medicare Parts A and B and Social Security together have ever actually required a transfer from the Treasury as a group. That is going to happen this year, and it is going to get much worse in the near future.

The other thing I think that is important—and in that sense, I am going to say something a little bit different than the last two witnesses. The fact that the Trustees' 2003 estimate of trust fund exhaustion date is 2042 has no bearing—I want to repeat that, no bearing—on the demands that Social Security and Medicare are going to place on the budget in the next few years. The trust fund is not going to help us fund the deficits that we are talking about, and I think that is very important, and it relates to what we might have done with a surplus or something that we might have had that we might have put somewhere that we think might have helped us. The question is: What would we have to had done with that to have helped us?

So there are a few years of good news remaining from these programs. Social Security and Medicare Part A payroll tax revenue currently exceed expenditures, and these surpluses are sufficient to cover almost all the Medicare Part B expenditure. So we can say that is really what we are doing with the money. We are subsidizing Medicare Part B.

This year and next, these combined programs will require only a small transfer. But in fewer than 5 years, beginning in 2008, and every subsequent year, these programs are going to become a drag

on the Federal budget. By 2010, less than 7 years, these programs are going to consume 1.5 percent of total Federal income tax revenues.

I would like to say something about income tax revenues, that if you look at a graph—and I do not have it with me—of the percent that Federal income tax revenues are of the gross domestic product, for the last 50 years—and we have had dramatic changes in the Tax Code over those 50 years—you will see that the percentage that is of gross domestic product is remarkably stable. It changes very, very little, and part of that is that incentives matter, and lower marginal tax rates are the difference between what we are like and what Europe is like, outside of Ireland and England, where they have become more like us in Tax Code, and as a result, have had much faster growth than the rest of Europe. The key to this is increasing gross domestic product.

Now I will go on. We project as Trustees that Social Security expenditures, the year they will first exceed revenues is 2018. But at 2020, just 2 years after that, these programs together are going to be using 17.5 percent of all Federal income tax revenues. That is what you can see on the chart, on Figure 1. By 2040, which is 2 years before we say the trust fund is going to be exhausted, something on the order of 47 percent of all Federal income tax revenues are going to have to be transferred to Social Security and Medicare. That is, half of almost every dollar that we are taking in as Federal income tax is going to have to go to these programs. That is clearly not sustainable.

So, in spite of Medicare reform that is getting most of the press right now, Social Security's financing future is ominous, and I think that is what this hearing is about. This year, Social Security is going to contribute the equivalent of 6.5 percent of Federal income tax revenues to the Treasury, and, of course, we have got good uses for that money. By 2020, just at the beginning of the baby boomer wave—we will be 10 years into it—Social Security is going to require a transfer of 3.4 percent of Federal income tax revenues. So it is going to go from providing you a 6.5-percent addition to Federal income tax revenues to taking almost 3.5 percent of those revenues. By 2021 or so, it is going to be at 4.5 percent of Federal income tax revenues. I might add, historically that is the largest that the Social Security transfer has ever been. In 1978 and 1983, it was that large, and those are the 2 years, as you know, that we changed Social Security. We reduced benefits in 1978, and we raised taxes and reduced benefits in 1983. So both of those things happened, and that is the largest that this transfer has ever been.

Then I want to say something about 2042, right here to the shortfalls, because these are dollar shortfalls in 2003 dollars. So these are the amounts in 2003 dollars we are going to be transferring to Social Security. I think if we look at 2042, the year we say the trust fund is going to be exhausted, we are going to transfer $427 billion in today's dollars out of Federal income tax revenues of $2.76 trillion, because that is 15.5 percent of Federal income tax revenues that will be transferred to Social Security. The next year, we would only have to transfer $438 billion. The message there is that if we have figured out how to transfer $427 billion to Social

Security, trust fund exhaustion is irrelevant. If we found that much money, the next year there is no way that you are going to tell constituents we are going to now spend this money on something else and not pay you your benefits. So if we figure out how to do that, we have solved the problem. I think that is important.

On tax requirements, I want to discuss now the size of the debt that we have. We have done some new things this year in the Trustees' Report. I want to come back to that. Usually, the Trustees' Report is concentrated on the 75-year deficit. That is what these numbers show, and the $3.5 trillion deficit that both the two witnesses discussed before is—the real amount of money you are going to have to come up with in a present value context is not $3.5 trillion. It is $4.9 trillion, because the trust fund is not going to help you pay the debt. In fact, you have to find the revenue somewhere, because the trust fund is simply debts you have decided to pay for yourself. They are not invested.

That is what I meant by if you had taken this so-called surplus that we had estimated we were going to have, you would have to have invested it in something real. I don't know what that would have been and how we would have done it. I know that, in general, the Senate in 1998 somewhat of unanimously said we are not going to have the Government invest in equities or in real capital. But that is what we would had to have done with that money.

We now report, in addition to this number—and I think something that is even more important in the Trustees' Report, and that is what we refer to as splitting up the future of Social Security into two things. One of them is the current members of Social Security, those 15 years old and older. Now, we give that a name. We call it the 100-year closed group. But it says: What do we owe the current members of the Social Security system? As it turns out, we owe them $11.9 trillion. That is the 10.5, as previously discussed, but now the question is: What are the new people going to contribute? The person who starts working tomorrow and everyone following them, if the system was in equilibrium, those people would do what? They would contribute $11.9 trillion. What are they going to actually contribute? Nothing. So the new people are going to contribute nothing to solving the $11.9 trillion that we owe everyone who is currently in the system. Therein is the problem, and how we are going to solve that problem is the issue.

That is why I think we have taken a very big step in the Trustees' Report this year by emphasizing what we do owe everyone who is in the system, and what are the upcoming people going to pay for it. If you think very simply about the Social Security system and what it is going to be in 2040 with two workers per retiree, on the average we replace 42 percent of earnings. That is what Social Security is like. If you have two workers for every retiree, what is the tax rate going to have to be to support that? It is going to have to be 21 percent. Each person gives up 21 percent of their earnings. Added together, that is the 42 percent that it is going to take for every retiree. It is a very simple idea.

What is the problem? The tax rate is way too low. Why is it too low? Well, two things. We have got baby boomers going through, a big generation supporting a small generation of retirees. We are able to get by with a small tax rate. When the big generation re-

tires, the smaller generation coming up is going to have to consume less. I was on the President's Commission, to strength Social Security and as I constantly reminded my fellow Commissioners all the time, the elderly are going to eat real food, drive real cars, live in real houses, use real hospital beds and doctors and nurses when they are consuming health care. Somebody has to produce that stuff. The only people who are going to produce it are the young. The question we really have before us is: How are the young going to produce more because, otherwise, they are going to have to drive smaller cars, live in smaller houses, and consume less perhaps—eat out less often, so that we can live it up the way we are scheduled to do so. So we are going to have—if we can't capture the baby boomers before they leave working—we are going to have a great deal of difficulty solving the problem.

I think I will stop there.

[The prepared statement of Mr. Saving follows:]

Statement of Thomas R. Saving
Public Trustee of the Social Security Board of Trustees
before the
Senate Special Committee on Aging
July 29, 2003

As Congress considers legislation to reform Social Security, it is important to understand the program's financial condition. In less than a decade the combined Social Security and Medicare programs will go from providing net revenue to the Treasury to requiring a significant revenue transfer. Even though this year's Trustees' Report shows slightly better short-term news coupled with slightly worse long-term news, from the perspective of the total federal budget, these programs will impose significant costs even in the near term. The fact that the Trustees 2003 estimate of the Trust Fund exhaustion date is 2042 has no bearing on the demands that Social Security and Medicare will place on the rest of the budget beginning in just a few years. This total budget perspective is important, because though Social Security and Medicare HI have Trust Funds, when revenues into the combined system fall below expenditures, real resources must come from somewhere else in the federal budget.

There are a few years of good news from the total budget perspective. Social Security and Medicare Part A payroll tax revenues currently exceed expenditures. These surpluses are sufficient to cover almost all of Medicare Part B expenditures that are not paid by premiums. This year and next, the combined programs of Social Security and Medicare Parts A and B are expected to require only a small transfer from the U.S. Treasury. For several years thereafter, as Figure 1 shows, the forecast is that Medicare and Social Security payroll tax revenues will be sufficient to actually provide revenues to the rest of the budget. However, in fewer than five years, beginning in 2008 and in all subsequent years, these programs will become a drag on the federal budget.

By 2010, in less than seven years, these programs will consume 1.5% of total federal income tax revenues, an amount that will accelerate rapidly. By 2020, just two years after the Trustees project that Social Security expenditures will first exceed revenues, the two programs together will be using 17.5% of all federal income tax revenues in addition to dedicated tax revenues. Rather than providing funds that add to federal income tax revenues, these programs will require a transfer from these same federal income tax receipts and begin to impinge on other federal programs.

The problem does not end in 2020, as the required transfers will continue to grow rapidly. By 2025, in order to maintain current program benefits, Social Security will require that almost 9% of all federal income tax revenues be transferred to beneficiaries. Moreover, Social Security and Medicare together will use up nearly 28% of all federal income tax revenues in 2025. As depicted in Figure 2, the total transfer will grow to more than 36% (13% for Social Security) of federal income tax revenues by 2030, and by 2040, just two years before the current estimate of Social Security Trust Fund exhaustion

and almost ten years before newly entered workers will retire, these programs will require over 47% (15.3% for Social Security) of total federal income tax receipts.

In spite of Medicare reform getting most of the current press, Social Security's financing future is ominous. This year, Social Security will contribute to the Treasury the equivalent of 6.5% of total federal income tax receipts. By 2020, just seventeen years from now and still at the beginning of the baby boomer retirement wave, Social Security will require a transfer of more than 3.4% of all federal income tax receipts to pay benefits forecast by the Trustees under current law. This transfer will grow rapidly so that by 2042, the year the Trustees forecast that the Social Security Trust Fund will be exhausted, it will reach 15.5% of all federal income tax revenues. In that year, we will be transferring to Social Security beneficiaries some $427 billion in today's dollars, out of projected federal income tax revenues of $2.76 trillion, as Figure 2 shows. Importantly, the size of the required transfer will remain almost the same in 2043, when the transfer must be $438 billion in today's dollars, out of projected federal income tax revenues of $2.81 trillion. Thus, the Trust Fund and its exhaustion date play no role whatsoever in the amount of resources that must be transferred to Social Security beneficiaries if the current program remains in place. At best, the Trust Fund is simply a commitment by Congress to find the money and not a source of any funding. At worst, it may provide solace for some and delay changes necessary to address the coming shortfalls in Social Security funding.

Clearly, elderly entitlement programs are out of control. If nothing is done, by 2060, the combination of Social Security and Medicare will account for more than 71% of a federal budget that remains at the current budget's share of the nation's gross domestic product. By way of comparison, these two programs today account for only 35% of federal expenditures.

These numbers, while staggering, are not meant to frighten, although they are frightening. They are based on the best estimates that we as Trustees of the Social Security and Medicare trust funds are able to put together. If not meant to frighten, they surely represent a sobering reality.

The tax requirements we have just considered quantify the annual resources the nation will have to transfer to the elderly in coming years. However, the debt implied by these future transfers over and above the programs' dedicated revenue sources can be quantified today. The promises implied by the Social Security and Medicare programs are essentially debts that must be paid by future taxpayers.

Since we are discussing Social Security today, its obligations will be the focus of my remaining comments. The Trustees now report several alternative measures of Social Security's unfunded obligations including the 75-year unfunded obligation, the 100-year closed group unfunded obligation and the perpetuity unfunded obligation. Reviewing these different measures is an instructive way to evaluate the generational burdens of the program. The components of the 75-year unfunded obligation, that is, the expected tax

revenues, benefit payments, and the Trust Fund are presented in Table 1 and come from Table IV.B6 in the Trustees report.

The table shows that in addition to current dedicated tax revenues, if scheduled benefits are paid and scheduled tax rates remain unchanged, $31.4 trillion 2003 dollars having a present value of $4.9 trillion, will have to be transferred to Social Security over the next 75 years. Moreover, at the 75th year and for all years thereafter, the program will experience deficits indicating that a more complete accounting is needed to describe the full cost of the system under its current rules.

This more complete accounting is now presented in two new tables from the Trustees Report: Tables IV.B7 and IV.B8. These tables report the perpetuity unfunded obligation and the 100-year closed group unfunded obligation. The two measures allow us to divide the total burden of the system between current generations and future generations. The simple equation below expresses the idea that the all generation unfunded liability must equal the sum of unfunded liability of the current generations plus the unfunded liability of future generations.

All Generations	**=**	**Current Generations**	**+**	**Future Generations**
(Liability or Asset)		**(Liability or Asset)**		**(Liability or Asset)**

If we keep Social Security unchanged for all those 15 years old and older and then calculate the difference between scheduled benefits and taxes until the last of this group is expected to be deceased, we have an estimate of the debt we owe to current generations. This debt is often referred to as the 100-year closed group unfunded obligation. It is considered a closed-group, because only the tax payments and benefit receipts of current beneficiaries and workers enter into the calculation. The calculation ends in the 100th year, because the youngest members in the group today are 15 and are expected to be deceased on or before the end of their 115th year.

The perpetuity unfunded obligation is the unfunded liability of all generations, present and future, and the difference between the two is the liability or asset of future generations beginning with those who turn 15 years old tomorrow. If the current Social Security system was sustainable, the all generations unfunded liability would be zero, and the debt owed to current generations would be completely offset by the taxes imposed on the next 100 years of new entrants. This separation of the liability allows for a complete evaluation of changes to the system since it accounts for all costs and benefits, not just for current members but also for those who enter the system tomorrow and thereafter.

Table 2 reports the 100-year closed group obligation along with the perpetuity unfunded obligation and the contribution of future generations. As the first row of the table indicates, if current scheduled benefits and taxes remain in place, future generations will have to pay the current generations $11.9 trillion debt. However, under currently scheduled benefits and taxes, they will contribute nothing toward this debt, as shown in the second row of the table. If the Social Security system was solvent, the future generations would be paying taxes sufficient to make their contribution to the debt of

current generations exactly $11.9 trillion. Thus, the fact that the Trustees estimate that future generations will contribute nothing toward the debt owed current generations is further evidence that Social Security, as it is currently constituted, is insolvent.

Table 2 reports the value of the Social Security Trust Fund that, in Table IV.B8 in the Trustees Report, is treated as an offset to the liability owed to current generations. However, as I have pointed out above, the Trust Fund has no effect on the magnitude of the transfers necessary to pay scheduled benefits. The Trust Fund simply indicates a commitment by Congress to provide funding but does not provide a source of the required funding. Thus, the present value of funding, in addition to scheduled payroll taxes that must be raised by Congress to provide for scheduled benefits, is the full $11.9 trillion owed to current generations.

Between now and the time it takes for the baby boomers to move through retirement, we will have to pay off most of the closed group debt. In doing so we must bear in mind that the retired baby boomers are going to eat real food, live in real houses, drive real cars and use real hospitals, doctors and nurses. The young will have to produce all this output, essentially paying off the huge debt by consuming less while the retired baby boomers consume more of the nation's output.

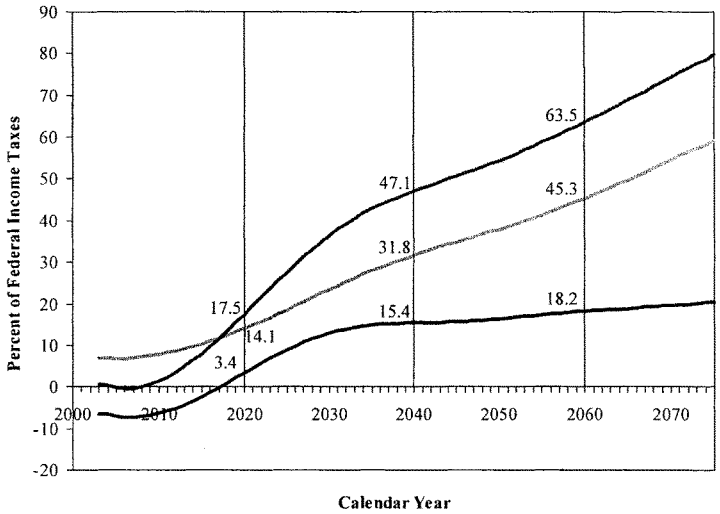
A measure of how much less future generations will have for their consumption can be had by examining the payroll tax rate that would have to be imposed to pay for Social Security and Medicare if we continue to provide scheduled benefits. Figure 4 shows estimated payroll tax rates that would provide revenue sufficient to pay scheduled benefits for Medicare and Social Security. Importantly, by 2030 the required payroll tax rate would be almost 27% and by 2040 would exceed 30%. Moreover, these tax rates assume that the fact that the young have less to consume has no effect on the nation's means of production or capital stock. However, tax rates at this level would significantly affect capital accumulation and labor supply. Thus, the magnitude of the coming financial crisis in the provision of elderly entitlements via generation transfers has the potential to reduce national income and economic growth.

Conclusion

In the debate concerning changes necessary to assure the future of Social Security, it is important to consider how these changes will impact on future participants. The deficits projected by the Trustees in the *2003 Annual Report of the Board of Trustees* are especially significant. If no changes are made in Social Security and Medicare, they will rapidly become the tail that wags the federal budget dog. By 2030, Medicare alone will require more than 21% of all federal income tax revenues. When coupled with the transfers to pay currently scheduled Social Security benefits, total transfers of general revenues to keep these programs intact will require more than 35% of federal income tax revenues in 2030. If other federal programs are to remain at anything like their current size, dramatic action will be required.

Fundamental reform can revitalize Social Security while reducing government debt. Over the short term, reform is expensive. Over the long term, reform reduces taxes and restores Social Security to a sound fiscal position. Total reformed benefits exceed the amount payable under the current system and exceed the purchasing power of today's benefits. Reform will eventually benefit recipients and workers alike. Even if Social Security is reformed, the even larger Medicare debt will remain. As we have seen, Social Security will require substantial transfers from the rest of the federal budget. An alternative to these future transfers is to have people save more for their retirement. Additional savings now can be used to lessen the tax burden required under the present financing arrangement.

Figure 1. Social Security and Medicare Funding Shortfalls as a Percent of Federal Income Taxes



Source: 2003 Social Security and Medicare Trustees Report and author's estimates

Figure 2. General Revenue Transfers to Social Security and Medicare
(as a % of income taxes)

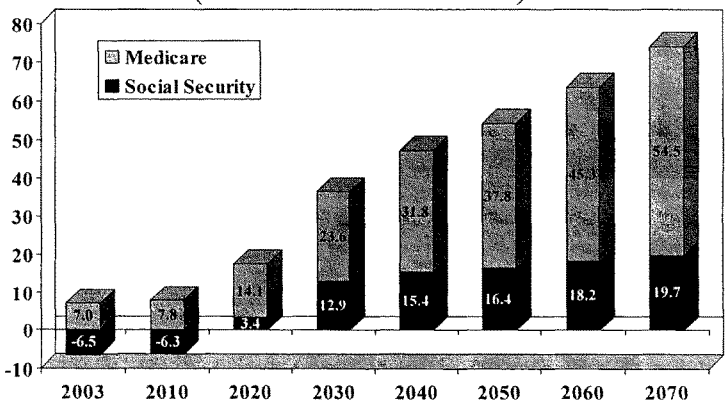
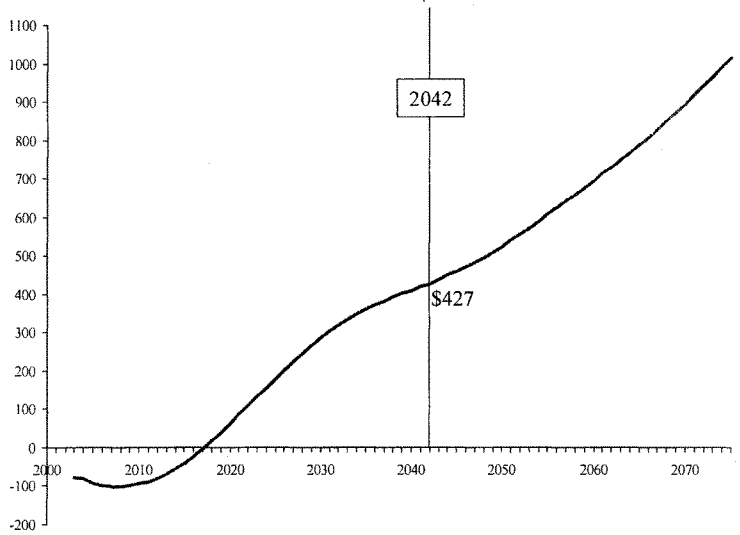
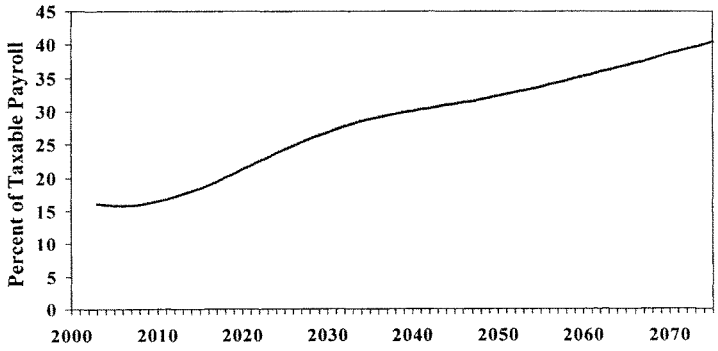


Figure 3. Social Security Surpluses and Shortfalls in 2003$



Source: 2003 Social Security Trustees Report

Figure 4. Projected Social Security and Medicare Costs as a percent of Taxable Payroll



Source: 2003 Trustees Report (OASDI), Table VI. F2. Part B costs are from Table II.A3 in the Medicare Trustees Report.

Table 1

Components of the 75-Year Social Security Unfunded Obligation
(2003)

Component	Present Value (in billions)
Tax Revenues	$26,147
- Benefit Payments	31,075
= Additional Future Resources Required	4,927
- Trust Fund	1,378
= 75-year Open Group Unfunded Obligation	3,550

Table 2

Components of the Perpetuity Social Security Unfunded Obligation
(2003)

Component	Present Value (in trillions)
Current generations' liability	$11.9
+ Future generations' liability	0.0
= All generations' liability	11.9
- Trust Fund	1.4
= Perpetuity Unfunded Obligation	10.5

The CHAIRMAN. Well, Mr. Saving, thank you very much. Obviously, Doctor, you have challenged us well beyond what the two first panelists did, so we are going to ask Brad to solve the problem. [Laughter.]

We are always looking for solutions, Brad, and we thank you very much. Brad Smith is President and co-founder of Social Good Through Politics. Please proceed.

STATEMENT OF BRAD SMITH, PRESIDENT/CO-FOUNDER, SOCIAL GOOD THROUGH POLITICS (HARVARD UNIVERSITY), KNOXVILLE, TN

Mr. SMITH. Thank you, Chairman Craig. It truly is an honor and a privilege to be here today to speak with you, so I thank you.

My name is Brad Smith. I am a junior at Harvard University majoring in economics and government. For the past 2 years, I have led a group of 20 Harvard students that has studied Social Security and developed a five-point plan that remedies the fiscal insolvency and increases the equality of the current Social Security system. We have discussed our plan with notable individuals including Harvard President and former Secretary of the Treasury Lawrence Summers, former CEA Director Martin Feldstein, current CEA Director Gregory Mankiw, former Senators David Pryor and Warren Rudman, and current Senators Kennedy and Hagel.

However, the reason I am here today is not to tell you about what my group has done, but rather to implore you to lead Congress and to take immediate action to guarantee that my generation has financial security in our retirement.

Since the Social Security system was instituted by Franklin Roosevelt in 1935, the system has lifted millions of our Nation's retirees out of poverty. But I am frightened for my peers today. As you have heard this morning, the system will not be able to do this for my generation of Americans.

If no changes are made to the current system, my generation will receive somewhere between 75 percent and two-thirds of the benefits we have been promised. This means that my generation of Americans will not have the social insurance we have been promised. This means that millions of retirees in my generation will fall below the poverty line. This means that my generation will receive less in benefits than we paid in taxes, never mind seeing a return on our investment.

To me it is clear: The insolvency of the current Social Security system is a threat to the social welfare of our Nation's future retirees.

However, there is good news. We do have the power to protect these future retirees. That is why I am here today: to plead with you to take action and to take it immediately.

Every day we delay, the cost of fixing the problem increases. Yes, it is better to undertake reform in an economic boom than during an economic recession. Yes, it is better to undertake reform when there is a budget surplus rather than when there is a budget deficit. But as any investor will tell you, it is better to start investing today than it is to start investing tomorrow.

I know that Social Security is not an easy problem to fix. If it was, it would have already been done. But I believe that is exactly

why Chairman Craig asked me here today: to be a voice for the millions of Americans who the current system will certainly fail.

I am not here to promote a specific solution, but I do believe that the plan my group has developed can serve as a starting point for a discussion on reform. Using a Social Security Administration caliber model, my group has developed a five-point plan that is progressive and that addresses the fiscal insolvencies of the current system. Our plan includes investing a portion of the FICA tax, redistributing wealth to lower-income and minority Americans, and ensuring that all retirees receive at least 100 percent of their promised benefits.

However, no matter how good our plan is and no matter how hard we work to inform Americans of the importance of reforming the system, the power to change the system lies only in your hands.

My generation needs you to be bold and commit yourselves to developing, publicizing, and passing a bipartisan reform plan. It will be difficult, perhaps even controversial. But, in the end, I can guarantee you that it will be worthwhile. My generation will thank you and your generation will leave a great legacy behind.

Thank you for your time.

[The prepared statement of Mr. Smith follows:]

Testimony of Brad Smith:
Senate Special Committee on Aging
July 29, 2003

Chairman Craig, Senator Breaux, and other members of the Special Committee on Aging, it is an honor and a privilege to be here today to speak with you.

My name is Brad Smith and I am a junior at Harvard University majoring in economics and government. For the past two years, I have led a group of twenty Harvard students that has studied social security and developed a 5-point plan that remedies the fiscal insolvency and increases the equality of the current social security system. We have discussed our plan with notable individuals including Harvard President and former Secretary of the Treasury Lawrence Summers, former CEA director Martin Feldstein, current CEA director Gregory Mankiw, former Senators David Pryor and Warren Rudman, and current Senators Kennedy and Hagel.

However, the reason I am here today is not to tell you about what my group has done, but rather to implore you to lead Congress and take immediate action to guarantee that my generation has financial security in our retirement.

Since the social security system was instituted by Franklin Roosevelt in 1935, the system has lifted millions of our nation's retirees out of poverty. But I am frightened for my peers because, as you have heard today, the system may not be able to do this for my generation of Americans.

According to the Social Security Administration, if no changes are made to the current system, my generation will only be able to receive 75% of the benefits retirees today receive. This means that my generation of Americans will not have the social "insurance" we have been promised. This means that millions of retirees in my generation will fall below the poverty line. And this means that my generation will receive less in benefits than we paid in taxes, never mind seeing a return on our investment.

It is clear- the insolvency of the social security system is a threat to the social welfare of our nation's future retirees.

The good news, however, is that each of you has the power to protect these future retirees. And that's why I am here today- to plead with each one of you to take action- and to take it immediately.

Every day you delay, the cost of fixing the problem increases. Yes, it's better to undertake reform in an economic boom than during an economic recovery. Yes, it's better to undertake reform when there is a budget surplus rather than when there is a budget deficit. But, as any investor will tell you, it's better to start investing today than it is to start investing tomorrow.

I know that social security is not an easy program to fix- if it was, it would have already been done. **But I believe that is why Chairman Craig asked me here today- to be a voice for the millions of Americans who the current system will fail.**

I am not here to promote a specific solution, but I do believe that the plan my group has developed can serve as a starting point for a discussion on reform. Using a Social Security Administration caliber model, my group has developed a 5-point plan that is progressive and that addresses the fiscal insolvencies of the current system. Our plan includes investing a portion of the FICA tax, redistributing wealth to lower income and minority Americans, and ensuring that all retirees receive at least 100% of their promised benefits.

However, no matter how good our plan is and no matter how hard we work to inform Americans of the importance of reforming the system, the power to change the system lies in your hands.

My generation needs you to be bold and commit yourselves to developing, publicizing, and passing a bipartisan reform plan. It will be difficult, and perhaps even controversial, but in the end, I can guarantee you that it will be worthwhile. My generation will thank you- and your generation will leave a great legacy behind.

Thank you for your time.

The CHAIRMAN. Well, Brad, thank you for that testimony and your thoughts.

Several years ago, I held a series of meetings across my State on Social Security with all the appropriate charts and graphs to tell the story of current versus future situations. I invited senior citizens and seniors in high school to attend. It was interesting to watch the interaction, because in the first instance, the senior citizen came somewhat defensive, and in the end, that defense was gone and they were thinking in a much broader sense about the totality of the system and the impact that it will have on your generation in relation to money in versus money out.

It was a fascinating experience, and it is some of what we are going to have to hear from the younger generation to cause this Congress to deal with this issue sooner, I think, rather than later.

Dr. Saving, you have made a somewhat broader perspective analysis, I think, of Social Security and the impacts ahead. In fact, your testimony suggests that Social Security and Medicare financing will have Federal budgetary implications as early as 2008. Will this create an immediate visible effect at the time? Or will it be kind of a gradual shadow effect, if you will, on the budget?

Mr. SAVING. Well, I think it is certainly going to be gradual, and, actually, before it goes into deficit, it would start to have an effect as soon as the revenues from this system have peaked and start to decline. So that is going to be almost immediate.

But, you know, those are very small effects, and until we reach—and perhaps we can go back to right here and get a feel for it. But by 2020, you are looking at 17.5 percent of Federal income tax revenues being transferred, and in the sense of your 10 years, that is well beyond 2013. But by 2013 we already will be transferring—we won't be transferring anything to Social Security, of course. Social Security is going to go on not requiring a transfer. But the sum of the two will indeed be requiring a transfer by then on the order of 7 or 8 percent of Federal income tax revenues.

But we have to recall that Medicare itself right now, Parts A and B together, have a deficit of about 7 percent.

The CHAIRMAN. Right.

Mr. SAVING. Because of Federal income tax revenues. So we are already transferring to the elderly, and the complicated part is to find a way to accomplish this within, I think, the fairly near future because these numbers are going to be huge, and as you are well aware, there is no way that even at 2020 that 17.5 percent of Federal income tax revenues is going to be obtainable as a transfer. It just can't happen. That means that we have to do something, and the problem that we can do something about more quickly is Social Security.

But the other issue is that we still have the debt to the existing people that we somehow have to do something about, and that is the $11.9 trillion. The question is: What do we do about it? I might say simply that, as you know, in the Commission we took care of a lot of that debt by price indexing benefits as of 2008. Actually, that wipes out about $5.5 trillion of that debt.

Now, if you try to do a reform, then you have to give something back to people, and what the Commission tried to do is give something back in terms of private accounts. I am not here to promote

the Commission's proposals or any other reform. I am here as a Trustee and just to discuss. But no matter what you do, that number has to be dealt with, and I think that is what the important point is. Each reform that we suggest has to say how are we going to deal with this $11.9 trillion, and we can deal with it by making the baby boomers pay more taxes because they, clearly, in a sense were undertaxed. Now, they might not agree with that if you would come to them and say——

The CHAIRMAN. I don't agree with it.

Mr. SAVING. Exactly. I assumed you didn't feel like you were undertaxed. But in the sense of supporting what you are expecting—and I think another important point is that a generation transfer system such as Medicare and Social Security have a bad effect on the economy in the sense they reduce the capital stock, because to the extent that people believe that their retirement is taken care of, they invest less in the economy and they then leave a smaller capital stock to the generations that follow them.

The CHAIRMAN. Well, on the first panel, following up on your comment there, we discussed the need to assess the potential economic effects of tax increases necessary to pay current promises. I am interested in your judgment as an economist on the economic impact of raising taxes to fill the financial gap in Social Security and Medicare. What is your general view on that?

Mr. SAVING. Well, I think if we take a look at this chart right here, it can give you an idea of where those taxes would have to be if we were going to pay Medicare costs. As a percent of taxable payroll, we are looking at tax rates that are double the current payroll tax rates by almost 2030 if we were going to really pay the Medicare that way. Those kind of tax incentives matter, and we were discussing one way to solve this problem is to have people work longer. The question is: How do we make people work longer? We have to make it profitable for them to work longer. If you are taking away 30 percent up front of what they earn, the labor force participation is going to fall. Jobs are going to fall, because jobs are a function of how many people want to work. If we make it less profitable to work, fewer people are going to want to work. I think we have to solve this—these are onerous tax levels that approach European levels, and that is the reason why they have grown so much more slowly than we have. I think there is no doubt that the capital stock will get smaller, and income and employment will fall, and that will actually exacerbate this problem, although it looks like it might solve it.

The CHAIRMAN. OK. Brad, you are probably the first person ever to testify before Congress who can expect to receive his entire Social Security retirement benefit off the edge of the cliff, that chart that both GAO and Social Security were showing us a few minutes ago. You are certainly one of the youngest, if not the youngest, witness ever to testify before the Aging Committee. [Laughter.]

There ought to be a message in that beyond what I am proposing, and that is that you, too, someday will grow older.

But, anyway, it is especially refreshing, I think, for young people like yourself now becoming very much involved in the system and the thought processes of this country to associate yourself with the older generation, and that cross-generational relationship, I think,

on the solution that we are all talking about is extremely important here for both sides to understand this issue and effectively deal with it.

Can you tell the committee what has compelled your interest and your group's interest in Social Security?

Mr. SMITH. My interest in Social Security and my group's interest sprung from a discussion we were having at Harvard's Institute of Politics. We were sitting around talking about what were going to be the issues that affected our generation and what were going to be the issues that affected our lifestyles in the future. One of the issues that kept coming to the forefront was Social Security. Social Security brings 40 percent of the people that receive its benefits above the poverty line. My Grandmom, Alma Smith, in Knoxville, TN, she relies on Social Security. It is how she feeds herself. What I am afraid of is that in the future the Social Security benefits my grandmother receives are not going to be there for my generation. Instead the people in my generation are going to have significant financial problems in their retirement because Social Security is not going to be there for them.

My group came together not only because we saw there was a problem with Social Security but because we saw there was a problem that could be fixed. Social Security is both a problem and an opportunity, for our generation to work with the older generation to develop a solution, that not only fixes the current problem but that improves individuals lifestyles well into the future.

The CHAIRMAN. Well, I am pleased to have you thinking about fixing it. A good number of young people I speak to just simply say to me, "Well, Senator, it is not going to be there. We understand we probably still have a social obligation to our parents and our grandparents, but we are not expecting to get anything. We are going to invest in other forms of retirement and annuity programs because it is not going to be there." That kind of pessimism, if you will, or I guess I could say pessimistic objectivity, at least at the current time, frustrates me because there are going to be a good many of our citizens out there of your generation who are going to probably need this kind of help.

The Comptroller General, Mr. Walker, pointed out in his testimony that the trust fund exhaustion scenario raises, and I quote, "significant intergenerational equity issues." I have told my grandchildren that they may someday look at me and say, "Gramps, we can't afford you any longer." We should not let that happen.

Do you see inaction on Social Security as increasing tension of the generations?

Mr. SMITH. What I see is that my generation is paying 12.4 percent of what we earn to FICA. I see that money going to help my Grandmom and lots of other elderly senior citizens. In the future, if Social Security is not there for my generation I think there is a great possibility that it will cause intergenerational tension. Right now we sit on the brink of opportunity, the opportunity to fix the Social Security system. If we pass over this brink without your generation considering the effects in action will have on my generation I think that intergenerational tension will increase. On the other hand, if our generations work together, we have the chance to increase generational cooperation.

The CHAIRMAN. It is important for us to find the best ways to educate our young people on important public issues. Obviously, the old phrase that you are the next generation of leaders may be old, but it is true. What, in your opinion, is the extent of awareness of your generation regarding Social Security insolvency issues? What lawmakers do to increase that awareness, Brad?

Mr. SMITH. I think there is a limited awareness and in a lot of cases, the awareness that people think they have is actually wrong, as you alluded to earlier. A lot of people think either there will be no Social Security for us in the future or people don't even think about Social Security at this point in their lives. I think that there is a two-pronged approach that we all can take to improve that into the future.

The first prong of this approach involves groups like mine going onto college campuses, reaching out to people in their 20's and 30's, and showing them the graphs, talking to them about the numbers, and explaining to them the tradeoffs that are inherently involved in the Social Security debate and saying be informed, be wise, so that when you go vote you know what you are voting for. Think about this when you choose who to vote for. Think about this when you are electing your Senators and Congressmen. In this way I think there is a lot that can be done by my generation to inform others in my generation.

But the second prong of this approach to increase fix awareness must involve Congress and the Senate. It involves concerned Senators like yourself standing besides the graphs we have seen this morning saying, Look, this is what is going to happen in the future; if we don't do anything, this is what our grandchildren are going to face. We need to do something. I have ideas, and you have ideas about how to fix the problem. We need to work together because the most important thing is finding a solution. No matter what that solution is, fixing the problem needs to come first, and then we can talk about different ways and different means of doing that.

The CHAIRMAN. Thank you very much. It is a thoughtful approach and the right one, I think, in the end to get there.

I was here in 1983. I made the tough choice of voting for that new reform at that time that we are currently living under today. You have spoken to it already, Dr. Saving, as it relates to the impact on revenue and the programs that were made available at that time.

You are suggesting that the tax necessary to fund the deficit or the reality of what you are looking at is not a move from 12 to 18 but a move ultimately from 12 to over 20 percent. Is that correct?

Mr. SAVING. That is correct. It is going to take that to do it, and I think that is what happened in 1983—and I think Pat Moynihan, who I worked with on the Commission and had a great deal of respect. He was a wonderful guy, and, of course, you knew Pat.

The CHAIRMAN. Absolutely.

Mr. SAVING. Wonderful person. But he recognized by 1990 that the approach taken in 1983 wasn't right because what was going to happen was there was no way for Congress or the Government to protect the excess revenue, because there was no real way to invest it. That was the real problem with it.

It led us down the path where even where, we are now, we look at the trust fund as if it is something real, because it was generated by this tax revenue that was there to help the system, presumably, but never really invested. I think it is a problem, and that is why, when one of the things that we produce as Trustees—and I was not going to mention this here, but it is something we call the actuarial deficit; that is, what is the immediate change in taxes which would solve the problem of the system? We do that in two ways now. One of them is the perpetuity one, if you say; if we immediately raise taxes 4 percentage points over what they are now, we would permanently solve the problem. But that would only be true if we really took the surpluses and invested them in factories. Because if we do not invest them in factories, all we have done is to raise taxes and spending somewhere.

The CHAIRMAN. You ultimately have fed the general fund of the U.S. Treasury.

Mr. SAVING. Exactly, which funds the current people in the world, but not the future. To fund the future requires that we build factories. If we do not do that, we have not funded the future. There is no real way to fund the future other than that. It may be possible for Government to do that, but we recognize that it is very difficult. I think the Senate in 1998, when they voted unanimously that they would not support something like that, recognized the difficulties—not that it cannot be done, but that it is difficult in the political system to do it. That is what private accounts were like. Or another way to do it independent of that, and I don't know the answer to that. But it does require—and when I speak to young people—and I do that a lot, obviously, on a university faculty, and they are the age of Brad. When you speak to them, of course, at that age most of them assume they are immortal so they are never going to be old. By the time I am done, I am pointing to this chart——

The CHAIRMAN. Well, let the record show they will get old. All right?

Mr. SAVING. They will get old, yes.

The CHAIRMAN. Let's establish that fact here.

Mr. SAVING. I say, Look, this isn't about—"You think this is about old people," I say. "It is not. I am going to get mine. This is about you because these are the taxes that you are going to have to pay. So the reform in Social Security is about you, not about old people." It is about young people.

The CHAIRMAN. Well, let's talk about——

Mr. SAVING. It is nice to see that Brad and his group recognize that.

The CHAIRMAN. Let's talk about that for just a little bit, because I have been through one of the most significant reforms in Social Security, and you have just spoken to it. In all instances, reforms have been a combination of two things: usually a reduction in overall benefits and increases in revenues through taxation. Of course, you have run into the biggest frustration of a major tax increase flowing into the treasury, therefore, being used up until it is needed for other purposes and that kind of negative obligation, if you will, resulting. That is what Congress, I think—that is what people like myself and others, and that is what I hope Brad and his group

are wrestling with at this moment. Are there other ways to reform it? Of course, I am one of those who believes you can begin to cause people to look at a portion of their revenue, their taxes into individualized accounts that change the character of the system.

Visit with us a little bit about those thoughts in your mind, because I am one of those that will no longer accept the standard form of adjusting the system. I don't think it is viable anymore.

Mr. SAVING. Well, I think step one of that is the point that I made earlier. The only way to transfer resources from the present to the future is with factories. That, in effect, is what individuals saving for their retirement do. In effect, they build factories so that when they retire, they are going to be able to sell to the younger generation, in effect. The younger generation is going to be willing to pay for them and to consume less. Because ultimately all we have to work with is the gross domestic product of the country. When retirees consume more of it, there is less of it for the younger generation.

So, part one of the whole thing is to get rid of this $11.9 trillion debt. Again, it comes back to that issue. If we are going to have young people save more, they have to consume less. The only way to increase the capital stock of the country in any year, since we only have a fixed amount of gross domestic product, if investment is going to be bigger, consumption has to be smaller. We have to let people know that, yes, consumption is going to be smaller, but the benefits of the smaller consumption are going to more than compensate you for the fact you get smaller consumption. That is what investment means. Whenever you put money in your savings accounts or you invest, you consume less.

The CHAIRMAN. Brad, do you agree with that?

Mr. SMITH. Yes.

The CHAIRMAN. Please go forward on that, because you and your group have thought of a variety of ideas. Obviously, you have mentioned five approaches or a five-point approach.

Mr. SMITH. Right.

The CHAIRMAN. Does it incorporate some of what Dr. Saving has just mentioned?

Mr. SMITH. It does incorporate some of what Dr. Savings mentioned. The only way we can really fix the Social Security system is by consuming less now and looking at how we can use the money we have now to ensure ourselves a secure financial future. I believe that the answer to the Social Security crisis does have to be some form of investment, and that does mean reducing our consumption now or adjusting how we distribute benefits to the elderly generation now or just looking at different possibilities for the way to do that. But I do think that it does require some form of investment in capital and in the future.

The CHAIRMAN. Historically, we have reached out into the future and adjusted in time slots that actuarially fit the trust funds. One of the things that I have heard constantly in my life as a public person—and I hear it from my parents, but I also hear it from a chorus of other seniors, and my parents are now in their mid–80's. They were notched babies or notch babies. Somehow, somebody else before them got more than they are getting, and that is inequitable, when, in fact, it was a Congress making a decision as the

Board of Directors of Social Security in making those adjustments to fit the cash-flow in part.

I reference that as a point of interest because if I have heard it once, the chorus has been loud, and there have been numerous efforts on the part of Congress to make adjustments in the notch.

Mr. SAVING. Yes. One of the interesting things about it—one of my brothers is a notch baby. I heard about this all the time. I spoke to him yesterday——

The CHAIRMAN. Were you ever able to effectively——

Mr. SAVING. I said I am going to Washington to testify before the Senate Committee on Aging. He had two comments. He said first, "Tell them don't age." But the second thing is—and he is always wanting to get me to impose upon you, "Fix this notch thing." But the other issue is——

The CHAIRMAN. Well, let me ask this question of you first, though. Have you ever been able to convince him of how the notch came about and that it was equitable at the time?

Mr. SAVING. Well, you know the answer to that. [Laughter.]

You aren't going to convince him of that.

The CHAIRMAN. But you are an economist. I am just a lowly politician. I have never been able to pull it off.

Mr. SAVING. You would be better at that than I would, though. But what is interesting is I gave him a piece of research that came out of the National Bureau of Economic Research recently that suggested that the notch babies have benefited from the fact that they got smaller Social Security benefits because they worked longer and have lived longer. When I tell my brother that he is lucky he was a notch baby, he does not buy that either.

But the thing that you had the GAO do here points very clearly at the impact of that approach, which creates several notches. As we know, politically, as you know, notches are not good. From that perspective it is clear that we can't just let the system go on the way it is, because it is going to re-create these notches. But also, I think that the points that were made here that the transfer is really not any different after the trust fund expires than it was before, the real problem is to deal with the deficits and forget the trust fund. But, again, anytime you compare any proposal to reform Social Security, you have to say: What is it if we don't do it? I am very pleased that you had GAO do this, because it is important for us to say these are the things that will happen if we don't do anything.

But I want to emphasize that here are the transfers that we—in order to even make that happen, this is the money we are going to have to raise and transfer to Social Security, even to make the so-called "do nothing" thing happen. It is going to be very expensive to, so to speak do nothing. It is important for us to say—and one of the things on the Commission we were always faced with, people would say this is expensive and let's do something else, and we would say, well, show us where you are going to find the money to do what you are talking about. That is the issue.

The other side always would simply have a better idea, but never tell you how they are going to fund it. That is important. I think that is why I like very much what you have done here.

The CHAIRMAN. Well, thank you very much for that statement.

Brad, I am going to give you the chance to have the last word.

Mr. SMITH. Well, I think the last word has to be reform and reform now. There are tons of ways—great people have looked at lots of different ways to reform the system. I think Pride of Retirement Council have a great way to reform the system. But I think there are other good ways on the table. We need to reform the system now in order to ensure that my generation has financial security in our retirements. My generation will make the necessary investment to secure our futures and I hope that your generation will assist us in this process.

The CHAIRMAN. Words well spoken. Thank you.

The committee will stand adjourned.

[Whereupon, at 11:32 a.m., the committee was adjourned.]

APPENDIX

United States General Accounting Office

GAO

Report to Congressional Requesters

July 2003

SOCIAL SECURITY REFORM

Analysis of a Trust Fund Exhaustion Scenario

GAO

Accountability • Integrity • Reliability

GAO-03-907

July 2003

GAO
Accountability · Integrity · Reliability
Highlights

Highlights of GAO-03-907, a report to congressional requesters

SOCIAL SECURITY REFORM

Analysis of a Trust Fund Exhaustion Scenario

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 solvency and sustainability challenge.

The Chairman of the Senate Special Committee on Aging and the Chairman of the Senate Committee on Finance asked GAO to use its analytic framework to evaluate an illustrative "Trust Fund Exhaustion" scenario under which 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. The analytic framework consists of three basic 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. The Trust Fund Exhaustion scenario is intended as an analytic tool, not a legal determination.

www.gao.gov/cgi-bin/getrpt?GAO-03-907.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Barbara Bovbjerg at (202) 512-7215 or Susan Irving at (202) 512-9142.

What GAO Found

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, the scenario illustrates trade-offs between sustainable solvency and benefit adequacy and equity.

By definition this scenario would achieve sustainable solvency because after trust fund exhaustion, benefit payments would be adjusted each year to equal annual tax income. Before exhaustion, the scenario would have the same unified fiscal results as paying currently scheduled benefits with no policy changes. After exhaustion, fiscal results would be increasingly similar to funding currently scheduled benefits with a tax increase (tax increase benchmark) and a benefit reduction benchmark that incorporates gradual and progressive reductions.

Benefits would differ sharply over time. Before trust fund exhaustion, currently scheduled benefits would be paid in full. After, benefits for all would be reduced across the board by 27 percent (to 73 percent of currently scheduled levels). Additional reductions would need to be taken in successive years such that at the end of the 75-year projection period, benefits would be reduced by 33 percent (to 67 percent of currently scheduled levels).

The Trust Fund Exhaustion scenario raises significant intergenerational equity issues. Specifically, a much greater burden would be placed on younger generations. Those born in 1955 would see no benefit reductions until age 83, while those born in 1985 would experience reduced benefits immediately upon retirement and benefits lower than under either GAO's benefit reduction benchmark or tax increase benchmark in all years of retirement. Consequently, lifetime benefits would be reduced more for younger generations. Benefits would be adjusted proportionately for all recipients, increasing the likelihood of hardship for lower-income retirees and the disabled.

Assessing the Social Security Administration's (SSA) administrative challenges under this scenario is difficult given a lack of historical precedent and legislative clarity on how SSA would proceed. A focus on cash management would be needed to calculate and implement the needed ongoing benefit adjustments.

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Abbreviations

GDP	gross domestic product
GEMINI	Genuine Microsimulation of Social Security and Accounts
MINT3	Modeling Income in the Near Term
OASDI	Old-Age and Survivors Insurance and Disability Insurance
PENSIM	Pension Simulator
PSG	Policy Simulation Group
SSA	Social Security Administration
SSASIM	Social Security and Accounts Simulator

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United States General Accounting Office
Washington, DC 20548

July 29, 2003

The Honorable Larry E. Craig
Chairman
Special Committee on Aging
United States Senate

The Honorable Charles Grassley
Chairman
Committee on Finance
United States Senate

This report responds to your request that we apply our criteria for assessing Social Security reform proposals to a "Trust Fund Exhaustion" scenario. As requested, this analysis assumes that once the combined Old-Age and Survivors Insurance and Disability Insurance (OASDI) Trust Funds are exhausted, monthly benefit checks will be reduced in proportion to the annual shortfall, effectively reducing everyone's benefits across-the-board.[1]

As agreed with your offices, our report is based on the analytic framework we have previously used to evaluate Social Security reform proposals.[2] This framework consists of three basic criteria:

- The extent to which the proposal achieves sustainable solvency and how it would affect the U.S. economy and the federal budget.
- The balance struck between the twin goals of income adequacy (level and certainty of benefits) and individual equity (rates of return on individual contributions).

[1]As presented in this report, the Trust Fund Exhaustion scenario illustrates potential outcomes, assuming that (a) the exhaustion of the combined OASDI Trust Funds in 2038 under the intermediate assumptions of the 2001 OASDI Trustees Report, (b) future program income and costs follow projections made by the Office of Chief Actuary at the Social Security Administration, and (c) only payroll taxes and taxes on benefits flow into the trust fund. The scenario is intended as an analytic tool, not a legal determination.

[2]See U.S. General Accounting Office, *Social Security: Evaluating Reform Proposals*, GAO/AIMD/HEHS-00-29 (Washington, D.C.: Nov. 4, 1999) and *Social Security Reform: Information on the Archer-Shaw Proposal*, GAO/AIMD/HEHS-00-56 (Washington, D.C.: Jan. 18, 2000).

- How readily changes could be implemented, administered, and explained to the public.

As in our evaluations of reform proposals, our assessment of the Trust Fund Exhaustion scenario uses a set of detailed questions that help describe potential effects of reform models on important policy and operational aspects of public concern. These questions are displayed in the report.

It is important to keep in mind that focusing on trust fund solvency alone is not sufficient. Solvency 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.

Although the Trustees' 2003 intermediate estimates show that the combined Social Security Trust Funds will be solvent until 2042,[3] program spending will constitute a growing share of the budget and the economy well before that date. In 2008, the first baby boomers will become eligible for Social Security benefits, and in 2009 Social Security's cash surplus—the difference between program tax income and the costs of paying scheduled benefits—will begin a permanent decline. By 2018, Social Security's tax income is projected to be insufficient to pay currently scheduled benefits. Importantly, neither the decline in the cash surpluses nor the cash deficit will affect the payment of benefits. However, the shift from positive to negative cash flow will place increased pressure on the federal budget to raise the resources necessary to meet the program's ongoing costs. 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. 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.

In analyzing the Trust Fund Exhaustion scenario, we used estimates provided in a memorandum dated May 8, 2003, prepared by the Social Security Administration's (SSA) Office of the Chief Actuary. Under these estimates, the cost of OASDI benefits equals OASDI income once the

[3]Separately, the Disability Insurance (DI) Trust Fund is projected to be exhausted in 2028 and the Old-Age and Survivors Insurance (OASI) Trust Fund in 2044.

combined trust funds are exhausted.[4] The analyses presented in this report are based on the Trustees' best, or intermediate, estimates of the 2001 OASDI Trustees Report.[5] Accordingly, our assessment uses the same framework as our January 15, 2003, report to you on the reform models put forward by the President's Commission to Strengthen Social Security.[6] This report follows the format of and uses the same economic assumptions as that report.

Although any proposal's ability to achieve and sustain solvency is sensitive to economic and budgetary assumptions, using a common framework can facilitate comparisons of alternative reform proposals. Our analysis of the Trust Fund Exhaustion scenario uses the same three benchmarks as did our January report:[7]

- 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.
- The "baseline extended" benchmark is a fiscal policy path developed in our earlier long-term model work that assumes payment in full of

[4]Income is defined as income from scheduled payroll-tax contributions and a portion of the income from taxation of scheduled benefits. The latter was adjusted to reflect the lower expected revenues from benefit taxation.

[5]Under the 2001 Trustees' intermediate estimates, the combined OASDI Trust Funds are projected to reach exhaustion in 2038. Under the 2003 Trustees' intermediate estimates, the projected exhaustion date is 2042.

[6]See U.S. General Accounting Office, *Social Security Reform: Analysis of Reform Models Developed by the President's Commission to Strengthen Social Security*, GAO-03-310 (Washington, D.C.: Jan. 15, 2003).

[7]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. Our benchmarks are solvent for the 75-year projection period commonly used by SSA's 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 Office of the Chief Actuary in its design.

currently scheduled Social Security benefits throughout the simulation period and no other changes in current spending or tax policies.[8]

As in other work assessing Social Security reform proposals, we used our long-term economic model in assessing the Trust Fund Exhaustion scenario against the first criterion, that of financing sustainable solvency.[9] 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, the 75-year actuarial period changes each year, 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.[10] In analyzing reform plans, the key fiscal and economic point is the ability of the government and society to afford the commitments when they come due. Our analysis addresses this key point by looking at the level and trends over 75 years in deficits, cash needs, and gross domestic product (GDP) consumed by the program.

To examine how the Trust Fund Exhaustion scenario balances adequacy and equity concerns, we used the Genuine Microsimulaion of Social Security and Accounts (GEMINI) model, a dynamic microsimulation model for analyzing the lifetime implications of Social Security policies for

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

[9]For this analysis, consistent with SSA's scoring of the Commission reform models, our long-term economic model incorporates the 2001 Trustees' best, or intermediate, assumptions.

[10]The Trustees have used the term "sustainable solvency" to mean maintaining a trust fund balance that is positive and either level or increasing as a percent of the annual cost of the program at the end of the 75-year period. GAO's definition of sustainable solvency seeks to gain a more complete perspective of a proposal's likely effects on the program, the federal budget, and the economy.

a large sample of people[11] born in the same year. GEMINI can simulate different reform features for their effects on the level and distribution of benefits. To assess benefit adequacy over time, we display median monthly benefit levels for those born in 1955, 1970, and 1985 ("birth cohorts") at different ages as well as their median lifetime benefits.

In analyzing reform proposals, we have stated that the use of our criteria to evaluate approaches to Social Security reform highlights the trade-offs that exist between efforts to achieve solvency for the combined OASDI Trust Funds and efforts to maintain adequate retirement income for current and future beneficiaries. For example, in our January report, we observed that the Commission reform models illustrate some of the options and trade-offs that will need to be considered as the nation debates how to reform Social Security. The Commission's proposals also illustrated the difficulty reform proposals face generally in balancing adequacy (level and certainty of benefits) and equity (rates of return on individual contributions) considerations.

The Trust Fund Exhaustion scenario illustrates the trade-offs between sustainable solvency and benefit adequacy and equity in a different way. By definition, this scenario would achieve sustainable solvency because once the combined trust funds have run out, benefit payments would be adjusted (i.e., reduced) each year to equal annual tax income. Under this scenario, shares of the federal budget and the economy devoted to Social Security would be lower compared to currently scheduled benefits. From a fiscal perspective, before exhaustion, the scenario would have the same unified fiscal results as paying currently scheduled benefits with no policy changes. Before 2038, the Trust Fund Exhaustion scenario would reduce unified surpluses and increase 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;

[11]The GEMINI cohorts consist of simulated samples of 100,000 individuals, sometimes called synthetic samples. These samples were validated against data from the Social Security Administration's Annual Statistical Supplement, the Survey of Income and Program Participation, the Current Population Survey, Modeling Income in the Near Term, and the Panel Survey of Income Dynamics.

subsequently, the Trust Fund 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 run out, benefits for all would be reduced across the board and remain below currently scheduled levels. Accordingly, after trust fund exhaustion all those receiving benefits would experience a sharp drop in benefits compared to currently scheduled levels; under the Trustees' 2001 intermediate estimates, this drop is estimated at 27 percent (or 73 percent of currently scheduled levels) in 2039.[12] Small further reductions would need to be taken in successive years such that by 2076 benefits would be one-third below currently scheduled benefits (i.e., to 67 percent of currently scheduled levels).

The Trust Fund Exhaustion scenario raises significant intergenerational issues. Specifically, due to the timing of the reductions under the Trust Fund Exhaustion scenario, younger generations would bear much greater benefit reductions. Those born in 1955 would see no benefit reductions until they reached age 83,[13] 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 that we used, 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.

The nature and scope of SSA's administrative challenges under the Trust Fund Exhaustion scenario are difficult to describe or assess given a lack of historical precedent and legislative clarity on how SSA would proceed. At a minimum, a focus on cash management would be needed for SSA to

[12]In 2038, the year the trust fund is exhausted, 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 the trust fund is exhausted, benefits would fall sharply, to about 27 percent below currently scheduled levels. Under the Trustees 2003 intermediate estimates, the overall drop is approximately the same.

[13]Assuming individuals are born on January 1st.

calculate and implement the ongoing benefit adjustments required under the scenario.

Concluding Observations

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 nature and extent 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 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. 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 Congress deliberates approaches to Social Security, the national debate also needs to include discussion of the various options for reform and the timing in which it should occur.

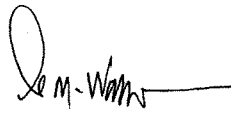
Early action to change Social Security would yield the highest fiscal dividends for the federal budget and would provide a longer period for prospective beneficiaries to make adjustments in their own planning. Waiting to build economic resources and reform future claims entails risks. First, we lose an important window where today's relatively large workforce can increase saving and enhance productivity, two elements critical to economic growth. We also 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 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.

Agency Comments and Our Evaluation

We provided a draft of this report to SSA. SSA provided informal technical comments, which we have incorporated where appropriate.

We are sending copies of this report to Senator John Breaux, Ranking Minority Member, Senate Special Committee on Aging; Senator Max S. Baucus, Ranking Minority Member, Senate Committee on Finance; the Honorable William M. Thomas, Chairman, and the Honorable Charles B. Rangel, Ranking Minority Member, House Committee on Ways and Means; the Honorable E. Clay Shaw, Chairman, and the Honorable Bob Matsui, Ranking Minority Member, Subcommittee on Social Security, House Committee on Ways and Means; and the Honorable Jo Ann B. Barnhart, Commissioner, Social Security Administration. We will also make copies available to others on request. In addition, the report will be available at no charge on GAO's Web site at http://www.gao.gov.

If you or your offices have any questions about this report, please contact Barbara D. Bovbjerg, Director, Education, Workforce, and Income Security Issues, on (202) 512-7215, or Susan Irving, Director, Strategic Issues, on (202) 512-9142.



David M. Walker
Comptroller General
of the United States

Appendix I: Briefing Slides

GAO

Analysis of a Trust Fund Exhaustion Scenario

July 2003

1

GAO

Objectives

- Evaluation of a scenario in which no changes are made to Social Security before the combined Old-Age and Survivors Insurance and Disability Insurance (OASDI) Trust Funds reach exhaustion.
- This evaluation uses the three basic criteria GAO has developed that provide policymakers with a framework for assessing proposed changes to Social Security:
  - Financing Sustainable Solvency.
  - Enhancing Adequacy and Equity in the Benefits Structure.
  - Implementing and Administering Reforms.

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Methodology

- **Financing Sustainable Solvency**
  - GAO's long-term economic model was used to help assess the potential fiscal and economic impacts of changes to Social Security.
  - Estimates of scenario costs and income are those made by the Office of the Chief Actuary, Social Security Administration (SSA), under the Trustees' 2001 intermediate assumptions.
- **Balancing Adequacy and Equity**
  - The GEMINI model, a dynamic microsimulation model,[1] was used to analyze the 1955, 1970, and 1985 birth cohorts to enable comparison of results over time as reform models are fully implemented.
- **Implementing and Administering Reforms**
  - Qualitative analysis based on GAO's issued and ongoing body of work on Social Security reform was used.

[1] GEMINI is useful for analyzing the lifetime implications of Social Security policies for a large sample of people born in the same year.

3

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Accountability • Integrity • Reliability

Benchmarks

GAO's analysis uses three benchmarks:

- Benefit reduction maintains current payroll tax rates and assumes a gradual reduction in Social Security benefits beginning with those reaching age 62 in 2005 and continuing for the next 30 years. In each of those years, this benchmark applies equal percentage point reductions to all three Primary Insurance Amount (PIA) formula factors. Relative to a proportional reduction, this benchmark is progressive in that it reduces benefits less for lower earners.
- Tax increase[1] assumes that the combined employer-employee payroll tax rate is increased by 0.34 percent for Disability Insurance (DI) and 1.56 percent for Old-Age and Survivor Insurance (OASI) beginning in 2002 in order to pay scheduled benefits.
- Baseline extended is a fiscal policy path that assumes payment in full of all scheduled Social Security benefits throughout the 75-year period and no other changes in current policies. In this analysis, it uses the 2001 Trustees intermediate economic assumptions, consistent with SSA scoring of reform models, implicitly financing trust fund shortfalls with debt held by the public.

[1]The benefit reduction and tax increase benchmarks were developed by GAO with technical input from SSA's Office of the Chief Actuary. Both use the 2001 Trustees intermediate economic assumptions and reflect cash outlays for benefits. Both restore 75-year actuarial balance to Social Security but are not solvent beyond this period. For more detailed information on the benefit reduction and tax increase benchmarks see appendix III of *Social Security: Program's Role in Helping Ensure Income Adequacy*. GAO-02-62. Washington, D.C.: November 30, 2001.

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Benchmarks (continued)

- All three benchmarks are used in analyzing sustainable solvency. From the perspective of sustainable solvency, the baseline extended differs from the tax increase benchmark. The tax increase benchmark assumes payroll tax financing of all scheduled benefits whereas the baseline extended benchmark assumes all scheduled benefits will be paid but does not specify any new financing--implicitly benefits are financed by increasing debt held by the public.
- There is no difference between the tax increase and baseline extended benchmarks in analyzing benefit levels, since only the financing of benefits differs, not the actual benefit levels. Therefore only the benefit reduction and tax increase benchmarks are used in analyzing benefit adequacy.
- Benchmarks are to be viewed as illustrative, polar cases or bounds for changes within the current system. Other benchmarks could be devised with different tax and/or benefit adjustments that would perform the same function.

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Trust Fund Exhaustion Scenario

- Under "Trust Fund Exhaustion," no changes would be made to program financing. Current tax rates would be maintained.
- Currently scheduled benefits would be paid in full until the year in which the combined OASDI Trust Funds are exhausted.[1] In that year, benefits are assumed to be reduced such that total benefits equal the remaining trust fund assets plus program income from present-law taxes.[2] Thereafter, benefits would be reduced in proportion to the annual Social Security shortfall, effectively reducing benefits for everyone.[3] (See fig. 1.)

[1] The DI Trust Fund is projected to reach exhaustion before the OASI Trust Fund. Treating them as one combined fund assumes assets will be transferred as needed from OASI to DI such that both funds reach exhaustion at the same time.

[2] Annual revenue from present-law taxes includes income from scheduled payroll-tax contributions and income from taxation of scheduled benefits. The latter was adjusted to reflect the lower expected revenues from benefit taxation.

[3] This definition of a Trust Fund Exhaustion scenario represents an analytic convenience and not a legal determination as to how benefits would fare in the event the combined OASDI Trust Funds were exhausted.

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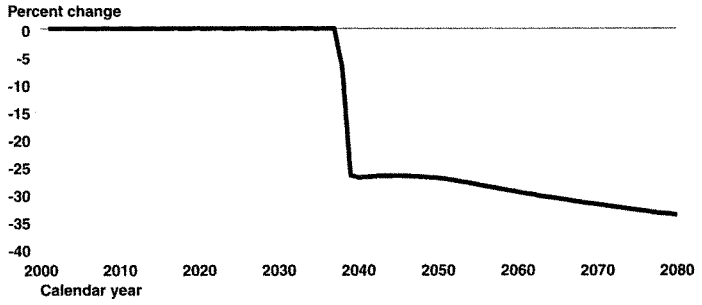
Trust Fund Exhaustion Scenario (continued)

Figure 1: Trust Fund Exhaustion Scenario

Change in Currently Scheduled Benefits under Trust Fund Exhaustion Scenario - 2001 Trustees Report



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

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Financing Sustainable Solvency

This criterion evaluates the extent to which the proposal achieves sustainable solvency, including how the proposal would affect the economy and the federal budget.

To what extent does the proposal:

- Reduce future budgetary pressures?
- Reduce debt held by the public?
- Reduce the cost of the Social Security system as a percentage of GDP?
- Reduce the percentage of federal revenues consumed by the Social Security system?
- Increase national saving?
- Restore 75-year actuarial balance and create a stable system?
- Raise payroll taxes, draw on general revenues, and/or use Social Security trust fund surpluses to finance changes?
- Create contingent liabilities?
- Include "safety valves" to control future program growth?

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Financing Sustainable Solvency (continued)

Figure 2

- The fiscal path under the Trust Fund Exhaustion scenario is the same as baseline extended through 2037; shortly thereafter unified deficits as a share of GDP are significantly lower under the Trust Fund Exhaustion scenario.
- Under the Trust Fund Exhaustion scenario, beginning about 2020 unified surpluses are considerably smaller and deficits considerably larger than under the benefit reduction benchmark until the combined OASDI Trust Funds are exhausted. From about 2040 through the end of the simulation period, the fiscal outlook under Trust Fund Exhaustion is quite similar to the fiscal outlook under the benefit reduction benchmark.
- Compared to the tax increase benchmark, unified surpluses are much smaller and deficits are much larger under the Trust Fund Exhaustion scenario through 2037, thereafter, the difference between the fiscal paths declines until the two are virtually indistinguishable after 2065 through the end of the simulation period.

Note: Analysis based on estimates from the Office of the Chief Actuary, SSA, under the Trustees 2001 intermediate assumptions and CBO's August 2002 baseline assumptions, including the scheduled expiration (sunset) of the tax reductions in the Economic Growth and Tax Relief Reconciliation Act of 2001.

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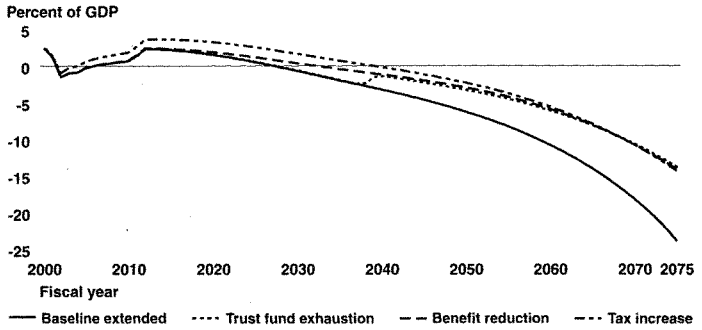
Financing Sustainable Solvency (continued)

Figure 2: Trust Fund Exhaustion Scenario

Unified Surpluses and Deficits as a Share of GDP



Source: GAO analysis.

Note: Analysis based on estimates from the Office of the Chief Actuary, SSA, under the Trustees 2001 intermediate assumptions and CBO's August 2002 baseline assumptions, including the scheduled expiration (sunset) of the tax reductions in the Economic Growth and Tax Relief Reconciliation Act of 2001.

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Financing Sustainable Solvency (continued)

Figure 3

- Debt held by the public under the Trust Fund Exhaustion scenario is the same as baseline extended through 2037, soon thereafter debt as a share of GDP is significantly lower under the Trust Fund Exhaustion scenario, and the gap increases over time.
- Under the Trust Fund Exhaustion scenario, debt held by the public as a share of GDP is higher than under the benefit reduction benchmark throughout the simulation period.
- Compared to the tax increase benchmark, debt held by the public as a share of GDP is significantly higher under the Trust Fund Exhaustion scenario for most of the simulation period.

Note: Analysis based on estimates from the Office of the Chief Actuary, SSA, under the Trustees 2001 intermediate assumptions and CBO's August 2002 baseline assumptions, including the scheduled expiration (sunset) of the tax reductions in the Economic Growth and Tax Relief Reconciliation Act of 2001.

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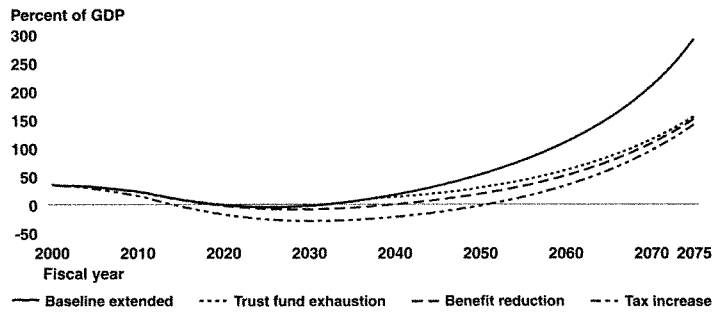
Financing Sustainable Solvency (continued)

Figure 3: Trust Fund Exhaustion Scenario

Debt Held by the Public as a Share of GDP



Source: GAO analysis.

Note: Analysis based on estimates from the Office of the Chief Actuary, SSA, under the Trustees 2001 intermediate assumptions and CBO's August 2002 baseline assumptions, including the scheduled expiration (sunset) of the tax reductions in the Economic Growth and Tax Relief Reconciliation Act of 2001.

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Financing Sustainable Solvency (continued)

Figure 4

- The government's cash requirement under the Trust Fund Exhaustion scenario is the same as both the baseline extended and tax increase benchmarks through 2037. After the combined OASDI Trust Funds are exhausted, the government's cash requirement falls significantly compared to the baseline extended and tax increase benchmarks and remains relatively constant as a share of GDP through the end of the simulation period.
- Compared to the benefit reduction benchmark, the government's cash requirement as a share of GDP is lower beginning in 2039 through the end of the simulation period.

Note: Analysis based on estimates from the Office of the Chief Actuary, SSA, under the Trustees 2001 intermediate assumptions and CBO's August 2002 baseline assumptions, including the scheduled expiration (sunset) of the tax reductions in the Economic Growth and Tax Relief Reconciliation Act of 2001.

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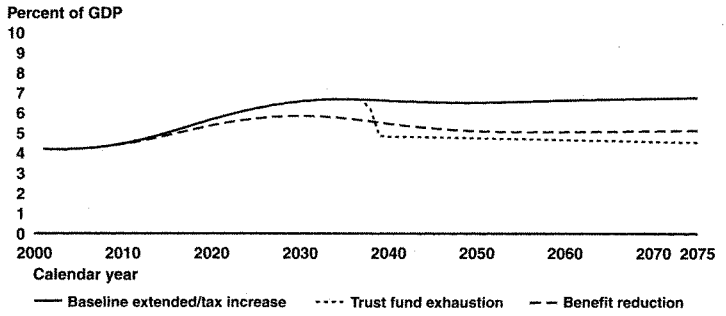
Financing Sustainable Solvency (continued)

Figure 4: Trust Fund Exhaustion Scenario

Government Cash Requirements



Source: GAO analysis of data from the Office of the Chief Actuary, SSA.

Note: All estimates are based on the Trustees' 2001 intermediate assumptions and reflect cash outlays for benefits. Benefit amounts shown for the baseline extended and tax increase benchmarks are scheduled benefits as estimated by the actuaries.

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Financing Sustainable Solvency (continued)

Under the Trust Fund Exhaustion scenario:

- National saving would increase on a first-order basis due to the improved fiscal position of the government resulting from the reduced benefit payments beginning in 2038.[1]
- 75-year actuarial balance would result as benefits are reduced to match program income. The system is stable at the reduced benefit level.
- No changes are assumed in program financing.
- No new contingent liabilities are created.
- Program growth is limited to growth in program income.

[1]Analysis limited to first order effects on saving. Effects on saving behavior in response to changes are not considered given the lack of expert consensus.

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Balancing Adequacy and Equity

This criterion evaluates the balance struck between the twin goals of income adequacy (level and certainty of benefits) and individual equity (rates of return on individual contributions).

To what extent does the proposal:

- Change scheduled benefits for current and future retirees?
- Maintain benefits for the disabled, dependents, and survivors?
- Maintain benefits for low-income workers who are most reliant on Social Security?
- Provide higher replacement rates for lower income earners?
- Improve intergenerational equity?
- Ensure that those who contribute receive benefits?
- Expand individual choice and control over program contributions?
- Increase returns on investment?

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Balancing Adequacy and Equity--Methodology and Assumptions

- We evaluate the adequacy and equity criterion for the Social Security Trust Fund Exhaustion scenario in comparison with GAO benchmark through analyses of:
  - Median monthly benefits for those born in 1955, 1970, and 1985 (birth cohorts) at various ages.
  - The present value[1] of lifetime benefits for beneficiaries surviving to age 65 and beyond.
  - Distribution of monthly benefits by benefit quintile and history of disability receipt.
- All cohorts we analyzed were produced using the GEMINI model, a dynamic microsimulation model of a representative sample of 100,000 individuals.
- Model Assumptions:
  - No cohort members work past age 65.
  - Retired worker beneficiaries start collecting benefits at age 65.[2]

[1]The current value of one or more future benefit payments discounted at an appropriate interest rate--for our analysis the Treasury rate specified by the intermediate assumptions of the 2001 OASDI Trustees' Report.

[2] Disability recipients, certain surviving spouses, and others may receive benefits prior to age 65.

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Balancing Adequacy and Equity--Overview of Trust Fund Exhaustion Scenario

- Scenario results in a benefits "cliff"--27 percent reduction in benefits in 2039 followed by continued benefit reductions.
  - Does not exempt current retirees and those near retirement age. (Those currently retired would be affected if they were receiving benefits in 2038.)
  - Benefits are reduced in a manner that does not protect low-income and disabled workers.
- Scenario reduces lifetime benefits more for younger generations.
- For those born in the same year, the scenario reduces lifetime benefits more for retirees who survive to older ages beyond the "cliff".

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Changes in Scheduled Benefits for Current and Future Retirees

- Under the Trust Fund Exhaustion scenario, the combined OASDI Trust Funds reach exhaustion in 2038, with benefits reduced in that year and all subsequent years.
  - Benefits are reduced across the board relative to currently scheduled benefits by 7 percent in 2038, about 27 percent between 2039 and 2045, and by increasingly larger percentages in subsequent years.
- Benefits under Trust Fund Exhaustion:
  - Mirror the the tax increase benchmark before 2038 and are substantially lower afterwards.
  - Are higher than the benefit reduction benchmark before 2038 and lower afterwards.

Table 1: Timing of the Benefit "Cliff"

	Those born in 1955	Those born in 1970	Those born in 1985
Year cohort reaches age 65	2020	2035	2050
Age at which the cohort reaches the "Cliff" (2038)	83	68	53

Source: GAO analysis based on Social Security Administration Office of the Chief Actuary data.

Note: Analysis assumes cohort members are born on January 1st.

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Changes in Scheduled Benefits (continued)

Figure 5

- Shows benefits in 2001 dollars for illustrative individual born in 1955, 1970, and 1985 under Trust Fund Exhaustion scenario.
- The 1955 and 1970 illustrative individuals receive currently promised benefits until ages 82 and 67, respectively, followed by a benefit "cliff" with reduced benefits thereafter.
- The 1985 illustrative individual never receives currently scheduled benefits; all benefits are received after the benefit "cliff" and benefits gradually decline with age.

Figures 6, 7, and 8

- Show median benefits for all surviving members of each birth cohort under Trust Fund Exhaustion scenario and benefit reduction and tax increase benchmarks.
- Benefits increase slightly over time under Trust Fund Exhaustion and benchmarks because some retirees change benefit status as they age.[1]

[1]When retirees become widowed they may receive the larger of either their own benefit or their spouses' benefit.

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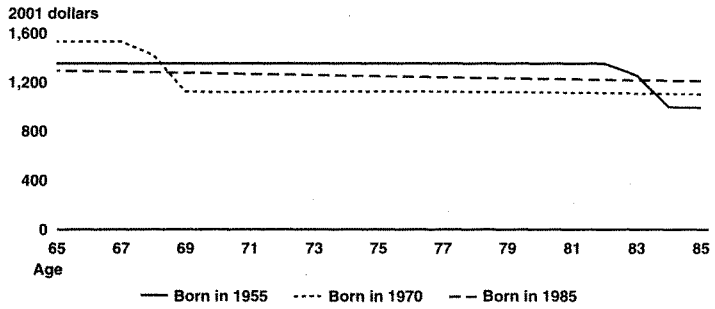
Changes in Scheduled Benefits (continued)

Figure 5: Trust Fund Exhaustion Scenario

Monthly Benefits under 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 (see fig. 1). In GEMINI, the median age of death for those living to age 65 and receiving a retired workers benefit is 84, 85, and 86 for the 1955, 1970, and 1985 cohorts, respectively.

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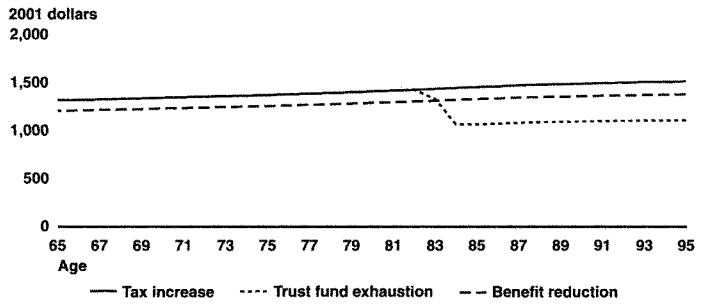
Changes in Scheduled Benefits (continued)

Figure 6: Trust Fund Exhaustion Scenario

Median Monthly Benefits by Age for Those Born in 1955



Source: GAO analysis using GEMINI model.

Note: The tax increase benchmark assumes a higher level of payroll tax (an increase of 1.9 percentage points beginning in 2002) than either the benefit reduction benchmark or the Trust Fund Exhaustion scenario.

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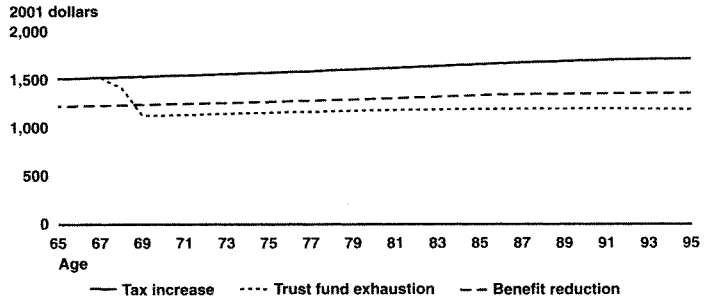
Changes in Scheduled Benefits (continued)

Figure 7: Trust Fund Exhaustion Scenario

Median Monthly Benefits by Age for Those Born in 1970



Source: GAO analysis using GEMINI model.

Note: The tax increase benchmark assumes a higher level of payroll tax (an increase of 1.9 percentage points beginning in 2002) than either the benefit reduction benchmark or the Trust Fund Exhaustion scenario.

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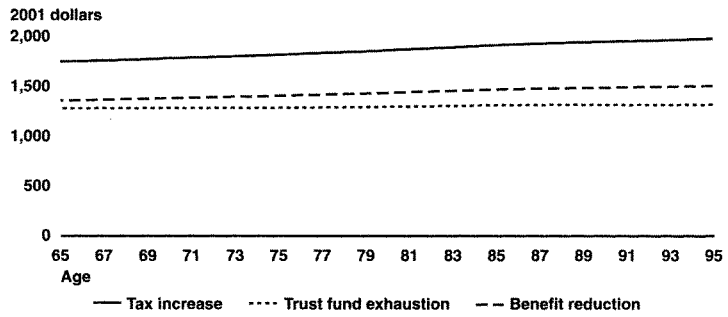
Changes in Scheduled Benefits (continued)

Figure 8: Trust Fund Exhaustion Scenario

Median Monthly Benefits by Age for Those Born in 1985



Source: GAO analysis using GEMINI model.

Note: The tax increase benchmark assumes a higher level of payroll tax (an increase of 1.9 percentage points beginning in 2002) than either the benefit reduction benchmark or the Trust Fund Exhaustion scenario.

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Benefit Outcomes for Low-Income Beneficiaries

Figures 9 and 10

Trust Fund Exhaustion scenario:

- Reduces benefits in a manner that does not protect low-income workers.
- Reduces benefits relative to the benefit reduction benchmark by more for the lower benefit quintiles
  - Benefit reduction benchmark cuts benefits in a more progressive manner.
- Reduces benefits relative to the tax increase benchmark by the same proportion for all benefit quintiles.
- Is more likely to adversely affect benefit adequacy and poverty rates than a more progressive reduction, all else equal.

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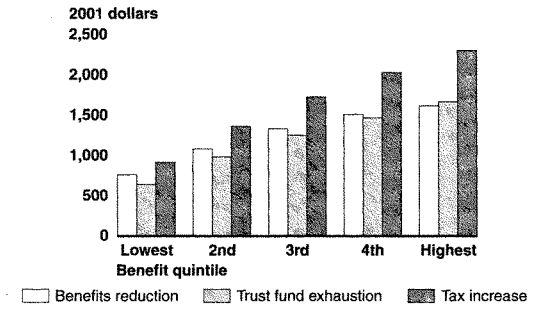
Benefit Outcomes (continued)

Figure 9: Trust Fund Exhaustion Scenario

Median Real Monthly Benefits at Age 67 by Quintile for Those Born in 1985



Source: GAO analysis using GEMINI model.

Note: Benefit quintiles are based on the distribution of benefits at age 67 under the tax increase benchmark. The tax increase benchmark assumes a higher level of payroll tax (an increase of 1.9 percentage points beginning in 2002) than either the benefit reduction benchmark or the Trust Fund Exhaustion scenario.

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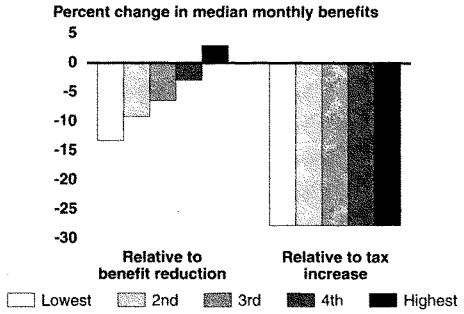
Benefit Outcomes (continued)

Figure 10: Trust Fund Exhaustion Scenario

Percentage Change in Benefits at Age 67 under the Trust Fund Exhaustion Scenario Relative to the Tax Increase and Benefit Reduction Benchmarks by Benefit Quintile for Those Born in 1985



Source: GAO analysis using GEMINI model.

Note: Compared to the proportional reduction specified by the Trust Fund Exhaustion scenario, the benefit reduction benchmark is progressive in that it reduces benefits less for lower earners. Benefit quintiles are based on the distribution of benefits at age 67 under the tax increase benchmark. The tax increase benchmark assumes a higher level of payroll tax (an increase of 1.9 percentage points beginning in 2002) than either the benefit reduction benchmark or the Trust Fund Exhaustion scenario. Similar analysis for the 1955 and 1970 cohorts shows similar results—benefits are not reduced by smaller percentages for the lower benefit quintiles relative to either benchmark.

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Benefit Outcomes for Disabled Beneficiaries[1]

Trust Fund Exhaustion scenario

Figure 11

- Reduces benefits by the same proportion for all beneficiaries including disabled workers.

Figure 12

- Reduces benefits relative to the benefit reduction benchmark by more for those who received disability before reaching the normal retirement age.
  - Disability recipients have lower lifetime earnings.
  - Benefit reduction benchmark cuts benefits in a more progressive manner.
- Reduces benefits relative to the tax increase benchmark by the same proportion for those who received disability and those who did not.

[1] Neither the Trust Fund Exhaustion scenario nor the benchmarks contain any specific provisions relating to disabled beneficiaries. For instance differences among the Trust Fund Exhaustion scenario and the benefit reduction benchmark are due in large part to the differing treatment of low lifetime earners.

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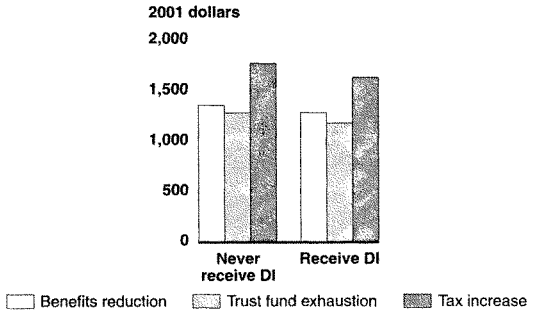
Benefit Outcomes (continued)

Figure 11: Trust Fund Exhaustion Scenario

Median Real Monthly Benefits at Age 67 by History of DI Receipt for Those Born in 1985



Source: GAO analysis using GEMINI model.

Note: The tax increase benchmark assumes a higher level of payroll tax (an increase of 1.9 percentage points beginning in 2002) than either the benefit reduction benchmark or the Trust Fund Exhaustion scenario.

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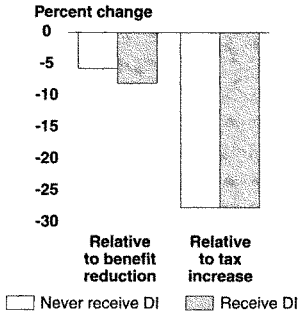
Benefit Outcomes (continued)

Figure 12. Trust Fund Exhaustion Scenario

Percentage Reduction in Median Monthly Benefits under Trust Fund Exhaustion Scenario at Age 67 Relative to the Tax Increase and Benefit Reduction Benchmarks by History of DI Receipt for Those Born in 1985



Source: GAO analysis using GEMINI model.

Note: Compared to the proportional reduction specified by the Trust Fund Exhaustion scenario, the benefit reduction benchmark is progressive in that it reduces benefits less for lower earners. The tax increase benchmark assumes a higher level of payroll tax (an increase of 1.9 percentage points beginning in 2002) than either the benefit reduction benchmark or the Trust Fund Exhaustion scenario. Similar analysis for the 1955 and 1970 cohorts shows the similar results—benefits are not reduced by smaller percentages for the disabled relative to either benchmark.

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Effect on Generational Equity

Figures 13 and 14

- For those born in 1955, lifetime benefits are higher under the Trust Fund Exhaustion scenario than under the benefit reduction benchmark. However, those living to age 83 and older would experience the "cliff."
- For those born in 1970 cohort, lifetime benefits are about the same under the Trust Fund Exhaustion scenario and the benefit reduction benchmark.[1] However, those surviving to age 69 and older would see their monthly benefits reduced well below the benefit reduction benchmark.
- Lifetime benefits for those born in 1985 are about 7 percent lower under the Trust Fund Exhaustion scenario than under the benefit reduction benchmark (see fig. 14).

[1] The Trust Fund Exhaustion scenario yields about 1 percent greater lifetime benefits relative to the benefit reduction benchmark (see fig. 14).

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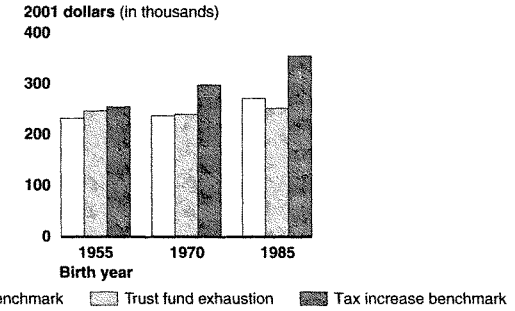
Effect on Generational Equity (continued)

Figure 13: Trust Fund Exhaustion Scenario

Present Value of Lifetime Social Security Benefits by Birth Year



Source: GAO analysis using GEMINI model.

Note: Benefits are calculated for individuals that survive to ages 65 and older. Assumes that benefits continue to decline beyond 2080 at the rate of decline for the period 2071-2080. This assumption affects benefits only for those born in 1985 surviving to age 95 or older. The tax increase benchmark assumes a higher level of payroll tax (an increase of 1.9 percentage points beginning in 2002) than either the benefit reduction benchmark or the Trust Fund Exhaustion scenario. Analysis does not reflect any behavioral changes resulting from the benchmark or scenario, such as the impact of higher taxes on consumption or retirement saving under the tax increase benchmark.

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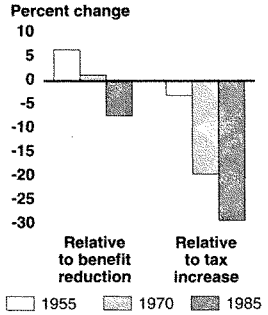
Effect on Generational Equity (continued)

Figure 14: Trust Fund Exhaustion Scenario

Percentage Change in Lifetime Benefits under the Trust Fund Exhaustion Scenario Relative to the Tax Increase and Benefit Reduction Benchmarks



Source: GAO analysis using GEMINI model.

Note: Compared to the proportional reduction specified by the Trust Fund Exhaustion scenario, the benefit reduction benchmark is progressive in that it reduces benefits less for lower earners. The present value of lifetime benefits are calculated in 2001 dollars for cohort members that survive to ages 65 and older. The tax increase benchmark assumes a higher level of payroll tax (an increase of 1.9 percentage points beginning in 2002) than either the benefit reduction benchmark or the Trust Fund Exhaustion scenario. Analysis does not reflect any behavioral changes resulting from the benchmark or scenario, such as the impact of higher taxes on consumption or retirement saving under the tax increase benchmark.

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Implementing and Administering Reforms

This criterion evaluates how readily such changes could be implemented, administered, and explained to the public.

To what extent does the scenario:

- Provide reasonable timing and funds for implementation and result in reasonable administrative costs?
- Allow the general public to readily understand its financing structure and increase public confidence?
- Allow the general public to readily understand the benefit structure and avoid expectation gaps?
- Limit the potential for politically motivated investing?

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Implementing and Administering Reforms (continued)

- Assessing the Social Security Administration's administrative and implementation challenges posed by a Trust Fund Exhaustion scenario is complicated by a lack of historical precedent and legislative clarity on how SSA would proceed.
- Any determination of benefit distributions after exhaustion of the combined OASDI Trust Funds would pose challenges to fundamental administrative functions of SSA.
  - 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.
- This Trust Fund Exhaustion scenario would require an educational campaign to make public aware of "cliff" in benefits and of subsequent reductions.
- Difficulty added to individuals' retirement planning as benefits develop into a moving target—"cliff" may be foreseen, but cuts tend to be deeper as an individual ages.

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Appendix II: Methodology

Fiscal Model

The model simulates the interrelationships between the budget and the economy over the long term and does not reflect their interaction during short-term business cycles. Long-term simulations provide illustrations—not precise forecasts—of the relative fiscal and economic outcomes associated with alternative policy paths. They are useful for comparing the potential outcomes of alternative policies within a common economic framework over the long term. Recognizing their inherent uncertainties, we have generally chosen conservative assumptions, such as holding interest rates and total factor productivity growth constant. Variations in these assumptions generally would not affect the relative outcomes of alternative policies.

Table 1: Fiscal Model Assumption Summary

Model Inputs	Assumptions
Social Security spending (OASDI)	2001 Social Security Trustees' intermediate projections.
Medicare spending (HI and SMI)	2001 Medicare Trustees' intermediate assumption that per enrollee Medicare spending grows with GDP per capita plus 1 percentage point.
Medicaid spending	CBO's July 2002 long-term assumption that per enrollee Medicaid spending grows with GDP per capita plus 1 percentage point.
Other mandatory spending	CBO's August 2002 baseline through 2012; thereafter increases at the rate of economic growth (i.e., remains constant as a share of GDP).
Discretionary spending	CBO's August 2002 baseline through 2012, adjusted for the 2001 Social Security Trustees' inflation assumptions; thereafter increases at the rate of economic growth.
Revenue	CBO's August 2002 baseline through 2012; thereafter remains constant at 20.5 percent of GDP (CBO's projection in 2012).
Nonfederal saving (percent of GDP): gross saving of the private sector and state and local government sector	Increases gradually over the first 10 years to 17.5 percent of GDP (the average nonfederal saving rate from 1992-2001).
Net foreign investment (percent of GDP)	Increases (or decreases) from 2002 share of GDP by one-third of any increase (or decrease) in gross national saving through 2012; thereafter increases (or decreases) from 2012 nominal dollar level by one-third of any increase (or decrease) in gross national saving.
Labor: growth in hours worked	2001 Social Security Trustees' intermediate projections.
Total factor productivity growth	Consistent with labor productivity growth in 2001 Social Security Trustees' intermediate projections.
Inflation (GDP price index and CPI)	2001 Social Security Trustees' intermediate projections.
Interest rate (average on the national debt)	CBO's August 2002 implied real average interest rate through 2011 adjusted for the 2001 Social Security Trustees' intermediate inflation assumptions; 6.3 percent thereafter.

Source: GAO.

Benefit Model

Genuine Microsimulation of Social Security and Accounts (GEMINI) is a microsimulation model developed by the Policy Simulation Group (PSG). GEMINI is linked with two other PSG models, the Social Security and Accounts Simulator (SSASIM), which has been used in numerous GAO reports, and the Pension Simulator (PENSIM), which has been developed for the Department of Labor. For our report, we used SSASIM to produce Social Security policy regimes consistent with the benefit reduction benchmark, the tax increase benchmark, and the Trust Fund Exhaustion scenario. PENSIM produced simulated samples, sometimes called synthetic samples, of lifetime histories, including earnings, educational attainment, marriage, disability, and death, for the cohorts born in 1955, 1970, and 1985. The lifetime histories were validated against data from the Survey of Income and Program Participation, the Current Population Survey, Modeling Income in the Near Term (MINT3),[1] and the Panel Study of Income Dynamics. Additionally, any projected statistics (such as life expectancy, educational attainment, employment patterns, and marital status at age 60) are, where possible, consistent with intermediate-cost projections from SSA's Office of the Chief Actuary. Because PENSIM cannot yet stochastically determine the age at which a member of the sample applies for benefits, we assumed that all retired worker beneficiaries claim benefits at age 65. GEMINI used the lifetime histories produced by PENSIM and the policy regimes produced by SSASIM to simulate Social Security benefits for retired and disabled workers and auxiliary benefits paid to spouses, widows, and children.

Additional information about GEMINI may be found in three previous GAO reports that used the model: *Retirement Income: Intergenerational Comparisons of Wealth and Future Income*, GAO-03-429 (Washington, D.C.: Apr. 25, 2003); *Social Security Reform: Analysis of Reform Models Developed by the President's Commission to Strengthen Social Security*, GAO-03-310 (Washington, D.C.: Jan. 15, 2003); and *Social Security: Program's Role in Helping Ensure Income Adequacy*, GAO-02-62 (Washington, D.C.: Nov. 30, 2001).

The GEMINI, PENSIM, and SSASIM models are updated to reflect changes in information sources. Notable changes from recent reports include updated mortality and disability patterns to reflect new information from

[1]MINT3 is a detailed microsimulation model developed jointly by the Social Security Administration, the Brookings Institution, RAND, and the Urban Institute to project the distribution of income in retirement for the 1931 to 1960 birth cohorts.

SSA's Office of the Chief Actuary. For more information on the models, see the PSG Web site at www.polsim.com.

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