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ANALYZING SOCIAL SECURITY: GAO WEIGHS THE PRESIDENT'S COMMISSION'S PROPOSALS

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WEDNESDAY, JANUARY 15, 2003

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

The committee met, pursuant to notice, at 9:33 a.m., in room SD–562, Dirksen Senate Office Building, Hon. John Breaux (chairman of the committee) presiding.

Present: Senators Breaux, Stabenow, Craig, and Talent.

The CHAIRMAN. The Senate Aging Committee will please come to order.

Good morning, everyone. Welcome to the 108th Congress. I am sure we will be joined by other members. I am delighted to have my ranking member, Senator Larry Craig. I call him the crown prince of chairs.

Senator CRAIG. Be careful with terms.

The CHAIRMAN. He is the chairman-in-waiting here, soon to be, and we are very, very delighted to begin this year, I think, in the same timeframe and in the same manner which we did last year, in a cooperative fashion, which I think is so important particularly on the questions of aging. There is really not a lot of difference in how we approach these issues.

I also want to welcome our new member, Senator Talent. Welcome to the Aging Committee. We are delighted to have you on board. A number of other members have requested to be members of our Aging Committee and we are delighted to have them and we will welcome them when they get to the meeting, and we look forward to working with them.

The purpose of our hearing this morning is really quite simple. It is to hear the findings of the GAO study that we requested on plans proposed by the President's Commission on Social Security.

I had asked the GAO and our good colleague, David Walker, to conduct this analysis really for one reason, to sort of call a timeout in some of the political rhetoric of the debate regarding Social Security. We can have a number of groups come before the Aging Committee and we will pretty much tell you what they are going to say before they get here with regard to Social Security and what should be done.

We wanted to try and get as much of a neutral recommendation and review of the commission proposal as possible, and we could think of no one better to conduct that review than the GAO. Of course, that is the purpose of the hearing, is for them to present this report.

I believe we have actually taken a giant step backwards in the Social Security reform debate in the past few years. Rather than a discussion about the real reform that we need with the American public, Social Security is once again becoming every politician's favorite 30-second negative ad.

I was at a speech in Washington yesterday and mentioned that I did not think that Social Security reform was going to happen this year. I got folks saying, "Well, then why should we even have a hearing this morning?" The answer is that reform, while it may be a long way off, rhetoric on Social Security is still here; it is now and it is red hot.

It is not that Social Security isn't getting enough attention; it is that it gets too much of the wrong kind of attention. The truth is simply that politicians and interest groups can't talk enough about Social Security, about protecting it and about saving it for future generations, or too often about the other side, trying to destroy it for our Nation's seniors.

So if we are going to do all this talking, I thought we should at least have a sort of non-partisan, objective voice in the mix. I might add that finding a non-partisan voice on Social Security is almost impossible. We are rapidly running out of interested parties who are not firmly in one camp or the other.

I am still a firm believer that Congress must address entitlement reform overall. The demographic changes in this country will soon cause an extraordinary collision of financial pressures. I referred to it yesterday as truly the perfect political storm.

Social Security and Medicare both are facing long-term insolvency. Medicaid, which is having to fill in for the lack of a long-term care system in this country, is already putting enormous pressure on State and Federal budgets. We have all heard time and time again that unless we do something, entitlement spending will crowd out dollars for other discretionary investments such as our national security and education, just to mention two. If I know Dave Walker, he will speak to these issues as well.

We truly are at a crossroads of either ducking and waiting for that perfect storm to hit or actually preparing to face it. Today's hearing will hopefully give the American public a realistic reminder about the tough choices facing our Social Security system for millions of Americans. It is such a critical program and it deserves better than what we have seen in recent times.

I want to thank once again Dave Walker and the terrific staff that he has at GAO for the enormous amount of work that has gone into the report that he has prepared for us this morning. We look forward to hearing that report and asking questions.

I would like to recognize now my friend and chairman soon, soon to be, Senator Craig.

STATEMENT OF SENATOR LARRY CRAIG

Senator CRAIG. Well, Mr. Chairman, thank you very much. I am here today because this was a hearing that the chairman had begun to work on some time ago, prior to the election. If it had not been, I would not be here.

I think it is important for the record to show that the transition of power in a democratic society is being flawed at this moment; that I should be the chairman, as should others, in a majority party.

When the transition occurred some months ago, with the change of a single member, that transition in this committee and others came almost immediately, and that is the way it ought to be. But because of the cooperative nature that the chairman and I have worked under and will continue to work under for the benefit of this committee, I am here today.

But it is very important that the record demonstrate that what is going on in this Senate at this moment is historic and precedent-setting and it will be denied. I think that is fundamentally important.

But this committee will work in a cooperative vein because, as I think the chairman laid out, the issues before it and the challenges in Aging America are critical and it is our opportunity, both John Breaux' and mine and Jim Talent's and others', to highlight those in this committee, to challenge authorizing committees within the Congress to meet those kinds of demands.

Today before us is a GAO review about Social Security, and I too welcome David Walker. Social Security, I think, has provided protection from financial uncertainty for generations of older Americans. However, America has changed dramatically over the past decades and continues to change.

The U.S. economy, for example, has evolved from an industrial-age workforce to an economy characterized more and more by information-age opportunities. America also faces unprecedented demographic changes, and it is in those changes that this committee has an opportunity to highlight and bring to the forefront.

As a Nation, Americans are living longer than ever before. Birth rates have stabilized to roughly replacement levels. The ratio of workers paying into Social Security to those collecting Social Security benefits has declined from 5-to–1 in 1960 to 3.4-to–1 today. The worker-to-beneficiary ratio is projected to decline to 2-to–1 by 2040.

Let us be clear. Current retirees and those nearly retirement age will continue to receive their promised benefits. Let me repeat that. There is not a Member of Congress, nor does the current system deny current retirees and those nearing retirement age being allowed to continue to receive their promised benefits.

Those receiving benefits now and in the near future need not fear losing their benefits. I think it is in that context that the chairman challenged us this morning to be able to openly, honestly and effectively review these programs that benefit our elderly, our Aging in America, without the political demagoguery that has historically mounted around it.

The challenge calling out to this generation of leaders is how to sustain Social Security beyond this generation of retirees without over-burdening our children and grandchildren with excessive taxes on their labor or huge cuts in their retirement income.

We are here today to learn how best to provide a Social Security program that is adequate and sustainable for the future. Our charge is to develop a Social Security program that future generations can depend on.

On May 3, 2001, President Bush courageously established a Social Security Commission to study the future of our national retirement program. The President tasked this commission with the responsibility of developing models designed to strengthen Social Security.

The commission featured an impressive bipartisan group of experts. This group produced three models using different design features to show how each approach might address the twin issues of benefit adequacy and sustainability.

So, Mr. Chairman, I too look forward to listening to the GAO's view of how the President's commission meets these twin goals because they are the twin goals that remain the challenge.

Thank you very much.

The CHAIRMAN. Thank you, Senator Craig, and you point out the great challenge facing us. We are challenged to fix Social Security and we still haven't even figured out how our committees are going to meet. So that puts everything in perspective here.

Senator Talent, comments? Welcome to the committee. We are glad to have you on board.

Senator TALENT. Thank you, Mr. Chairman. It is a pleasure to be here. In the House, generally you don't get to make opening statements unless you are the chairman or the ranking member. So while normally I probably wouldn't, I think I will take advantage of the opportunity at least on this one occasion.

The CHAIRMAN. One minute. [Laughter.]

Senator TALENT. Oh, the 1-minute rule. Thank you, Mr. Chairman. It is the first time I have ever served on a committee where you say "Mr. Chairman" and two people turn around.

The CHAIRMAN. You should see what happens when you say "Mr. President." [Laughter.]

Senator TALENT. I would like to associate myself with the comments both of the chairman and the future chairman. I am also frustrated with the slow pace of change in terms of reflecting the last elections, and I hope that will be dealt with in the next day or two.

I asked on this committee and am pleased to be here because I think really what this committee is going to be dealing with today and in the future are the most important issues that we are confronting.

If you just look at this issue on a very concrete basis today, if you are a couple approximately my age and you are thinking about your retirement and thinking about what kind of assets you are going to have available and how much money you are going to need to be able to sustain your quality of life, that $900 a month that you ought to have a right to expect to get from Social Security is very important.

Whether that is going to be there depends in large part on what we do in the next few years. So I think this isn't an issue where we can just afford to do nothing because politically it is hard to bring it up. I think we do have to confront it. I think we need to strengthen this system for current recipients and future recipients.

I congratulate the chairman on scheduling this hearing and I am looking forward very much to what Mr. Walker has to say.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Talent, and we are glad to have you on the committee.

David, you have heard our comments and now we are very pleased to have you report on Social Security Reform: Analysis of Reform Models Developed by the President's Commission to Strengthen Social Security. We are glad to see you back at the committee. Welcome.

STATEMENT OF HON. DAVID M. WALKER, COMPTROLLER GENERAL, U.S. GENERAL ACCOUNTING OFFICE, WASHINGTON, DC.; ACCOMPANIED BY BARBARA BOVBJERG, DIRECTOR, EDUCATION, WORKFORCE, AND INCOME SECURITY ISSUES, U.S. GENERAL ACCOUNTING OFFICE, WASHINGTON, DC

Mr. WALKER. Thank you, Senator Breaux, Senator Craig, Senator Talent. It is a pleasure to be here.

Senator Talent, congratulations on your victory and on joining the world's most prestigious deliberative body.

It is a pleasure to be here to talk about Social Security reform. This is not the first time and I am sure it won't be the last time that I will talk about this, but I hope I don't have to do it every year during the balance of my tenure. I have only 11 years left and I am hoping that the Senate and the House might act on comprehensive reform well in advance of the expiration of my term.

Since there are only three of you here, and I understand I am the only witness, what I would like to do, Senator, is to go through some background information and then talk about the results of our study.

You have held up the report. This is the report that we are issuing today. But as all of you know, we have done a lot of work in this area over the past several years, and expect to do more in analyzing various reform proposals as they come forth.

The CHAIRMAN. We have a pending request right now on voluntary versus mandatory private accounts that we are working with you on.

Mr. WALKER. I believe you are correct, and we have other ones that we are discussing with Senator Craig and others to do as well. So our cup runneth over and we are looking forward to trying to help to the extent that we can.

If I can, let's go to the first slide. There are a few important points that I think we have to lay out in an overall framework before we get into this particular proposal. This represents projected cash-flows for the Social Security Trust Fund starting in 2002 moving forward.

Now, we hear a lot about the Social Security Trust Fund and we hear a lot about the issue of trust fund solvency. But as we all know, cash is key, and Social Security's combined trust fund, OASIS, which is old age and survivor's insurance and DI, disability insurance, turns a negative cash-flow in 2017. That is really the key date, not just 2041 when the trust fund becomes insolvent because we have liquidated all of the bonds that are in the trust fund. So we really need to recognize that the sense of urgency is a lot more immediate than many people realize.

Now, if you were to add on top of this Medicare's cash-flow problems which are greater than Social Security, you will find they begin at about the same timeframe and we see red as far as the eye can see with a never-ending escalation, unless something is done.

Looking back and over time until the present time it is important to understand that in 1962 when John F. Kennedy was President, continuing to 1982 when Ronald Reagan was President, and until 2002, with President George W. Bush, the composition of the budget has changed fundamentally.

In 1962, had you been in the Senate, you would have been able to decide how 68 percent of the Federal budget was going to be spent for that year. Last year, the Congress was able to decide how 37 percent of the Federal budget was going to be spent, and the squeeze is getting tighter every year.

Now, if we can look forward, one of the things GAO has done for about 10 years now is we have performed various long-range budget simulations. Now, this is important. This is not a projection. It is a simulation and I will tell you what the key assumptions are.

As you know, the CBO is responsible for being the official budget scorekeeper for the Congress. They do projections for 10 years. The problem is that those are all based on cash-flows and the world doesn't end in 10 years. In fact, our biggest problems actually don't start until after 10 years. So, therefore, we believe it is important to take a longer-term intergenerational view, in part not just because of Social Security, but Medicare and various other issues.

The blue line that goes horizontally across, this graphic represents Federal revenues as a percentage of the overall economy. The left-axis is the percentage of GDP. So we assume that that stays what it is under current law. We are not getting into the details about tax rates and tax preferences and all those issues, just the relative share of the economy represented by Federal tax revenues.

Then if you look at the bars, the bars represent the composition of Federal spending. In the year 2000, you see there was a gap. The gap was what we used to call a surplus. In 2015, 2030, 2050, you see what the future may hold if certain things happen: No. 1, if the Social Security and Medicare trustees are correct that their best estimate assumptions of what the spending on those programs will be will come true. Historically, they have been a little bit optimistic. So in other words, it could be somewhat worse. I was a trustee for Social Security and Medicare from 1990 to 1995, so I have got firsthand experience dealing with these issues.

Second, if the economy grows at the rate that the CBO is expecting, which at the end of 10 years is 3.1-percent real GDP growth, although this model assumes that it is affected by deficits and so it goes down if you just leave it on auto pilot. It starts at 3.1 percent read GDP growth. If you don't do anything, it is going to go down. It could go up with other policies.

Finally, if discretionary spending as a percentage of the economy does not change; in other words, discretionary spending grows by the rate of the economy, not by the rate of inflation, but the rate of the economy. As you know, discretionary spending includes such things as defense, homeland security, education programs, transportation, infrastructure, the judicial system of the Nation, some things that arguably shouldn't be discretionary because they are in the Constitution, but nonetheless under our current system they are.

So let's just say that is not a scenario anybody wants. All the more important why we need to be talking about this. This means several things. One, we must have Social Security and Medicare reform, and we need it sooner rather than later.

Second, we also need to take a look at the base of Federal spending and other policies and programs to consider what should the Government do, how should the Government do business, and who should do the Government's business in the 21st century. We need to set new priorities because the numbers don't add up. The status quo is unacceptable. We have got to get on with the heavy lifting.

The next figure shows what happens just to Social Security, Medicare and Medicaid spending as a percentage of GDP, given the escalation that is expected. That is unsustainable, Senators. There is no way we can sustain these escalating deficits and maintain economic growth.

This shows why it is important to act sooner rather than later. Basically, it says that if you look at early action, let's say 2002 versus 2017 versus 2041, if you act in 2002 and all you did was adjust benefits, you can see there would be a 13-percent across-the-board adjustment necessary. I am not proposing that is what you do. Nobody is for that, but it gives you a sense of the relative order of magnitude.

If you waited until 2017, you would have to adjust them by 16 percent. If you wait until the trust fund runs out, you would have to adjust them by 31 percent across the board, at this time.

On the other hand, if you looked on the revenue side, you could increase payroll taxes by 15 percent now, 22 percent in 2017, or 45 percent in 2076, as compared to current payroll tax levels, and you would get the same job done. The problem is that these actions would balance the system for only for 75 years and at the end of 75 years, we are still facing escalating deficits. So that is why we talk about sustainable solvency.

The point here is not that you are going only to adjust benefits, not that you are just going to look on the revenue side, but that early action causes the miracle of compounding to work for you. The miracle of compounding means that if you act earlier, the amount of change you are going to have to make is much less dramatic and people have a lot more time to be able to adjust to that change.

The last figure shows the three basic criteria that we used to evaluate the proposal that I will talk about today and that we evaluate all proposals on. First, financing sustainable solvency. It is not just trust fund solvency; it is what percentage is this program as a percentage of the economy. Is it solvent and sustainable in the year 2075 and beyond? The world won't end in 10 years and it won't end in 75, and therefore, we need to look for a longer horizon.

Second, balancing adequacy and equity in the benefit structure. Are the benefits adequate and are they equitable from a variety of different perspectives? Third, what about the issues of implementing and administering reforms? This is particularly important if you are talking about individual accounts because that would be a new ball game. It is more like a defined contribution plan.

By the way, I used to be Assistant Secretary of Labor for Pensions and Health, and so I have a lot of experience dealing with pension and health issues in the private sector, and there are a lot of analogies here, I think, that could be drawn with regard to potential reform proposals along the lines of the commission's and others.

So these are the real keys and the bottom line is that there are tradeoffs. Every reform proposal is going to have pros and cons. Every one is going to be able to be attacked on individual elements. You need to look at reform proposals as a package and you need to look at them as compared to at least two benchmarks.

First, you increase revenues. Second, you only cut benefits. Those are the two extremes. I don't think you are going to do either one. I don't think you are going to do either extreme and I wouldn't recommend that you do either extreme, but those represent the extremes. The solution is someplace in between and may possibly involve individual accounts, which would add a new element.

But you need to be able to look at it both ways. Why do I say that? Because, for example, all promised benefits aren't funded, as a result it is not fair just to look at a benchmark that is based just on promised benefits because they are not all funded.

But, Congress could decide to fund promised benefits. That is why you all are elected. I don't have a vote, but hopefully I can help you get to some of this information.

Now, if I can, Senators, I will now go to the commission's proposals. We have applied our criteria to the commission models and what I would respectfully suggest is that I focus on Model 2 because when you get right down to it, I think there is a fairly broad-based consensus that Model 2 is the one that is being discussed the most. It is kind of like the three bears theory. One is too hard, one is too soft, and the other one may or may not be just right. But Model 2 is the one that I think people are focusing on as having the most potential with regard to the commission's proposals.

As you see, if you apply our criteria to the commission models, especially Model 2, you are going to see there are tradeoffs. There are tradeoffs between achieving sustainable solvency and maintaining adequate retirement income for current and future retirees. They illustrate these tradeoffs that have to be part of this national debate.

Now, as far as financing sustainable solvency, a few key points. Overall, Model 2 would provide for sustainable solvency not just during the 75 years, but also beyond the 75 years, and it would reduce the share of the Federal budget and the economy that are projected to be devoted to Social Security as compared to currently scheduled benefits, regardless of how many individuals selected the accounts.

The CHAIRMAN. Could you give us sort of a synopsis of what Model 2 does? I know you are talking about the effects. Could you just structurally say what that recommendation is?

Mr. WALKER. I sure can, Mr. Chairman. I think that is important.

Senator TALENT. Mr. Chairman, if I could, I wonder since I am new, if I just don't understand a term he is using, would it be all right if I just asked him to explain that so I can follow?

The CHAIRMAN. Sure.

Senator TALENT. Again, explain sustainable solvency. Do you mean something that corrects the cash-flow problem? Is that what you mean?

Mr. WALKER. We mean something that not only causes the trust fund to be in actuarial balance for 75 years. It is in balance in year 75 and beyond, and it is sustainable as a percentage of the economy. That is basically it.

Senator TALENT. OK, so by "imbalance" you mean the money coming in will be enough to pay the money going out that we promised?

Mr. WALKER. Through the end of 75, at the end of 75, and our analysis also considers beyond 75.

Senator TALENT. The total volume of it is economically sustainable, in your judgment?

Mr. WALKER. Correct.

Senator TALENT. Those are the two things you mean by that?

Mr. WALKER. Right, and we have a more technical and detailed definition in the material. I would be happy to speak with you separately, Senator, on these issues if you would like.

Senator TALENT. I follow what you are saying.

Mr. WALKER. In Model 2, there are several key elements. It provides for a defined benefit base, which is the form of the current system. It does not propose to change benefits for anybody who is 55 or older today. That is something that Senator Craig talked about. In other words, for people who are 55 and older today, it does not propose to change their benefits.

For individuals who are younger than that, it proposes that starting in the year 2009 they would have an opportunity to elect, choose, if they so desire, to have a voluntary individual account of up to 4 percent of taxable payroll, or $1,000 annually. If they choose that, they are agreeing to certain benefit adjustments, as compared to what they would otherwise get under the current defined benefit system. Namely, a benefit offset amount.

So they can choose the individual account in exchange for agreeing to certain benefit offset adjustments. In addition, the primary general benefit adjustment would be that right now under Social Security, in calculating your initial benefit when you retire, in order to calculate that benefit, in indexing the amounts that you earned during your working life, right now those amounts are indexed to real wage growth; in other words, not just inflation to make the dollars comparable, but also increases in productivity, increases in standard of living.

So what this would propose is that rather than indexing the initial benefit that you get to real wage growth, which would include again productivity increases and improvements in the standard of living, you would index to inflation. So you would calculate benefits to maintain purchasing power, not for overall changes in the standard of living.

Now, as you know, right now the way that it works is once you retire, benefits are indexed to inflation to maintain purchasing power. There would be an enhanced benefit for low wage workers. In addition, there would be a requirement for general fund transfers for about three decades to fund the transition obligation, which is to fund the benefits already payable under the old system, along with the individual accounts.

The CHAIRMAN. How much?

Mr. WALKER. About $2.2 trillion, but the unfunded obligation for Social Security today for 75 years alone is about $3.4 trillion. So one of the things we always have to keep in mind is you have to start with where we are and how do things compare to where we will be if we do nothing.

I know, Senator Craig, one of the things we are looking at is the possibility of, what would happen if we waited until the trust fund ran out of money. That is something that we can look at from an analytical standpoint, but that raises major intergenerational and timing issues. But you may want to consider that and debate it.

Senator CRAIG. David, in analyzing these models, though, did you not in your evaluation make a couple of assumptions on baseline activity?

Mr. WALKER. On the baseline?

Senator CRAIG. Yes, as it relates to these are not analyses from the status quo, the current status quo.

Mr. WALKER. Well, let me clarify. Basically, what they are is if you look—let's go back to the figure right before this one. We use two benchmarks.

Senator CRAIG. Right.

Mr. WALKER. We believe you ought to have at least two. You could add others, but for simplicity we just start with two. The left one is a tax adjustment benchmark which says you increase payroll taxes, and we are not recommending that, but increase payroll taxes, or otherwise generate revenues of an equivalent amount, starting in 2000 necessary to try to be able to deal with the funding over the next 75 years.

The tax adjustment is the blue and the benefit adjustment is the yellow. Under the benefit adjustment, you would change benefits across the board effective immediately. You are not going to do that. So those are our two baseline assumptions.

Senator CRAIG. But I mean in going forward in analyzing these models, those assumptions are built in there that action would have taken place, are they not?

Mr. WALKER. That is correct.

Senator CRAIG. That Congress would raise taxes and cut benefits?

Mr. WALKER. These are two extremes. The solution is likely to be somewhere in between. These are the two extreme benchmark.

Senator CRAIG. Politically, don't assume we are going to do either of those.

Mr. WALKER. No, I don't, but on the other hand I think it is important to recognize that is what many people debate. Many people say, “Well, gee, we need to deliver on our promised benefits.” Well, if you are going to deliver on your promised benefits, that means you have got to come up with the revenues. There are some other people who say, “Well, you know, we need to live within our means and we need to make sure we only pay what we have revenues for.” Well, OK, that is what this would do.

The scenario you are talking about, Senator Craig, I believe, the so-called status quo scenario, would be theoretically as follows. Once you starting turning negative cash-flow in 2017, you start drawing on these Government bonds which are basically an unsecured promise to pay. They represent a first claim on future general revenues. They are not readily marketable.

You have got to either raise taxes, cut benefits, or do additional public debt financing to pay them off, to turn them into cash. So you do that until 2041, and in 2041 you are faced with either cutting benefits 31 percent or raising payroll tax revenues 45 percent.

Now, theoretically, you could say, “Well, we could slow down payments and pay everybody a hundred percent.” But, realistically, that is a kiting scheme. I mean, you are not going to do that, and so that is theoretically what the status quo is. I don’t think anybody would want that.

The CHAIRMAN. Well, give us your summary of Model 2, then, as to what that recommendation consists of.

Mr. WALKER. As I mentioned Model 2 would provide for sustainable solvency not only for the 75 years, but beyond the 75. It would require significant general fund transfers, but quite frankly virtually every proposal requires significant general fund transfers.

In addition, viewed from the perspective of the economy, the total payments—Social Security is defined benefits, plus income from individual accounts as a percentage of GDP—would fall under Model 2 with universal account participation relative to both the baseline extended and the tax increase benchmark. In 2075, the share of the economy absorbed by payments to retirees from the Social Security of the system as a whole would be roughly 20 percent lower than the baseline extended or tax increase benchmark and roughly the same as the benefit reduction benchmark.

As far as balancing adequacy and equity, the commission’s proposal illustrates that there are tradeoffs here in order to try to achieve a plausible solution. Both models 2 and 3 protect benefits for current and near-term retirees, and the shift to advanced funding could improve intergenerational equity.

However, under each of the models, some future retirees could face potentially significant benefit reductions over the long term because of how you change the benefit formula. In Model 2, the initial benefit is based upon earnings indexed to the cost of living rather than by real wage growth.

Median benefits for those choosing individual accounts are always higher than those who do not choose the account, and that gap grows over time. In other words, what this says for younger people, in other words for people that are under 55, is take the deal if it is offered. I mean, that is basically what it says based on our probability analysis. As you know, you don’t know for certain because you don’t know exactly what investment returns are going to do, but the probability analysis says you take the deal.

However, median monthly benefits received by those without accounts would fall below the benefit reduction benchmark. In other words, those who don't choose the accounts could end up being worse off over the long term.

For the 20 percent of beneficiaries with the lowest income, the median monthly benefits with universal participation in the accounts tend to be higher than benefits under the benefit reduction benchmark. This is likely due to the enhanced benefit for low wage workers. In other words, there is a minimum benefit provided in here that is enhanced over current law, and so that is the primary reason why that lowest 20 percent is in the aggregate better off.

Senator CRAIG. Both in Models 2 and 3, low-income and low-income disabled actually benefit.

Mr. WALKER. From this enhanced benefit. From my understanding, that is correct. Both Models 2 and 3 have that.

Senator CRAIG. More than under the current situation, is that not correct, making these assumptions and this kind of reform?

Mr. WALKER. For median benefits, the answer is yes. For everybody, the answer is no. But most, yes.

Senator CRAIG. Correct.

Mr. WALKER. Regardless of whether an account is chosen under Model 2, many people could receive monthly benefits that are higher than the benefit reduction benchmark. However, some could fare worse. Some people could also receive a greater benefit than if you just essentially raise payroll taxes or otherwise generate other revenues, general revenues, to meet today's promise. Some could actually be better off than that.

Now, as far as implementing and administering reforms, there would be a governing board that would be established in order to administer the individual accounts that would decide which investment options would be available to individuals and that would provide various financial information to individuals.

The commission didn't spend a whole lot of time trying to work out the details. This would be a significant undertaking because there is nothing of this size and magnitude anywhere in the world, but intellectually and technologically it is possible to accomplish with time and resources to get this done.

We do, however, believe that making the accounts voluntary ends up increasing the complexity, and that furthermore even if you end up having individual account options and can do it in an administratively feasible manner, which you can, it is going to be incredibly important to have a significant education campaign for individuals who would be involved in having to, one, make a choice, and two, after having made a choice, if they decide to go with individual accounts, how they should invest and what they should do once they do that. The fact of the matter is that the dynamics of who is bearing the risk are changed fundamentally, and therefore this has to be recognized.

So in summary, Senators, I think it is important to know that Social Security reform is part of a broader fiscal and economic challenge, that focusing on trust fund solvency alone is not sufficient. In fact, it can be misleading to focus on trust fund solvency alone. We need to put the program on a path of sustainable solvency.

Solving Social Security's long-term financing problem is more important and complex than simply making the numbers add up. It is a balancing of all these interests. Given the current projected financial shortfall in the program, it is important to compare proposals to at least two benchmarks, the two that we have used and possibly others, and we are obviously looking for continuous improvement on this.

The reform proposals should be evaluated as packages because if you try to look at them on each individual element, you will get ripped apart. Every individual element will get ripped apart. You have to look at a proposal as a package and you need to look at it as compared to these two benchmarks in order to put it in perspective. Acting sooner rather than later will clearly help you be able to be successful here.

Last, let me just say—and I have said this for years, probably 10 years or more, since I was a trustee of Social Security and Medicare—it is possible to exceed the expectations of all generations of Americans in connection with Social Security reform if you decide to act.

Why? Because from a practical standpoint, current retirees and near-term retirees aren't going to be affected. They are going to get what they have been promised. They fear they won't. It wouldn't be fair not to deliver on the promise, and I would argue it wouldn't be politically feasible not to deliver on the promise.

But on the other hand, individuals such as myself, baby-boomers, and my kids, generations X and Y, are already discounting what they think they are going to get from Social Security because they know that all the promises aren't funded. Every survey and poll will tell you that, and I have gone around the country as part of public education campaigns over the last 10 years and you see that.

So, therefore, if you structure a reform proposal that leaves current and near-term retirees alone and that restructures the program with or without individual accounts—we can debate that, but with or without them, that provides for more adjustments to younger people, you can end up giving them more than they think they are going to get and yet achieve all these objectives. I call that win-win.

The bad news is the longer you wait, the tougher it is going to be, and this is easy lifting compared to Medicare. This is real easy lifting compared to Medicare. So it is important that we deal with the easy lifting so we can get on with the tough work.

Thank you, Senators.

The CHAIRMAN. David, thank you very, very much for a very clear and I think a very concise presentation.

I would say to our colleague, Senator Stabenow, we had asked GAO to conduct this assessment of the various proposals of the President's commission. We have had a lot of the political groups make their presentations on both sides of the issue. Guess what? There were no surprises in what they said. So we were trying to get someone from GAO who would be more neutral on this issue.

I think one thing is clear from the presentation and the graphics that you have, David, that to me the twin problems of Social Security and Medicare are a greater threat to the economy of the United States than the twin threats of Iraq and North Korea because these threats affect not just this generation, but these affect the next generation and the next generation and all Americans into the future.

I mean, this is a huge threat to the economic security of the United States, the twin problems of Medicare and Social Security. The urgency of us beginning to address this, I think, is so graphically presented by your testimony that I would hope very much that when the President presents the State of Union Address that he addresses both of these, that he says what needs to be done on Medicare and prescription drugs, and also Social Security reform that is desperately needed.

Without leadership from all of us, this will not happen. I mean, it is going to take the President, it is going to take Republicans, it is going to take Democrats trying for just a moment to set aside the harsh political rhetoric of these issues and the 30-second sound bites which we have seen time and time again and try and work for resolution. I really do hope that the White House addresses this in the State of the Union. We are trying to buildup the record, pointing out the urgency of this, and I think it is going to take that leadership.

Let me ask, if I could, how close is Model 2 that you have discussed today to the type of program that I as a member of the Senate and the Thrift Savings Plan, and all of us here, all of these people behind me and 9 million other Federal workers have with regard to our retirement in terms of the voluntary nature of the private accounts that we have a chance to invest in, with regard to how those accounts are managed? Can you give some discussion?

It seems that Model 2 is not so novel that it has never been tried before. It seems very similar to what I have as a member of the U.S. Senate.

Mr. WALKER. There are some similarities and some differences. No. 1, Federal workers that were hired after 1983 had to come in under the new Federal Employee Retirement System, which includes the Thrift Savings Plan.

There are some similarities to individuals who were hired before that as well. They were given an option. They could elect whether or not to stay under the old CSRS system or whether to go to the new system. So there is a direct comparison, I think, that could be made in that regard. It was a one-time election to make at that point in time.

I will be able to provide more information for the record if you would like. What we are talking about here is something very similar. Under Model 2, Individuals would be able to make a one-time election whether or not they are going to do this or not, although the relative amount of defined benefit under Model 2 is greater than the relative amount of defined benefit under FERS. In addition, there is a minimum benefit guaranteed under Model 2.

The CHAIRMAN. We also can, I think, put up to 12 percent in.

Mr. WALKER. Yes, you can put a lot more money in TSP as a percent of pay.

The CHAIRMAN. Three times more.

Senator CRAIG. There is a difference, also. The base amount that comes out for the retirement plan is fixed and the percentage that we put into our 401(k) is voluntary above that as a percentage of our retirement amount that goes into the retirement fund.

Mr. WALKER. That is correct. You can put a lot more money in. That is correct.

Senator CRAIG. I assume in Model 2, when you say "4 percent of," you are talking about 4 percent of the payroll tax.

Mr. WALKER. Four percent of taxable payroll, correct, up to $1,000, as I recall. So it is less money on a relative basis than you can do in the Federal TSP.

Senator CRAIG. Taxable payroll or percentage of the tax that is paid in?

Mr. WALKER. It is 4 percent of that person's taxable payroll. If I was making $40,000 a year, it is 4 percent of that, up to $1,000.

Senator CRAIG. I was wrong in that assumption, then. I thought it was a percentage of the total already coming in.

Mr. WALKER. That is not my understanding; 4 percentage points of the 12.4, with a maximum of $1,000.

Senator CRAIG. Then I was right, OK, thank you.

Mr. WALKER. So, therefore, we are saying the same thing. The fact is it is very similar, but the amounts involved are different. For Social Security, under Model 2, you would continue to have much more of a defined benefit element than defined contribution. The Federal Thrift Savings Plan provides much more of a defined contribution.

Another similarity, and then I will respond to any more questions, is under the Federal Thrift Savings Plan you have a board that oversees it. They provide several mutual fund options that are managed by the private sector, which shares are voted not by Government employees but by private sector investment managers. They maintain individual accounts, and so there are a lot of analogies.

The CHAIRMAN. Those accounts would be inheritable?

Mr. WALKER. Yes.

The CHAIRMAN. The children and grandchildren of the employee?

Mr. WALKER. Yes, so you could have a sizeable pre-retirement benefit which you don't have now under Social Security.

The CHAIRMAN. Let me wind up my questions with this. I have seen the rhetoric on both sides on this issue and I have seen some that have argued, look, if we compare the idea of an individual account to the Enron debacle and scandal, how would that type of calamity be protected against in Model 2?

I mean, I think the obvious way is you don't put your money in one single account and one single company. It is diversified. But can you elaborate on how that type of calamity could be prevented under the structure that they are recommending?

Also, I remember the numbers say that we have never had a negative 20-year period of market returns in the history of this country. Most people not just one year for their retirement, but probably an average of 20 years, plus. Give me a little bit of discussion on that.

Mr. WALKER. Well, first, it is envisioned that there would be several investment choices and that each of those investment choices would be collective investment pools. In other words, you would have an investment in a mutual fund where you own a piece of a broadly diversified fund. That is what the Federal Thrift Savings Plan——

The CHAIRMAN. We have five accounts we can choose from.

Mr. WALKER. Right. It is not anticipated that you would be able to buy the stock of any particular company, nor would you be able to buy the bonds of any particular company. So therefore you manage risk through diversification between asset classes, and diversification within asset classes.

Then, second, obviously you have an investment horizon that covers a number of different years. Depending upon what your age is, you may want to change what your investment strategy is in order to reduce the potential volatility or variation in return the closer you get to retirement or once you are in retirement.

So you have broad-based diversification between classes, within classes, and that should help to moderate risk. It doesn't eliminate it, but it helps to moderate it.

The CHAIRMAN. Senator Craig, then Senator Stabenow.

Senator CRAIG. Well, David, I have already asked several of the questions that I had planned to ask. But in your testimony, you do make a couple of assumptions and I want to make sure those are clear for the record.

You talk about general fund contributions or participation in all of this. You make that statement under what assumptions? No. 1, that there would not be a tax increase to fund current promises and benefits, a Social Security tax, or is it an offset to the 4 percent that would be coming out to the individual accounts?

Explain general fund contribution because right now I am under the assumption that the payroll tax is taking care of Social Security and there is no general fund contribution.

Mr. WALKER. There is a very small amount of general fund contribution right now. As you know, there are certain Social Security benefits that are subject to individual income tax. The income tax associated with that goes into the Social Security Trust Fund. That is a general revenue fund.

Senator CRAIG. I see.

Mr. WALKER. But it is not significant.

Senator CRAIG. But that is not what you were meaning here?

Mr. WALKER. No, it is not. Let me clarify what I was meaning. What I was meaning is in order to make this program sustainable and solvent over the long term, and yet try to have a program that has reasonable adequacy and equity, you are going to have to come up with money somehow.

Now, how you come up with the money—you could increase the payroll tax, you could use general revenue, or whatever. Every proposal that I am aware of but one provides for general revenue funding. The question is how much and when you get general revenue funding.

Model 2 assumes about $2.2 trillion in general revenue funding over about three decades.

The CHAIRMAN. How much over ten?

Mr. WALKER. I will have to find out and provide it for the record, Senator.

The CHAIRMAN. It was about $1 trillion. Is it still about that?

Mr. WALKER. I think that is correct, but I would be happy to provide it for the record. I wouldn't want to shoot from the hip on that.

But again I think it is important to look beyond ten. I think one of the problems we have is that we look at ten, but our real problems don't start until after ten because the baby-boomers don't really start retiring in big numbers until after ten. So we are deluding ourselves, I think, if we just look at ten.

It is kind of like the flat earth theory. In our budget, we have a flat earth theory. It is like everything is going to end in ten. Well, Columbus showed us the earth isn't flat, it is round, and so we have got this huge tidal wave right beyond the 10 years that we have got to deal with.

Senator CRAIG. Columbus did it on deficit, too, remember. [Laughter.]

Mr. WALKER. Right. I know you are big on trying to keep the deficit under control and eventually eliminating the deficit.

The CHAIRMAN. A new Republican theory, keeping it under control.

Senator CRAIG. Well, we are just following our leader.

Mr. WALKER. We are talking about how do you end up financing whatever gap, and most people are not proposing a payroll tax increase because that is the most regressive tax that we have. So most people don't believe that that makes a lot of sense. If you are not going to do a payroll tax, well, then what else are you going to do?

Now, some people are proposing to eliminate the payroll tax cap for Social Security. In other words, right now you only pay 12.4 percent, the combined employer and individual total up to a certain level. Some people are proposing that everybody should have to pay Social Security payroll taxes that on every dime of earned income. That obviously would be somewhat controversial. That is the only proposal that I know of that does not require general revenue transfers. Every other one does.

Senator CRAIG. Again, in examining the models, I still don't quite understand. I know you have not put the figures to it in the sense of just a broad analysis, but you are not assuming status quo?

Mr. WALKER. No.

Senator CRAIG. You are assuming some adjustments in benefits and revenue?

Mr. WALKER. Yes. Our two benchmarks are, simply stated, in 2002 you either adjust income to meet benefit payments as projected or you adjust benefits to meet income availability. But you do it up front; you don't wait until the trust fund is out of money. We are going to do an analysis of that for you.

Senator CRAIG. In 2002, by this analysis, it is an either/or or both, 15 and 13?

Mr. WALKER. No. It is either/or. So if all you did was just adjust benefits in 2002, that is what it would be, and that would be for everybody. You could decide, for example, let's leave persons 55 and over alone. So it would be zero for them, but you would have to adjust a lot more than 13 percent, obviously, for people under 55. Then you get another notch, maybe, situation for some people.

Senator CRAIG. That begins to resolve that original chart where, at 2017, you went from surplus to deficit, is that not correct? That is what you are saying?

Mr. WALKER. That is correct. That was the negative cash-flow date.

Senator CRAIG. That shoves that back, then?

Mr. WALKER. It does, it does. As I said, “We have got one that adds Medicare.” That will get your attention.

Senator CRAIG. Do you have it with you?

Mr. WALKER. We have one that adds Medicare to that and, believe me, it is a sobering chart.

Do we have it with us? We will provide it to you this afternoon, Senator.

Senator CRAIG. We would like to see that.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Stabenow, and then Senator Talent.

Senator STABENOW. Thank you, Mr. Chairman, and thank you for holding this hearing on this very important topic.

Mr. Walker, thank you for joining us. I have deep concerns about this proposal, and your comments it just reemphasize the concerns that I have.

First of all, when we look at these charts, it is one of the reasons that many of us on the Budget Committee last year at a time when we were projecting $5.6 trillion in surpluses, suggested that one of the most responsible things that we could do for ourselves and for our children, grandchildren and on to the future would be to prefund Social Security, put dollars into that rather than doing the tax cut that was proposed, the supply side tax cut over a 10-year period reducing revenue.

So I share your concern about these numbers, and understand what happens with Social Security and Medicare as we go, and think we have a very important challenge in being responsible.

Given that, though, when I look at these numbers, I am concerned that the commission at this point has not identified exactly how to come up with the dollars that you are talking about. We are talking about the need for more dollars to go in the system, and this is the transitional cost if we are going to a system that involves private accounts.

You were saying, “Over a 30-year period, $2.2 trillion, or over a 75-year period, $3.4 trillion.” Then your comments just a moment ago, it sounds like you are assuming that in 2002 all of this would be predicated on a payroll tax increase or benefit cuts. It seems to me that is what you are suggesting at this point in time, or some other general fund transfer. Would that be correct?

Mr. WALKER. Well, we are not suggesting a payroll tax increase or benefit cut. We are doing that for illustrative purposes just to give you a sense of the magnitude of the charges that are needed.

Senator STABENOW. I understand.

Mr. WALKER. But every proposal that I am aware of, Senator Stabenow, other than the one that comes from the House that proposed eliminating the cap on payroll taxes—in other words, what wages are subject to payroll taxes—every one assumes general revenue transfers.

I would argue that if you want to deliver on the promises that have been made right now, and if you don't want to raise the payroll tax, then ultimately you are going to have to do general revenue transfers under the status quo.

Senator STABENOW. So just to put it in perspective—and this is where we are now when we look at the numbers on deficits, and so on, based on decisions that we have made to this point—now we have in front of us another proposal for somewhere between $600 billion and $1 trillion, depending on how you figure the interest costs, of additional tax cuts.

Again, we could argue fairness on who receives those, but looking at the overall numbers, we are looking at deficits as far as the eye can see. We are looking at another round of tax cuts, and yet at the same time you are warning us, and I believe correctly, that the biggest challenge that we have to the economy and to the Federal budget is Social Security and Medicare, and that it, in fact, will require, as you have said, "Significant general fund transfers whether we go with the current system or with a new system." Certainly, with a new system, as I understand it, it is even greater transfers because of the costs of going to a new system.

Mr. WALKER. I am not recommending any proposal. I am trying to be an honest broker here and there are a lot of proposals out there.

Under current law, if you were just to let the trust fund run out of money and then fill up the gap between 2041 and 2075, the discounted present value of that today is $3.4 trillion. You wouldn't have to start paying it until the trust fund runs out, but you would have to have $3.4 trillion today invested at Treasury rates to close the gap.

Senator STABENOW. I understand.

Mr. WALKER. Under Model 2, it is $2.2 trillion. So both of them cost money. It is a matter of how much and when, and then to the extent there is a difference, then how did you make up that difference. Did you adjust benefits? Did you get additional rate of return on investments? That is really what it comes down to.

Senator STABENOW. So Model 2, if I understand correctly, then, would involve some changing of revenue coming in—i.e. payroll tax increase—or benefit cuts to offset some of that cost?

Mr. WALKER. Model 2 would leave everybody who is 55 today, as I understand it, alone. For people who are under 55 today who chose to go with the individual account—they don't have to go with the individual account. If they chose to go with the individual account, their defined benefit would be reduced by an offset amount because they are getting part of their payroll taxes for this individual account, and so that is part of what they are paying. In other words, that is part of making up the difference between the 3.4 and the 2.2.

Now, one of the differences is if you went with Model 2, it means that the money that you are going to have to raise is going to have to come quicker because right now under the status quo, let the trust fund run out, you don't have to raise it until further on out.

On the other hand, if you go with Model 2 or anything like Model 2 that has individual accounts, you are going to have to raise the money quicker because you have to pay the promised benefits to current retirees and near-term retirees and start funding these individual accounts.

Senator STABENOW. So the pressure, in other words, under Model 2 with individual accounts is dollars sooner in some way, decisions having to be made, general fund transfer, payroll tax increase, benefit cuts, or some kind of combination of those, then?

Mr. WALKER. That is correct. It is the timing and the magnitude. Let me say for the record to clarify one thing that I may have misspoke on, everybody's defined benefit formula changes under Model 2. There is just an additional offset for the ones that choose the individual accounts. Model 2 also proposes an across-the-board benefit formula change, to set the record straight.

Senator STABENOW. Mr. Chairman, just one more point, if I might.

The other concern that I have—and I am very concerned about what we are talking about in terms of the dollars and how we would pay for this in the context of the current budget and the economy, and so on. The second issue, though, that I think is important for all of us to understand—and you have said this; you said the dynamics of who is bearing the risk are fundamentally changed.

So in the current system, Social Security is a base, a foundation. We then add to our accounts on top of that, 401(k)s or other kinds of investments that we all do, and that is on top of that. I know that the folks, for instance, at Enron that had come in said thank goodness for Social Security because it at least was there as a foundation for them when everything else went bad.

One of my major concerns relates to that, that we are changing the fundamental risk, fundamentally changing a policy that has been in place in this country now for many, many years.

I had one example brought to my attention from a grandmother of a young woman who is a junior at Michigan State University, my alma mater, who had invested in what is called the Michigan Educational Trust, which is an investment program that accepts tax-deductible contributions, and so on.

In Michigan, she was lucky because the Michigan trust fund invests primarily in bonds and so it was not affected by the latest stock market situation. But she indicated that in looking at other States that had up to 60 percent of their fund revenue in the stock market, they lost a great deal of money and their ability to send their children to college.

So it has a direct relationship when we are investing and what happens in terms of the ability to send our children to college if it is a college fund, or the ability to prepare for retirement, and so on. Fundamentally, under the proposal that includes private accounts, that risk is shifted to the individual as opposed to a fundamentally defined benefit program that serves as a floor or a foundation for retirement for individuals.

Mr. WALKER. That is correct, Senator. Can I respond real quickly?

First, the risk is shifted, you are correct, between a defined benefit plan and a defined contribution plan. By definition, individual accounts are defined contribution arrangements. I think it is important to note that right now the investment risk is borne to some extent by the taxpayers of the United States broadly.

The nature of the investment risk would be that it would shift from the taxpayers broadly to individuals involved. Not all the benefit because let's keep in mind that under every proposal that I have seen here there would be a base defined benefit, just as you have in many cases in the private sector.

A portion of the risk would be shifted to the individual, but the individual would make a choice as to whether or not they want to assume that risk. It would not be thrust upon them. They could say, "Yes, I want to assume that risk or, no, I don't want to assume that risk, and that would be their choice."

Furthermore, as I understand Model 2—and again I am not a proponent for any plan—as I understand Model 2, there is also a minimum benefit guarantee which is not there under current law; that for the bottom 20 percent, the lowest income 20 percent, it is obviously helpful because it is not there right now.

Senator STABENOW. Thank you very much.

The CHAIRMAN. Thank you.

I was just noticing, having the discussion with you on the various rates of return, over the period 1992 to 2001, looking at what we have as Senators, the G Fund, which is the bond fund only, as I understand it—the rate of return has been about plus 6.5 percent.

The C Fund, which is basically the market, even with the bad years of 2000 and 2001—over that 10-year period, our rate of return for those who chose voluntarily to go into the market, has been almost a 13-percent return, 12.9 percent. So that is an average-out, so that is really significant.

Senator TALENT.

Senator TALENT. Thank you, Mr. Chairman.

Mr. Walker, I want to make certain what I understood to be a predicate, what you said at the beginning. Did I understand you to be saying that the current system, at the current tax and benefit levels, is actuarily mathematically impossible? Is that correct?

Mr. WALKER. It is not in actuarial balance. It is not solvent in the long term, it is not sustainable in the long term. The difference between the projected revenues and the projected expenditures over 75 years alone, not beyond that—the discounted present value of that difference is $3.4 trillion as of the end of fiscal 2001. That gives credit to the bonds that are in the trust fund which don't have economic significance.

Senator TALENT. It is actuarily impossible, it is mathematical impossible?

Mr. WALKER. Well, the numbers don't add up.

Senator TALENT. It is not sustainable. It is like a Ponzi game is not sustainable, right?

Mr. WALKER. Ponzi schemes aren't sustainable. I am not equating this to a Ponzi scheme.

Senator TALENT. Well, I understand, but I mean in the sense that it is not sustainable, right, long term?

Mr. WALKER. It is not sustainable, correct.

Senator TALENT. Are you certain about that? Couldn't you make different assumptions about the productivity of the American economy? Let's say there was another information revolution, maybe, that came along and all of a sudden workers became ten times more—I mean, is that the kind of thing it would take to make the current system safe for our people?

Mr. WALKER. Well, in fact, having been a trustee myself for 5 years, the trustees every year do 75-year projections and they assume three sets of assumptions: high-cost, low-cost, best estimate or the so-called intermediate assumption. Ours are based upon the best estimate, or intermediate set of assumptions.

Under the low-cost assumptions, which assumes very positive assumptions across the board not just with regard to economic growth, but also with regard to immigration, also with regard to birth rates, also with regard to a whole variety of things—under that, it says we don't really have a problem. Now, I don't know anybody who believes that.

Senator TALENT. OK.

Mr. WALKER. I think the other thing is that even if we were to have a new paradigm shift with regard to economic growth and be able to grow which would really help the situation, to grow faster than this has assumed—that would clearly help. I would, however, respectfully suggest that when you look at our aggregate fiscal challenge, you are not going to grow your way out of that challenge.

The imbalance, when you look at Social Security, Medicare, Medicaid—you are not going to grow your way out of that problem. Additional growth that can help, but you are going to have to make some tough choices.

Senator TALENT. I am pushing you on this because this is an important predicate for even taking this issue on for me. I have no ideological axe to grind in this. I have no desire to change the system unless we need to, but what I hear you telling me is we are like in the position of somebody who is standing in the middle of a highway and a big truck is coming down the highway and if we don't move, the truck is going to hit us.

I would just say, Senator Stabenow, that is how I view this. I know there are risks to moving. I mean, maybe you will sprain your ankle in the ditch if you move. But if you are correct, there is no chance about what is going to happen if you stay there; you are going to get run over.

Is that your perception essentially of where we are at with this thing?

Mr. WALKER. You have got to act. You don't have a choice. The question is when are you going to act and how are you going to act. This is a truck, but Medicare is a much bigger truck. Medicare is a freight train coming.

Senator TALENT. It is a train.

The CHAIRMAN. You could jump in a ditch full of alligators, which may not be a good idea.

Senator STABENOW. Would my colleague yield for just a moment?

Senator TALENT. Yes, sure, I would be happy.

Senator STABENOW. There is no question that we have a big hole. I think the first thing is to stop digging, which is a major issue around here because we just keep digging the hole bigger by the tax proposals that come forward, and so on. So we are just making it bigger.

But there is a significant difference between shoring up Social Security, the current system, and transferring to another system that involves keeping the current system and transferring to private accounts. My concern is, for instance, when we look at what Mr. Walker has indicated, the $2.2 trillion in transfer costs, that, as I understand it, includes a benefit cut. So I think we just need to be clear on that, that there are major tradeoffs here.

Senator TALENT. If I could just reclaim my time, I understand that. There is an area here where it just seems to me, regardless of what we think of tax cuts versus tax increases or this or that or the other thing, there is a quite appealing, perhaps narrow area where we may all be able to agree.

For example, you were mentioning before that we are going to have to have general fund transfers under Model 2. But if indeed it is true that no matter what we do, we are going to have to have general fund transfers and if we don't do Model 2 the general fund transfers are going to have to be even greater, then while we can all concede we don't like the idea of general fund transfers, let's at least do the model that lets us have the lowest general fund transfers.

Do you see what I am getting at?

Senator STABENOW. I might just say that Model 2, though, includes a benefit cut. So I think that is important.

Senator TALENT. Reclaiming my time again, if we don't do Model 2, I mean what I hear Mr. Walker saying is we are going to have to have either much bigger benefit cuts or very substantial tax increases on everybody. I don't think anybody here really wants either one of those two things.

I really would like to get with the chairman to talk about some kind of common ground so we can agree. You know, we are going to disagree about things like how we create prosperity, but regardless of what we feel about that, there may be some proposals that we can all agree on, and that is kind of what I would like to get at and I hear you maybe trying to move us a little bit in that direction.

Let me ask one other thing, though, about Model 2. As I understand it, because of the floors that we establish, low-income workers and disabled workers, the neediest, are better off under your assumptions about Model 2. Is that correct?

Mr. WALKER. Low-income, the bottom 20 percent, most are better off, not all, than the——

The CHAIRMAN. Why don't you just pull her up to the table and she can help you explain?

Mr. WALKER. We are drilling down deep now.

The CHAIRMAN. Go ahead, and just mention your name.

Ms. BOVBJERG. I am sorry to interrupt. I am Barbara Bovbjerg. I am Director of Education, Workforce——

The CHAIRMAN. You are not interrupting. Mr. Walker is happy to have you.

Ms. BOVBJERG. I am Barbara Bovbjerg. I am Director of Education, Workforce, and Income Security.

We did look at these two polar benchmark and when we compared those, most of the lower earners and the lower-earner disabled come out better than under the benefit reduction benchmark.

Some, not a lot, not the majority—some will come out better than the tax increase benchmark which is essentially equivalent to currently scheduled benefits.

Senator TALENT. Thank you, Mr. Chairman.

The CHAIRMAN. Let me go ahead. I have a couple of questions and then I will recognize everybody again for a second round.

On page 26, David, you are talking about your analysis of Model 2 shows that median monthly benefits for those choosing individual accounts are always higher than for those who do not choose the accounts, and the gap grows over time.

Then in the next paragraph you say for the lowest quintile of beneficiaries, median monthly benefits with universal participation in accounts tend to be higher than the benefits received under the benefit reduction benchmark.

Tell me what that means so that I can perhaps understand it a little bit better. Are you saying that the median monthly benefits for people choosing individual accounts are always going to be higher? I mean, that is what I read it as saying. It is on page 26 in my earlier copy. I don't know if it is the same in the book.

Ms. BOVBJERG. That is true because the people who do not select the accounts only have the benefits that are being reduced by the change from wage to price indexing. The people who select the accounts, while the account income is offset with the defined benefit portion, still will generally do better. That increases over time with the different cohorts.

We looked at three different cohorts, those born in 1955, 1970 and 1985, and because the 1985 cohort would have the longer time with both the defined benefit reduction and the individual account, you can see that that disparity widens.

Mr. WALKER. It is because of compounding, basically.

The CHAIRMAN. The point of the projection on whether individual accounts work is a projection on what the markets are going to be doing, which is sort of anybody's guess, but we have a track record. I mean, we have a track record ever since we have had a market, and we had a track record which I just read over the last 10 years for the Thrift Savings Plan that we have showing what the combination of investment in stocks have done over the last 10 years.

So tell us a little bit about how GAO went about creating a model that gave us some idea of what these individual accounts would generate because people always use the argument, well, if the market collapses, you are not going to have any retirement left.

So how did you project this? Give me a little bit more about the protections involved.

Mr. WALKER. What we tried to do in order to assure consistency, and also in order to be able to assure that we weren't in the business of coming up with new assumptions that are, GAO assumptions, is we used the same assumptions that the Social Security actuaries use for the different analysis that they do.

If you look at page 66 of the report, 6.3 percent for Treasuries, 6.8 percent for corporate bonds, and 10 percent for equities over time. Those are the assumptions, and that is consistent with the Social Security actuaries.

The CHAIRMAN. Senator Craig, do you have any follow-up, or Senator Stabenow after Senator Craig?

Senator CRAIG. Well, I don't have any additional questions. A couple of observations.

First of all, David, thank you very much, and your troupe, for being here and the work you are doing. As we thrust these things upon you to analyze, we are all going to work to build a record here.

But I am sitting here looking at that chart and I refer, Senator Stabenow, to it because that is what David went through before we began to look at different models. The reality is right there. We should cut benefits 13 percent this year or raise taxes 15 percent to sustain outward, or by 2017 we should a 16-percent benefit cut or a 22-percent increase in payroll tax, or by 2041 we should do a 31-percent benefit cut or a 45-percent payroll increase.

That is the reality upon us based on current assumptions, current projections. That is what we have all been looking at for a time. I am not one that is going to saddle my grandchildren in a huge payroll tax increase. At the same time, I am going to want them, because they are very dynamic people, to go to their computer and pull up their account and make some assumptions and know what they are dealing with, as other countries have taught or educated their people into doing.

I think there is a phenomenal assumption that I have always found totally faulty. When you give the American public adequate information, they respond in a phenomenal way.

You had said very early, David, in your comments that there is one thing that is obvious in all of this, that if we make these changes, there needs to be driving it a major educational program that allows people to make certain assumptions and understand where they are and what their opportunities might be, and certainly for younger people a great deal more opportunity in the long term, compounding, if you will, than those of an older age and of no benefit to me at my age, but certainly I think the opportunity for my children and grandchildren to have something that is worth their money, or they are going to aggressively depart from it or find alternative ways because the law will demand they can't depart.

I have always said in this debate I am not going to be part of creating a generational rift in this country of the magnitude that will occur by 2075 if we don't make the adjustments now. I still want kids to be willing to help their grandparents out just a bit. At the same time, obviously the grandparents of that day are going to be a much more sophisticated American from the standpoint of understanding and making decisions and having information available to them than probably the grandparents of today.

That is our challenge, to be able to be forward-looking in this instead of reactionary as it relates to current circumstances. It is critical that we view long-term projections and we look at historic averages because we are talking about actuarily thinking down the road and that is a phenomenal challenge for all of us.

Thank you.

Mr. WALKER. Senator, if I can quickly respond, you actually are going to need to do more than this.

Senator CRAIG. You didn't need to say that. [Laughter.]

Mr. WALKER. But I am just trying to keep the record straight here, and the reason I say that is this would achieve solvency and actuarial balance for 75 years. But at the end of 75 years, you still have a big imbalance, and every year we take off a good year and we add a bad year. Now, in our analysis we think you need to achieve sustainable solvency, which means not just for 75, but beyond. So you really need to do more than that.

The last thing is, coming back to what Senator Breaux said——

Senator CRAIG. Excuse me for interrupting. This does also assume there are some unpaid promised benefits in there now, are there not?

Mr. WALKER. Yes.

Senator CRAIG. This assumes that?

Mr. WALKER. This assumes that for 75 years, but it doesn't deal with perpetuity. We think you need to do something that not only works for 75 years, but isn't pre-programmed to not work beyond 75 years. That is our current system. I mean, even if you can make it work for 75, it is pre-programmed that it doesn't work beyond that.

The last thing on this and then I think Senator Stabenow has a point. Senator Breaux said at the outset—and I think it is important to say this—this will require Presidential leadership.

Senator CRAIG. No question.

Mr. WALKER. I know that President Bush is dedicated to do something in this area, and I also know that President Clinton was, too.

Senator Breaux, you and I and others were involved in at least one commission in the past, and we were also involved in a massive national education campaign that included going around the country, including the President and the Vice President, to try to educate Americans as to the nature, extent, timing and magnitude of our problem. They get it.

The CHAIRMAN. Oh, yes.

Mr. WALKER. They understand it. Realistically, that has got to happen because you get elected and you can't get too far ahead of the people. So something has to happen that will cause the American people to understand the nature, extent timimg and the magnitude of the problem. Believe me, they get it, and that will enable you to act in a way that is not only prudent, but in a way that can exceed the expectations of all generations of Americans.

The CHAIRMAN. Senator Stabenow, any comments?

Senator STABENOW. Yes, thank you. I do have a comment.

I do, Senator Craig, understand these numbers very, very well and what we have right here. In the last Budget Committee last year as we were debating what to do, as we at that time thought we had substantial surpluses, there were many of us arguing exactly these points and why we should be looking to the future.

If I remember the budget numbers from the hearings, the second 10 years of just the current tax cut is a $4 trillion loss, which is more than the liability totally of Social Security during that time period. It was something like $3.8 trillion.

We have made decisions—"we" meaning the Congress—that have substantially dug the hole deeper by decisions made last year. I fear, in all seriousness, that the hole will get even deeper based on what is being proposed right now. So I have grave concerns about that, understanding that, in fact, we have to make decisions either way regarding Social Security. It is a question of what.

The point I would just make in conclusion is I want to make a pitch for Social Security and just tell you as somebody who has watched over the years—I wasn't here when it was passed, but we have substantially brought people out of poverty, seniors out of poverty. This is a system that has about a 1-percent administrative cost, much cheaper than anybody, if we are out managing our own accounts, will be paying.

This is a system also that is not only retirement; it is a disability policy and a life insurance policy. We haven't talked about that today and I am wondering, as we look at all of this, we are looking only at the retirement piece of this. Yet if you are a worker that becomes fully disabled, your dependent children know that they have a safety net. If you die on the job, your family knows that there is a safety net there. So this is broader; Social Security is broader than just retirement.

I guess I would just ask, in conclusion, for your comments and analysis as to how the system is affected, the broader system of Social Security, with the disability provisions and life insurance provisions of changes that are made as it relates to individual accounts, and so on.

Mr. WALKER. Well, you are correct that Social Security is much more than retirement income. That is the primary part of Social Security, but disability income and certain survivor benefits, et cetera, are part of it.

My understanding is that this proposal really is focused primarily on the retirement income portion. In other words, it envisions that there will still be a disability program. I know there is a proposed change in here that in the case of certain low-income individuals, there are actually some potential enhancements to disability income for low-income people, the bottom 20 percent.

So I think it is very important that we recognize exactly what you said. This isn't just the monthly payments. It is also disability, which could be in monthly form. It is also these other factors. But at the same time, I think we also have to recognize that right now you don't get a pre-retirement death benefit out of Social Security, and that under this option if you chose to have an individual account, you would get a pre-retirement death benefit. So there are tradeoffs. There is no free lunch, there is no perfect solution.

The CHAIRMAN. Well, thank you very, very much. While there is not a perfect solution, we may be in the middle of a perfect storm when you have all of these things colliding at the same time, with Medicare and Social Security all coming due in approximately the same timeframe because of the baby-boom generation and other factors.

It was difficult when we had a $200 billion surplus. It is going to be a lot more difficult with a $200 billion deficit. But the problem doesn't go away and political rhetoric is not enough to solve it. We have to find ways to work together to get something done.

David, thank you very much. We look forward to future reports in this area for the Aging Committee and for our new chairman when he takes over next time.

[The prepared statement of Mr. Walker follows:]

United States General Accounting Office

GAO

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

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SOCIAL SECURITY

Analysis of Issues and Selected Reform Proposals

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

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GAO-03-376T

Mr. Chairman and Members of the Committee:

Thank you for inviting me here to talk about our nation's Social Security program and how to address the challenges presented in ensuring the long-term viability of this system. 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. However, as I have said in congressional testimonies over the past several years,[1] the system faces both solvency and sustainability challenges in the longer term. In their 2002 report, the Trustees emphasized that while the program's near-term financial condition has improved slightly, Social Security faces a substantial financial challenge in the not-too-distant future that needs to be addressed soon. In essence, the program's long-term outlook remains unchanged. Without reform, Social Security, Medicare, and Medicaid are unsustainable, and the long-term impact of these entitlement programs on the federal budget and the economy will be dramatic.

Over the past few years, a wide array of proposals has been put forth to restore Social Security's long-term solvency, and a commission established by the President has presented three models for modifying the current program. The Commission's final report[2] called for a period of discussion lasting at least a year before legislative action is taken to strengthen and restore sustainability to Social Security. Today we are issuing the GAO report you requested on the Commission's options.[3] At your request, we have also done a qualitative review of three other proposals introduced in the 107th Congress. In my testimony today I will discuss not only our report but also the broader issue of Social Security. I hope my testimony will help clarify some of the key issues in the debate about how to restructure this critically important program.

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

[3]*Social Security: Analysis of the Commission to Strengthen Social Security* (GAO-03-310, Jan. 15, 2003).

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

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

- **Focusing on trust fund solvency alone is not sufficient. We need to put the program on a path toward sustainable solvency.** Trust fund solvency is an important concept, but 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.

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

- **Given the current projected financial shortfall of the program, it is important to compare proposals to at least two funded benchmarks—one that funds currently scheduled benefits and one that adjusts to current tax financing.** Comparing the beneficiary impact of reform proposals solely to currently scheduled Social Security benefits is inappropriate since all current scheduled benefits are not funded over the longer term. As a result, comparisons to currently scheduled benefits after the point of trust fund insolvency assume a payroll tax increase or general revenue infusion that have not been enacted and may not occur. Likewise, comparisons of reform proposals solely to funded benefits after the point of trust fund insolvency are inappropriate since that assumes a future sudden and sharp reduction in benefits that is not likely to occur. The key point is that there is a significant gap between scheduled benefits and projected revenues. In fact, a primary purpose of most Social Security reform proposals is to close or eliminate this gap.

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

- **Acting sooner rather than later helps to ease the difficulty of change.** As I noted previously, the challenge of facing the imminent and daunting budget pressure from Medicare, Medicaid, and OASDI increases over time. Social Security will begin to constrain the budget long before the trust funds[4] are exhausted in 2041. The program's annual cash flow is projected to be negative beginning in 2017. 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 and Medicaid). Acting sooner rather than later would allow changes to be phased in so that future and near retirees have time to adjust their retirement planning. It would also help to ensure that the "miracle of compounding" works for us rather than against us.

Our Social Security challenge is more urgent than it may appear. Failure to take remedial action will, in combination with other entitlement spending, lead to a situation unsustainable both for the federal government and,

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

ultimately, the economy. This problem is about more than finances. It is also about maintaining an adequate safety net for American workers against loss of income from retirement, disability, or death; Social Security provides a foundation of retirement income for millions of Americans and has prevented many former workers and their families from living their retirement years in poverty. As the Congress considers proposals to restore the long-term financial stability and viability of the Social Security system, it also needs to consider the impact of the potential changes on different types of beneficiaries. Moreover, while addressing Social Security reform is important and will not be easy, Medicare presents a much greater, more complex, and even more urgent fiscal challenge.

To assist the Congress in its deliberations, we have developed criteria for evaluating Social Security reform proposals. These criteria aim to balance financial and economic considerations with benefit adequacy and equity issues and the administrative challenges associated with various proposals. The use of these criteria can help facilitate fair consideration and informed debate of Social Security reform proposals.

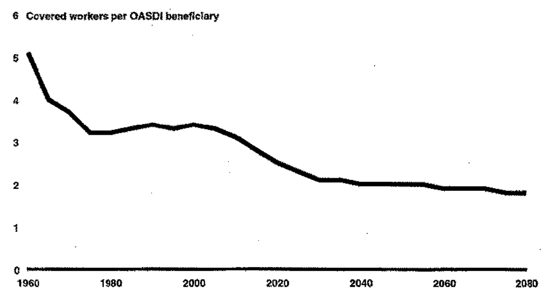
Social Security's Long-Term Financing Problem Is More Urgent Than It May Appear

Today the Social Security program faces not an immediate crisis but rather a long-range and more fundamental financing problem driven largely by known demographic trends. The lack of an immediate solvency crisis affects the nature of the challenge, but it does not eliminate the need for action. Acting soon reduces the likelihood that the Congress will have to choose between imposing severe benefit cuts and unfairly burdening future generations with the program's rising costs. Acting soon would allow changes to be phased in so the individuals who are most likely to be affected, namely younger and future workers, will have time to adjust their retirement planning while helping to avoid related "expectation gaps." 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. In the 1960s, the ratio averaged 4.2:1. Today it is 3.4:1 and it is expected to drop to around 2:1 by 2030. The retirement of the baby boom generation is not the only demographic challenge facing the system. People are retiring early and living longer. A falling fertility rate is the other principal factor underlying the growth in the elderly's share of the population. In the 1960s, the fertility rate was an average of 3 children per woman. Today it is a little over 2, and by 2030 it is expected to fall to 1.95—a rate that is below replacement. Taken together, these trends threaten the financial solvency and sustainability of this important program. (See fig. 1.)

Figure 1: Social Security Workers per Beneficiary

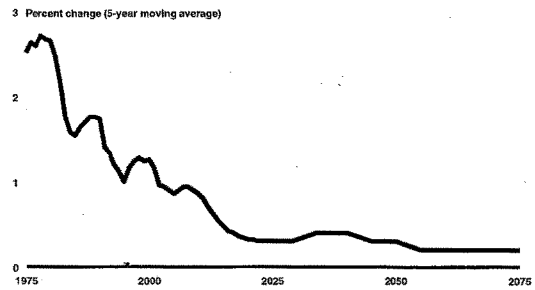


Source: *The 2002 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds.*

Note: Projections based on intermediate assumptions of the 2002 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: GAO analysis of data from the Office of the Chief Actuary, Social Security Administration.

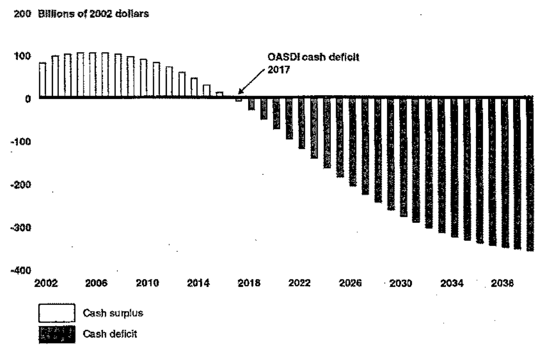
Note: Projections based on intermediate assumptions of the 2002 Trustees' Report.

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 2017

Today, the Social Security Trust Funds take in more in taxes than they spend. Largely because of the known demographic trends I have described, this situation will change. Under the Trustees' intermediate assumptions, combined program outlays begin to exceed dedicated tax receipts in 2017 (see fig. 3), a year after Medicare's Hospital Insurance (HI) Trust Fund outlays are first expected to exceed program tax revenues. At that time, both programs will become net claimants on the rest of the federal budget.

Figure 3: Social Security's 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 2002 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds.

Although the Trustees' intermediate estimates show that the combined Social Security Trust Funds will be solvent until 2041,[5] program spending will constitute a rapidly growing share of the budget and the economy well before that date. 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.

[5]Separately, the Disability Insurance Fund is projected to be exhausted in 2028 and the Old-Age and Survivors Insurance Fund in 2043.

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.

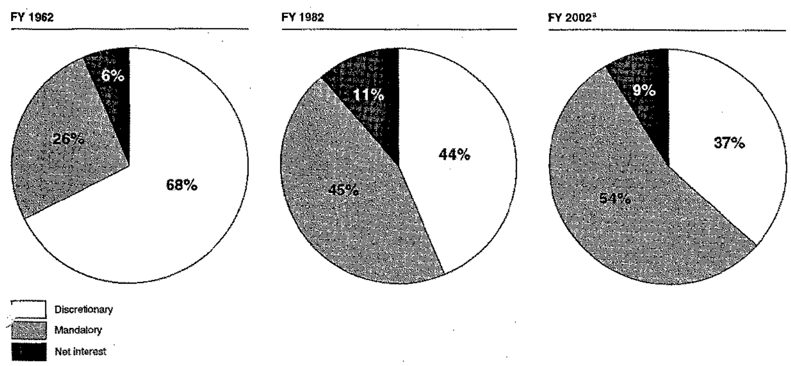
Beginning in 2017, the Trust Funds will begin drawing on the Treasury to cover the cash shortfall, first relying on interest income and eventually drawing down accumulated trust fund assets. The Treasury will need to obtain cash for those redeemed securities either through increased taxes, spending cuts, increased borrowing from the public, or correspondingly less debt reduction than would have been the case had Social Security's cash flow remained positive.[6] Neither the decline in the cash surpluses nor the cash deficit will affect the payment of benefits. The shift will, however, affect the rest of the budget. The negative cash flow will place increased pressure on the federal budget to raise the resources necessary to meet the program's ongoing costs.

Decline in Budgetary Flexibility Disappears 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 1962, 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 2002, this share had almost doubled to approximately 63 percent of the budget. (See fig. 4.)

[6] 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 4: Federal Spending for Mandatory and Discretionary Programs, Fiscal Years 1962, 1982, and 2002



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

[a]Office of Management and Budget current services estimate.

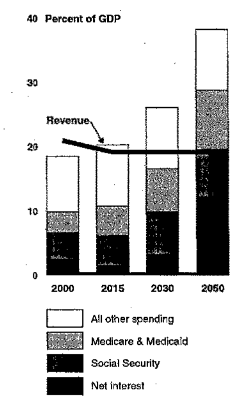
In much of the last decade, reductions in defense spending helped accommodate the growth in these entitlement programs. Even before the events of September 11, 2001, however, this ceased to be a viable option. Indeed, spending on defense and homeland security will grow as we seek to combat new threats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

We prepared 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 mid-century federal revenues may only be adequate to pay Social Security and interest on the federal debt. [7] Spending for the current Medicare program—without

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

the addition of a drug benefit—is projected to account for more than one-quarter of all federal revenues. 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 Assuming Discretionary Spending Grows with GDP, the Tax Cuts Do Not Sunset, and Currently Scheduled Social Security Benefits



Source: GAO's August 2002 analysis.

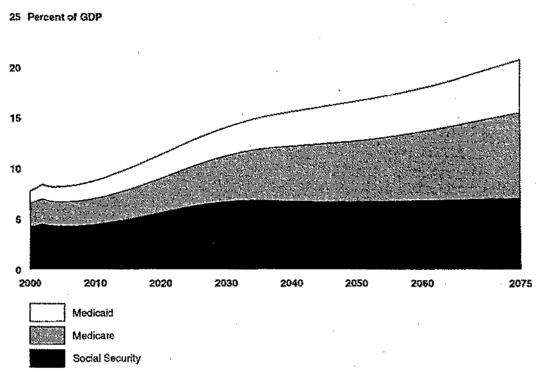
Although this figure assumes payment of currently scheduled Social Security benefits, the long-term fiscal imbalance would not be eliminated even if Social Security benefits were to be limited to currently projected trust fund revenues. This is because Medicare (and Medicaid)—spending for which is driven by both demographics and rising health care costs—present an even greater problem. Absent a change in design, these two health programs together are projected to nearly triple as a share of gross domestic product (GDP) over the next half-century.

This testimony is not about the complexities of Medicare, but it is important to note that Medicare presents a much greater, more complex, and more urgent fiscal challenge than does Social Security. Unlike Social Security, Medicare growth rates reflect not only a burgeoning beneficiary population, but also the escalation of health care costs at rates well exceeding general rates of inflation. Increases in the number and quality of health care services have been fueled by the explosive growth of medical technology. Moreover, the actual costs of health care consumption are not transparent. Third-party payers generally insulate consumers from the cost of health care decisions. These factors and others contribute to making Medicare a much greater and more complex fiscal challenge than even Social Security. We are developing a health care framework to help focus additional attention on this important area and to help educate key policymakers 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. We have work underway regarding how to describe 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. 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 2002 Trustees' intermediate estimates and the Congressional Budget Office's most recent long-term Medicaid estimates, spending for these entitlement programs combined will grow to 13.9 percent of GDP in 2030 from today's 8.3 percent. Taken together, Social Security, Medicare, and Medicaid represent an unsustainable burden on future generations.

Figure 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.

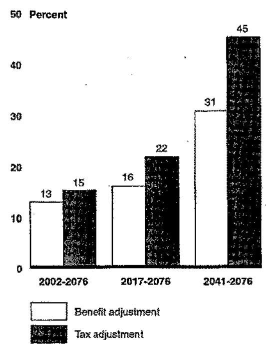
Note: Projections based on intermediate assumptions of the 2002 Trustees' Reports and CBO's June 2002 long-term projections under mid-range assumptions.

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 Alan 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.[8] The most direct way the federal government can raise national saving is by increasing government saving, that is, as the economy returns to a higher growth path, a balanced fiscal policy that recognizes our long-term challenges can help provide a strong foundation for future economic growth and can enhance future budgetary flexibility.

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

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.[9] Figure 7 shows this. If we did nothing until 2041—the year the Trust Funds are estimated to be exhausted—achieving actuarial balance would require changes in benefits of 31 percent or changes in taxes of 45 percent. As figure 7 shows, earlier action shrinks the size of the necessary adjustment.

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



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

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

[9]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 with 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 nearly 40 years away, but the squeeze on the federal budget will begin as the baby boom generation starts to retire. Actions taken today can ease both these pressures and the pain of future actions. Acting sooner rather than later also provides a more reasonable planning horizon for future retirees.

Evaluating Social Security Reform Proposals

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

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

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

Implementing and Administering Proposed Reforms

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

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

Range of Proposals Illustrates Options for Reform and Choices to be Made

Over the course of the last several years, various reform proposals have been crafted. Many proposals involve restructuring the Social Security program to include individual retirement accounts. These individual accounts are similar to defined contribution pension plans in that benefits are based on contributions to and investment returns (gains and losses) on the accounts. This approach offers the potential for increased investment returns, but, depending on the design of the reform, may expose retirees and/or the government to investment risk. Increasing rates of return through investment in private securities, whether through individual accounts or collective government investment, cannot achieve sustainable solvency without additional changes to the current system.

There has been considerable variation in the individual account proposals introduced in the past couple of years. For example, some earlier proposals required that individuals participate in the accounts while more recent proposals provide individuals with the choice of whether or not to participate. As you know, Mr. Chairman, we are currently working on a report to be released next month that examines the unique issues surrounding voluntary individual accounts. Individual account proposals also differ in other areas, such as the manner in which accounts are financed, how the accounts interact with the existing Social Security program, the extent of choice and flexibility concerning investment options, and the way in which benefits are paid from the account balances.

A number of Social Security reform proposals were introduced in the 107th Congress. At your request, we have done a qualitative review of the proposals introduced last year by Representatives Shaw, De Mint, and DeFazio. These three proposals illustrate different approaches to reform. Representative Shaw introduced a new reform proposal last week—which we have not had a chance to look at—and we realize that other proposals may undergo some revisions as well. Like the Commission models, the proposals by Representatives DeMint and Shaw included voluntary individual accounts. All three proposals included significant revenue enhancements, and two of them (Rep. DeMint and Rep. Shaw) included a guarantee of future benefits at least as large as currently scheduled levels. Some of these plans include general revenue transfers, collective investment of some portion of trust fund assets in private securities, and eliminating the cap on the maximum amount of earnings subject to the payroll tax. In addition, some include provisions that would reduce future expenditures, such as an individual account offset against Social Security retirement and aged survivor benefits and an increase in the number of benefit computation years in the benefit formula.

As I noted previously, last year the President's Commission to Strengthen Social Security issued a report containing three reform models. At your request, we looked at the Commission's proposals and is today issuing a report on our findings. Each of the Commission's three reform models represents a different approach to including a voluntary individual account option to Social Security. Model 1 adds individual accounts to the current system but does not restore solvency. Models 2 and 3 restore solvency to the Old-Age and Survivors Insurance and Disability Insurance Trust Funds through a combination of changes in the initial benefit calculation, general revenue transfers, and/or benefit offsets for those who choose to participate in the individual account option. Model 3 also requires an additional contribution equal to 1 percent of taxable payroll under the voluntary individual account option. All models share a common framework for administering individual accounts.

Examining the Effects of Reform Using the Commission's Proposals

Applying our criteria to the Commission models highlights trade-offs between efforts to achieve sustainable solvency and maintain adequate retirement income for current and future beneficiaries. The models illustrate some of the options and trade-offs that will need to be considered as the nation debates how to reform Social Security.

We used our long-term economic model in assessing the Commission reform models against the first criterion, that of financing sustainable solvency.[10] Over the past few years, we have been developing a capacity to estimate the quantitative effects of Social Security reform on individuals. Such estimates are useful in applying our adequacy/equity criterion to reform proposals. 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. To show the range of possible outcomes given the

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

voluntary nature of individual accounts in the Commission models,[11] we simulated each model assuming (1) no participation in the individual account option and (2) universal participation in the account option.

Our analysis of the Commission reform models included comparison with three benchmarks:[12]

- 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.[13]
- 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.

Financing Sustainable Solvency

The use of these criteria to evaluate approaches to Social Security reform highlights the trade-offs that exist between efforts to achieve solvency for the OASDI trust funds and efforts to maintain adequate retirement income for current and future beneficiaries.

Overall, Model 2 would provide for sustainable solvency and reduce the shares of the federal budget and the economy devoted to Social Security compared to currently scheduled benefits (tax increase benchmark) regardless of how many individuals selected accounts. With universal account participation, general revenue funding would be needed for about

[11]In this testimony, the term "individual account" is used for the voluntary accounts, consistent with published GAO work. The Commission used the term "personal account" in its final report.

[12]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.

[13]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 Social Security's Office of the Chief Actuary in their design.

3 decades. Specifically, our analysis of sustainable solvency under Model 2 showed that:

- As estimated by the actuaries, Model 2, with either universal or zero participation in voluntary individual accounts, is solvent over the 75-year projection period, and the ratio of annual income to benefit payments at the end of the simulation period is increasing. However, in Model 2 with universal account participation, over 3 decades of general revenue transfers are needed to achieve trust fund solvency. Model 2 with zero account participation achieves solvency with no general revenue transfers.

- Model 2 with universal account participation would ultimately reduce the budgetary pressures of Social Security on the unified budget relative to the baseline extended benchmark. However, this would not begin until the middle of this century. Relative to both our benefit reduction benchmark and tax increase benchmark, unified surpluses would be lower and unified deficits higher throughout the simulation period under Model 2 with universal account participation. Model 2 with zero account participation would reduce budgetary pressures due to Social Security beginning around 2015 relative to the baseline extended benchmark. This fiscal outlook under Model 2 with zero account participation is very similar to the fiscal outlook under our benefit reduction benchmark.

- Under Model 2 with universal account participation, the government's cash requirement (as a share of GDP) to fund the individual accounts and the reduced defined benefit would be about 20 percent higher initially than under both the baseline extended and tax increase benchmarks. This differential gradually narrows until the 2030s, after which less cash would be required under Model 2 with universal account participation. By 2075, Model 2 with universal account participation would require about 40 percent less cash than the baseline extended and tax increase benchmarks.

- Viewed from the perspective of the economy, total payments (Social Security defined benefits plus income from individual accounts) as a share of GDP would gradually fall under Model 2 with universal account participation relative to the baseline extended and tax increase benchmarks. In 2075, the share of the economy absorbed by payments to retirees from the Social Security system as a whole under Model 2 with universal account participation would be roughly 20 percent lower than the baseline extended or tax increase benchmark and roughly the same as under the benefit reduction benchmark.

- With regard to national saving, Model 2 increases net national saving on a first order basis primarily due to the proposed benefit reductions. The individual account provision does not increase national saving on a first order basis; the redirection of the payroll taxes to finance the accounts reduces government saving by the same amount that the individual accounts increase private saving.

  Beyond these first order effects, the actual net effect of a proposal on national saving is difficult to estimate due to uncertainties in predicting changes in future spending and revenue policies of the government as well as changes in the saving behavior of private households and individuals. For example, the lower surpluses and higher deficits that result from redirecting payroll taxes to individual accounts could lead to changes in federal fiscal policy that would increase national saving. However, households may respond by reducing their other saving in response to the creation of individual accounts.[14]

  Because the benefit reductions in Model 3 are smaller than in Model 2, long-term unified deficits are larger under Model 3. Model 3 requires an additional contribution equal to 1 percent of taxable payroll for those choosing individual accounts. Assuming universal account participation in both models, Model 3 would result in a larger share of the economy being absorbed by total benefit payments to retirees—about the same share as would be the case under the baseline extended and tax increase benchmarks.

Balancing Adequacy and Equity

The Commission's proposals also illustrate the trade-offs reform proposals face generally in balancing adequacy and equity considerations. Both of the models protect benefits for current and near retirees, and the shift to advance funding could improve intergenerational equity. However, under each of the models, some future retirees also could face potentially significant benefit reductions in comparison to either the tax increase or the benefit reduction benchmarks. This is because primary insurance amount formula factors are reduced by real wage growth, uncertainty in rates of return earned on accounts, changes in benefit status over time, and annuity pricing.

Our analysis of Model 2 shows that:

[14] No expert consensus exists on how Social Security reform proposals would affect the saving behavior of private households and businesses.

- Median monthly benefits (the individual account annuity plus the defined benefit reduced by an offset) for those choosing individual accounts are always higher than for those who do not choose the account, and this gap grows over time. In addition, median monthly benefits under universal participation in the accounts are also higher than the median benefits received under the benefit reduction benchmark. However, median monthly benefits received by those without accounts fall below those provided by the benefit reduction benchmark over time.

- For the lowest quintile of beneficiaries, median monthly benefits with universal participation in the accounts tend to be higher than the benefits received under the benefit reduction benchmark, likely due to the enhanced benefit for full-time "minimum wage" workers. This pattern becomes more pronounced over time.

- Regardless of whether an account is chosen, under Model 2 many people could receive monthly benefits that are higher than the benefit reduction benchmark. However, a minority could fare worse. Some people could also receive a benefit greater than under the tax increase benchmark although a majority could fare worse. Monthly benefits for those choosing individual accounts will be sensitive to the actual rates of return earned by those accounts.

The cohort results for Model 3 are generally similar to Model 2. However, median monthly benefits for those choosing individual accounts are higher than the benefit level under the tax increase benchmark for the 1970 and 1985 cohorts. This result is likely because of Model 3's feature of a mandatory extra 1 percent contribution into the individual accounts for those who choose to participate.

Implementing and Administering Reforms

Each of the models would establish a governing board to administer the individual accounts, including the choice of available funds and providing financial information to individuals. While the Commission had the benefit of prior thinking on these issues, many implementation issues remain, particularly in ensuring the transparency of the new system and educating the public to avoid any gaps in expectations. For example, an education program would be necessary to explain the changes in the benefit structure, model features like the benefit offset and how accounts would be split in the event of divorce. Education and investor information is also important as the system expands and increases the range of investment selection. Questions about the harmonization of such features with state laws regarding divorce and annuities also remain an issue.

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 in 2002 and earlier, generally reflect this. Proposals employ possible benefit reductions within the current program structure, including modifying the benefit formula, raising the retirement age, 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.[15] 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.

The Commission report highlights the trade-offs and challenges in reform. Model 2 uses a combination of benefit reductions and revenue increases to restore long-term solvency. For example, we found that the model reduces Social Security's defined benefit from currently scheduled levels through formula changes, provides enhanced benefits for low-wage workers and spousal survivors, and adds a voluntary individual account option. Model 2 would both restore trust fund solvency and reduce the shares of the federal budget and the economy devoted to Social Security compared with currently scheduled benefits regardless of how many individuals selected accounts. With universal account participation, general revenues would be needed for about 3 decades. The other three proposals we examined take somewhat different approaches, relying heavily on additional sources of revenue. For example, Representative DeFazio's proposal would restore solvency primarily on the revenue side, allowing a portion of trust fund assets to be invested in marketable securities and eliminating the cap on taxable payroll earnings.

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

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

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.

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.

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.

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

The CHAIRMAN. With that, the committee will stand adjourned.

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

APPENDIX

Prepared Statement of Senator Russ Feingold

Mr. Chairman, thank you for calling this hearing. This may be your last hearing as Chair of the Committee, at least for two years, and let me take this opportunity to congratulate you on your tenure. You have continued the tradition of previous Chairs in using this Committee to help educate both policymakers and the public about issues of concern to our seniors. In particular, I want to congratulate you on the series of hearings you held in the last Congress on long-term care, an issue on which I have worked for the past twenty years, first in the Wisconsin State Senate, and now as a member of the United State Senate.

It is fitting, in what for a while may be your last hearing as Chair, that we will be focusing on what may be the single most important issue to seniors—especially tomorrow's seniors-namely, the future of Social Security. And I am especially pleased that the Comptroller General will discuss the GAO's review of the President's Social Security Commission. Since the President's Commission made its report more than two years ago, there has been little discussion of it, even though the recommendations from that Commission would affect every single American currently receiving, or expecting to receive, Social Security benefits.

Mr. Chairman, we should have the debate over whether or not to privatize Social Security. I strongly oppose privatization, but I recognize that there are some, including President Bush, who want to privatize the program. The public is entitled to a robust and informed debate on the topic, and today's hearing would be an excellent beginning.

Mr. Chairman, contrary to what some advocates of privitization argue, Social Security is in good shape for the near term. We can extend the program's solvency for 75 years if we make changes now equal to less than 2 percent of our payroll taxes or 13 percent of benefits. If we wait until 2038, we will need payroll tax increases of more than 5 percent or benefit cuts of more than 27 percent, so there is a strong case for acting on this matter soon.

By contrast, the President's commission seems bent on taking 2 percent of the payroll taxes away from the present Social Security system and devoting those funds to private accounts. As the Institute for America's Future notes, this 2-percent plan would require Social Security to come up with another $1.5 trillion in the next 10 years alone. And as former Presidential economic advisor Gene Sperling has pointed out, it will move forward the date when payroll taxes no longer cover benefits from 2016 to 2007.

The plan of the President's Commission to divert Social Security money into private investments would thus just add to Social Security's problem. It would take resources away from Social Security that we would have to make up with either more taxes or more benefit cuts. As the Wall Street Journal reported, it would require making huge offsetting benefit cuts, averaging 40 percent.

In the 107th Congress, Congressman Kolbe and Stenholm did a great service to this debate by introducing a bill that largely tracked the President's approach. Their bill demonstrated just how unacceptable that approach would be. The proposal reduced Social Security's guaranteed benefit, reduced cost-of-living adjustments, and raised the retirement age, all made necessary in order to help fund the diversion of Social Security revenues into private accounts.

Mr. Chairman, reducing cost-of-living adjustments would disproportionately hurt older beneficiaries, particularly women, who have longer life expectancies. And raising the retirement age would disproportionately hurt blue collar workers and African-American beneficiaries, when African-American men have a life expectancy of 68 years.

It was not surprising, then, that Speaker Hastert and Leader Gephardt both said that they could not support the bill. I couldn't either.

Prior to the last Congress, I initiated a series of discussions with the people of Wisconsin about Social Security—at town-hall listening sessions, through letters to my office, and through a special page on my web site. Of course, this wasn't a scientific sample, but hundreds of my constituents expressed some clear opinions.

Part of that discussion was a section on my web site that allowed people to choose among various options to extend the solvency of Social Security. Respondents rejected most options. I note that because I want to make it clear that there are no easy options. Extending the solvency of Social Security will require tough decisions. In this regard, the people I heard from do not want us to cut Social Security benefits or raise taxes significantly.

But, Mr. Chairman, a majority of respondents did support five options, which, taken together, would keep Social Security solvent for 75 years. They supported former President Clinton's plan, including transferring to Social Security general revenues equal to the interest savings Social Security generates, and having an independent board invest 15 percent of trust fund assets in the stock market.

They also supported two other structural changes to the Social Security program: requiring all new State and local government employees to participate in Social Security, and raising the cap for earnings subject to Social Security taxes to the level of salary that a member of Congress makes.

Respondents also rejected a number of options, many by resounding majorities. They overwhelmingly opposed across-the-board benefit cuts, COLA cuts, across-the-board payroll tax increases, and raising the retirement age.

Let me note that President Clinton's proposal to transfer to Social Security general revenues equal to the interest savings Social Security generates was made at a time when we had projected budget surpluses. As we know, those surpluses were dissipated quickly in large part by President Bush's massive tax bill, and compounded by increased spending and the economic slow down, and what might have been the basis for a rational plan to ensure that Social Security would be available for future generations was squandered.

But as difficult as our task is now to extend the solvency of Social Security, it will be made far worse by the President's plans to privatize the program. As the Institute for America's Future points out, each of the three Bush Commission plans diverts at least $1.5 trillion from Social Security over the next 10 years, and thus would create an immediate problem for the program that does not currently exist.

This is a fundamental flaw of privatization. Not only does privatization undermine the Social Security program's well-proven principle of shared commitment to a decent life for our seniors, privatization also creates a financial hole that, as economist Paul Krugman has noted, "must be filled by slashing benefits, providing large financial transfers from the rest of government, or both."

Mr. Chairman, we do not have $1.5 trillion to transfer from the rest of government. Indeed, just the opposite is occurring. Thanks to the massive Bush tax cut, a slowed economy, and increased spending, the rest of government is relying on Social Security surpluses. There is no money in the budget to protect current Social Security beneficiaries from the benefits cuts that would almost surely result if the Bush privatization plan were to be enacted.

Mr. Chairman, thank you again for calling this hearing. I very much hope it will mark the beginning of a real debate on the future of Social Security.