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SOCIAL SECURITY

Criteria for Evaluating Social Security Reform Proposals

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Social Security: Criteria for Evaluating Social Security Reform Proposals

Mr. Chairman and Members of the Committee:

Thank you for inviting me here today to continue the ongoing discussion on how best to ensure the long-term viability of our nation's Social Security program.[1] According to the OASDI Trustees' 1998 mid-range estimates, the program's cash flow is projected to turn negative in 2013. In addition, all of the accumulated Treasury obligations held by the Trust Funds are projected to be exhausted by 2032. The financing problems facing Social Security pose significant policy challenges that should be addressed soon in order to lessen the need for more dramatic reforms later.

Social Security forms the foundation for our retirement income system and, in so doing, provides benefits that are critical to the well-being of millions of Americans. A wide array of proposals have been put forth to restore this program's solvency, and the Congress will need to determine which proposals best reflect our country's goals for a retirement income program. Today, I would like to provide an analytic framework for assessing these proposals. I would like to begin by discussing the purpose of the Social Security system. The role that we envision for the program will be vital in deciding which proposals to adopt. Next, in response to your invitation to me to appear at this hearing, I would like to offer what I believe are the basic criteria for assessing reform proposals. I would then like to stress that the Congress needs to compare reform proposal packages. If we focus on the pros and cons of each element of reform, we will get mired in the details and lose sight of important interactive effects. It will also be more difficult to build the bridges necessary to achieve consensus. Finally, I want to point out the importance of establishing the proper benchmarks against which reforms must be measured. Often reform proposals are compared to current promised benefits, but this benchmark, while in some ways valid, has some drawbacks. Currently promised benefits are not fully financed, and so it might be necessary to use a benchmark of a fully financed system to fairly evaluate reform proposals.

My comments today are based largely on a body of work we have published as well as on ongoing work for this Committee. It is not my intention to take a position for or against any individual reform proposal or elements. Rather, my testimony is designed to help clarify the debate on various proposals to help the Congress move forward in addressing this

[1]Social Security refers here to the Old-Age, Survivors, and Disability Insurance program, or OASDI.

important national debate. In choosing among proposals, policymakers should consider three basic criteria:

- the extent to which the proposal achieves sustainable solvency and how the proposal would affect the economy and the federal budget;
- the balance struck between the twin goals of individual equity (rates of return on individual contributions) and income adequacy (level and certainty of benefits); and
- how readily such changes could be implemented, administered, and explained to the public.

While there are many reform proposals with a wide range of features and options, all proposals to restore long-term solvency involve some combination of cutting benefits, raising revenues, or capturing increased returns from investing contributions. We will face many difficult choices in making Social Security a sustainable program. But our strong economy gives us an historic opportunity to address this problem. Focusing on comprehensive packages of reforms that protect the benefits of current retirees while achieving the right balance of equity and adequacy for future beneficiaries will help us to foster credibility and acceptance. This is the best way to meet our obligations and achieve overarching goal that we all seek—that is, ensuring the retirement income security of current and future generations.

Difficult Choices Are Necessary to Restore Social Security's Solvency

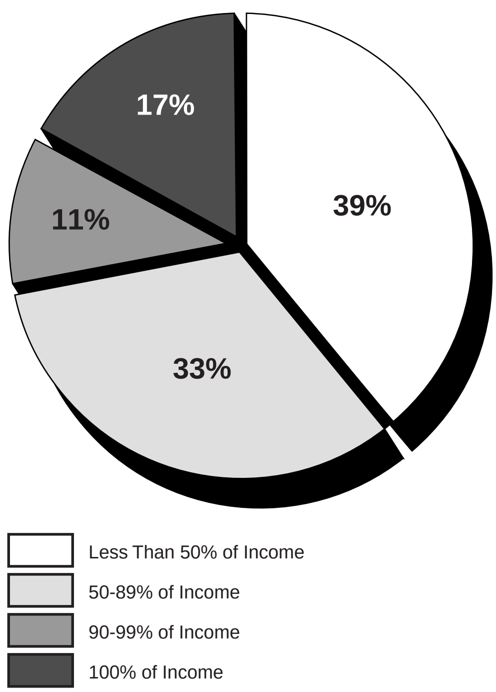
In the past few years, as attention has focused on Social Security's future financial situation, a wide array of proposals have been put forth. Some reduce benefits, some raise revenues; most propose some combination to restore financial solvency. The more traditional reforms seek to preserve the program's structure, restoring solvency through adjusting benefit and revenue provisions; others would restructure the system by allowing workers to fund at least some portion of their benefits through individual accounts. Regardless of structure, many proposals rely on capturing increased returns from market investments. In evaluating these proposals, it is important to understand Social Security's fundamental role in ensuring the income security of our nation's elderly and the nature, timing, and extent of the financing problem.[2]

[2]For a discussion, see Social Security: Different Approaches for Addressing Program Solvency (GAO/HEHS-98-33, July 22, 1998).

Social Security Is the Foundation of Our Nation's Retirement Income System

Social Security has long served as the foundation of our nation's retirement income system, which has traditionally been comprised of three parts: Social Security, employer-sponsored pensions (both public and private), and personal savings.[3] Social Security provides a floor of income protection that the voluntary forms of employer pensions and individual savings can build on to provide a secure retirement. However, private pension plans only cover about one-half of the full-time workforce, and a significant portion of the American public does not have significant personal savings. In addition, Social Security is the sole source of retirement income for almost a fifth of recipients. (See fig. 1.)

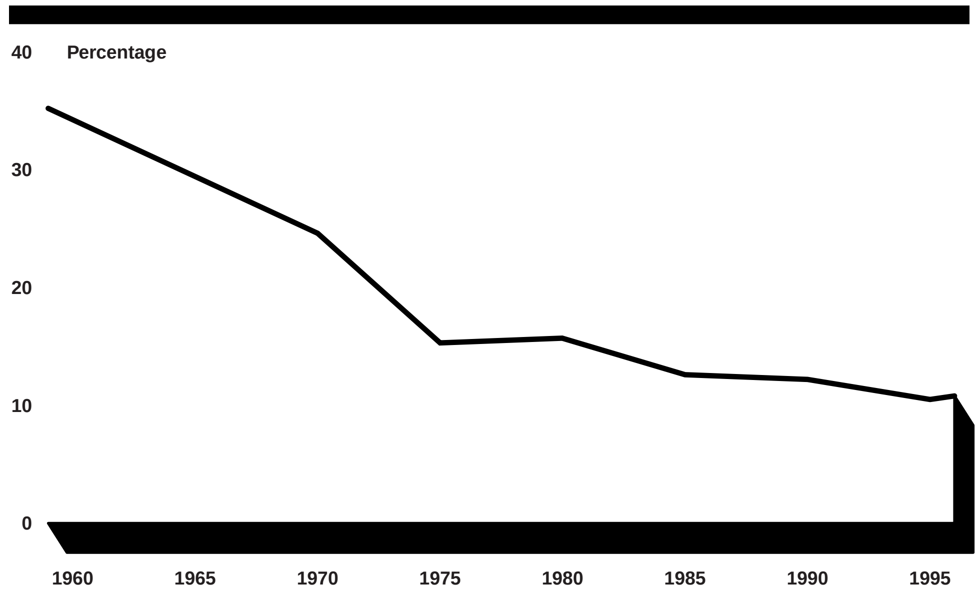
Figure 1: Social Security Benefits as a Percentage of Income



Given Social Security's importance as the foundation of retirement income security, it has been a major contributor to the dramatic reduction in poverty among the elderly population. Since 1959, poverty rates for the elderly have fallen from nearly 35 percent to 10.5 percent. (See fig. 2.)

[3]For a discussion of this traditional approach to retirement income, see Retirement Income: Implications of Demographic Trends for Social Security and Pension Reform (GAO/HEHS-97-81, July 11, 1997).

Figure 2: Poverty Rates for the Elderly, 1959 to 1996



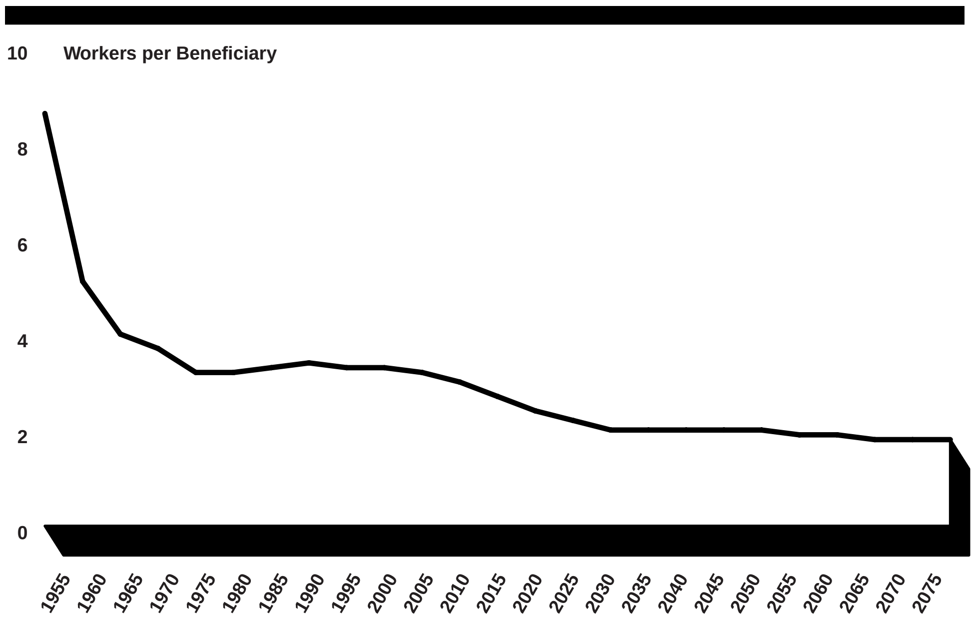
Social Security's benefit structure represents a retirement income insurance program whereby workers pool the risks associated with the loss of earnings due to old age, disability, or death. It is a mandatory and almost universal program. As a result, the vast majority of American workers take Social Security credits with them whenever they change jobs. Social Security also provides inflation-protected benefits for the life of the retiree. No matter how long they live, retirees will continue to receive Social Security benefits uneroded by inflation. The program, which provides benefits not generally available as a package in the private market, includes benefits for retired workers, their spouses and dependents, and their survivors as well as for those who are disabled.

The Financing Problem Needs to Be Addressed Now

The Congress has always taken the actions necessary to ensure Social Security's future solvency when faced with an immediate solvency crisis. These actions have generally been adjustments to the benefit and revenue provisions of the program. Today, the program does not face an immediate crisis; rather, it faces a long-range and more fundamental financing problem due to demographic trends. While the crisis is not immediate, it is important to act soon if we are to avoid having to unfairly burden future generations with the program's rising costs and give these individuals time to make necessary adjustments to their retirement planning.

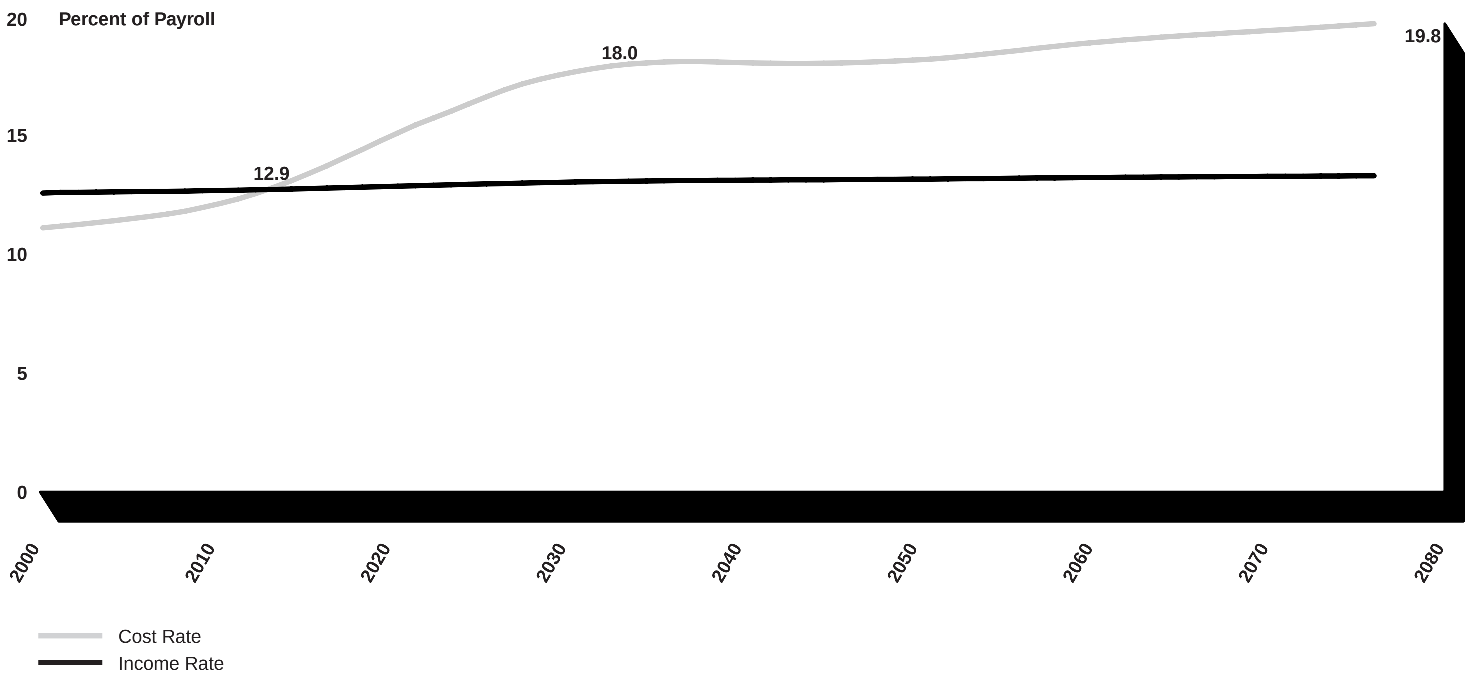
Social Security's financial condition is directly affected by the relative size of the populations of covered workers and beneficiaries. Historically, this relationship has been favorable, but a major reason we are debating Social Security's financing today is that the covered worker-to-retiree ratio and other demographic factors—in particular, life expectancy—have changed in ways that threaten the financial solvency and sustainability of this important national program. (See fig. 3.)

Figure 3: Ratio of Workers to Beneficiaries



Thus, while the program was put in 75-year actuarial balance just 15 years ago, Trust Fund balances now are projected to be exhausted in 2032. In addition, the program will begin to experience a negative cash flow in 2013, which will accelerate over time. (See fig. 4.) Absent meaningful program reform, this will place increased pressure on the federal budget to raise the resources necessary to meet the program's ongoing costs. To restore the 75-year actuarial balance to the program today, we would need to immediately increase annual program revenues by 16 percent or reduce annual benefit payments by 14 percent across the board.

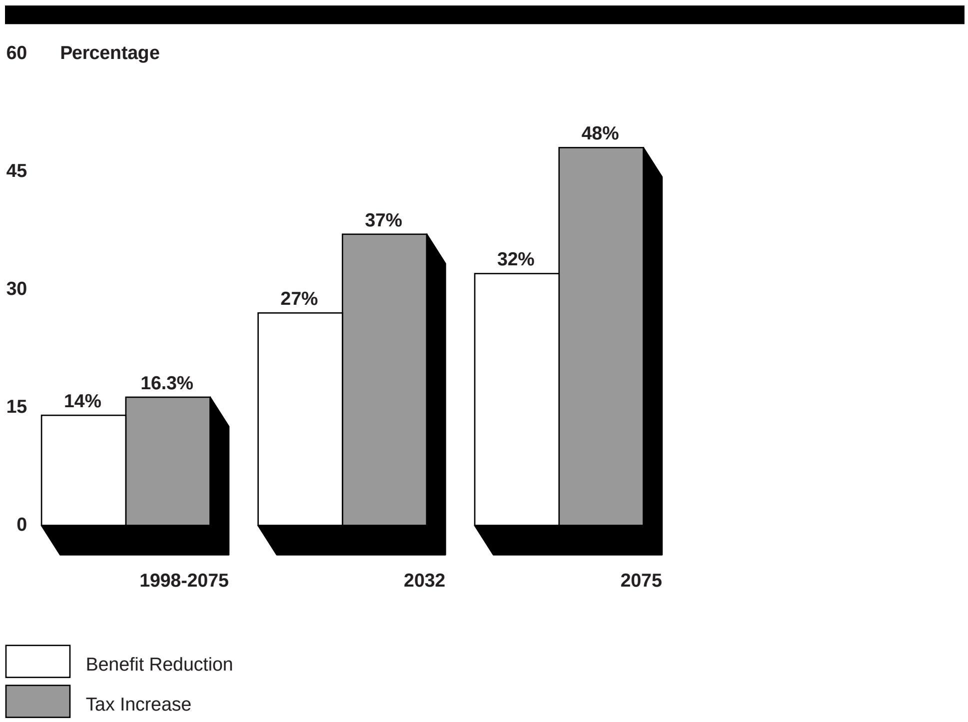
Figure 4: Social Security Income and Cost Rates



Note: Includes revenues from income taxation of Social Security benefits. By 2075, the amount would be 13.4 percent of payroll.

Another way to understand the magnitude of the problem is to consider what the system will cost as a percentage of taxable payroll in the future. Consider what would happen if we did nothing and let the Trust Funds be exhausted in 2032, as estimated in the 1998 Trustees' report. It would then be necessary to find resources in the following year that would be more than 37 percent higher than the revenues projected to be available under the 12.4 percent payroll tax that currently finances the system. (See fig. 5.) Alternatively, we would have to reduce benefits in the year following Trust Fund exhaustion by 27 percent. Clearly, we must act soon in order to minimize the needed changes and maximize the fairness to future generations.

Figure 5: Percentage Changes Needed to Maintain Solvency



Note: Percentage changes are necessary to maintain solvency for the next year only.

Proposals Rely on Different Benefit Adjustments and Financing Arrangements

A variety of proposals have been offered to address Social Security's financial problems. Some would reduce benefits by modifying the benefit formula (such as increasing the number of years used to calculate benefits), reducing cost-of-living adjustments (COLA), raising the normal and/or early retirement ages, or revising dependent benefits. Others have proposed revenue increases, including raising the payroll tax that finances the system; increasing the taxation of benefits; or covering those few remaining workers not currently required to participate in Social Security, such as older state and local government employees. A number of proposals would incorporate investment returns to increase revenues and to reduce benefit cuts, or tax increases that would otherwise be required, or both.

In fact, almost all proposals combine benefit reductions and changes designed to gain increased investment returns. The proposals differ not only with regard to specific benefit changes but also in how investment returns are captured. Some would change the Trust Fund's investment policy so that the government could purchase equities or other instruments besides Treasury securities; others would restructure the Social Security system so that participants could invest at least part of their own contributions. The latter approach creates individual accounts as a means to finance and accumulate future benefits, rather than relying entirely on payroll tax financing through a centrally managed government trust fund account.

These proposals also differ in how such increased returns would be financed. Some would use a portion of current payroll tax collections—a “carve-out” from the Trust Fund—while others would “add-on” federal budget surpluses (that is, general revenues) or additional payroll taxes as a means to finance either current benefits or individual accounts. These choices carry with them implications for individual beneficiaries, the Social Security program, the federal budget, and the national economy. Such implications should be well understood before a policy choice is made.

Choosing Among Reform Proposals

Proposals that restore solvency to Social Security necessarily combine several or even a multitude of changes to the program. Although these changes are presented in a comprehensive package, debate often focuses on individual aspects that, on their own, are undesirable. For example, many criticize proposals to raise the normal retirement age without considering the other, potentially offsetting elements of the proposals of which this change would be a part. Although such criticisms are legitimate and can contribute to the public debate, it is critically important to evaluate the effects of an entire package before considering whether these proposed changes add up to acceptable program reform. If a comprehensive package of reforms meets policymakers’ most important goals for Social Security, individual elements of the package may be more acceptable. After all, individual reform elements can drive interactive effects that can tend to smooth the rough edges of the individual elements. In addition, it’s important to look at a complete puzzle before rendering final judgments and understand how it would stand up against relevant reform criteria. For example, phasing in an increased normal retirement age coupled with adding individual accounts could result in more flexibility and benefit levels for baby boomers and generation Xers compared with the current system.

Evaluating such packages can be complex, however. What factors or elements should such evaluation measure? What weight should be placed upon particular factors? I would not presume to tell policymakers which factors or elements should prove decisive for them in choosing among proposed reform packages. I am, however, in a position to suggest what factors to consider in making these choices.

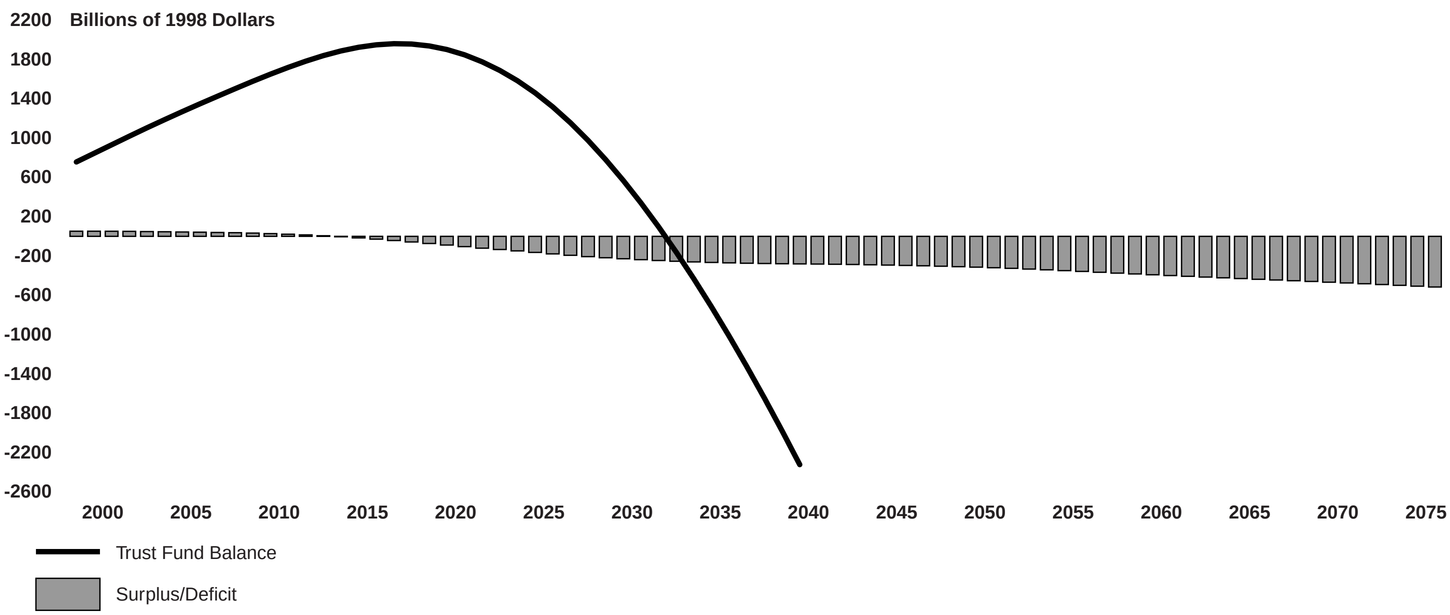
Over the course of the last several years, various reform proposals have been crafted with specific goals in mind—articulated in terms of solvency, the economy, individual equity, and income adequacy. Two primary criteria can be used to evaluate these proposals: (1) the extent to which they achieve sustainable solvency and their effect on the economy and the federal budget and (2) the balance they strike between the twin goals of individual equity and income adequacy. I would also add a third criterion, which, although not addressing a goal of Social Security reform, focuses on the important practical aspects of reform—that is, how readily such changes could be implemented, administered, and explained to the public. These elements provide a basis to address a range of more detailed questions (see attachment 1) that help describe and measure the potential effects of various proposals on important policy and operational aspects of public concern. Measuring proposals against these three criteria can help shed light on the important choices we face; I will discuss each in turn.

Criterion 1: Financing Sustainable Solvency

Crafting a sustainable solution to Social Security's financing problem involves more than ensuring long-range actuarial balance, although actuarial balance is also a goal to be achieved. Simply taking the actions necessary to put the Social Security system back into an exact 75-year actuarial balance could result in having to revisit these difficult issues again in the not-too-distant future. For example, if we were to raise payroll taxes 2.19 percent—which, according to the 1998 Trustees' annual report, is the amount necessary to achieve 75-year balance—the system would be out of balance almost immediately and the 2013 cash problem I cited earlier would move forward only to the year 2020.

Historically, the program's solvency has generally been measured over a 75-year projection period. If projected revenues equal projected outlays over the 75-year time horizon, then the system is declared in actuarial balance. Unfortunately, this measure of solvency is highly transient and involves what could be called a "cliff effect." (See fig. 6.) 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 solvency only for the 75-year period will result in future actuarial imbalances almost immediately.

Figure 6: Social Security Trust Fund Financial Outlook



Moreover, the problem is not one that is 74 years away because the program will begin running annual cash deficits long before the trust funds actually deplete their assets. Add to this the possibility that adverse economic or demographic conditions could accelerate the depletion of the trust funds, and the time when the Congress would need to address the problem moves even closer. Therefore, simply restoring 75-year actuarial balance today could mean that the Congress would have to visit these issues again in just 15 or 20 years. In fact, today’s debate is a testimony to this fact. About 16 years ago, the President and the Congress thought they had saved Social Security for current and future generations. That reform package did save us from the brink of bankruptcy, but it did not address the cliff effect.

Solutions that lead to sustainable solvency are those that avoid the need to periodically revisit this difficult issue, but they have implications for the risk borne by individuals. To the extent that a worker's future retirement benefits are funded in advance—in that they will depend on contributions and the earnings (rates of return) on those contributions—the system is at less risk of insolvency from unfavorable demographic or economic trends. While pre-funding benefits has obvious advantages with respect to sustainability over the largely pay-as-you-go system currently in place, individuals bear more risk under such an approach, and the social insurance aspects of the program could be weakened.

Reforms that provide sustainable solvency could also have positive effects for the economy at large. To the extent that pre-funding worker retirement results in increased savings and investment, the overall future economy would be larger, making it easier for the nation to support a larger elderly population. Simply put, if the dollar that the worker contributes today is invested in private assets (stocks and bonds), there is a reasonable chance that the dollar will contribute to a growing economy. The dollar invested will grow in value and provide a return to the owner of the asset. Thus, investment returns will, in general, help us finance a given benefit in the future more cheaply (that is, with less expenditure today) than the way we currently finance Social Security.

How the measures to achieve solvency are financed can have important implications for the federal budget and the national economy. In addition, federal fiscal policy itself can be an important element in fostering economic growth. Our work on the long-term fiscal outlook shows that replacing deficits with surpluses increases national income over the next 50 years, thereby making it easier for the nation to meet future needs and commitments. Thus, it is important to consider the interaction of federal fiscal policy with measures to restore program solvency in laying a foundation for a sustainable Social Security program. For example, proposals using budget surpluses to fund individual accounts, to purchase private stocks or bonds for the trust fund, or reduce publicly held debt would all have some positive effects on national saving and economic growth. Yet, considerable debate exists over the relative extent of the economic benefits under these different alternatives. Using the projected budget surpluses to reduce publicly held debt alone would indirectly make the Social Security system more sustainable but would not reform or restructure the existing program. I discussed this at greater length before this Committee several weeks ago in the context of the President's budget proposals.[4]

[4]See Social Security and Surpluses: GAO's Perspective on the President's Proposals (GAO/T-AIMD/HEHS-99-96, Feb. 23, 1999).

Furthermore, some proposals must finance what most analysts call "transition costs," and how these are financed matters as well. When proposals incorporate some degree of pre-funding—either via individual accounts or through the current program structure—current workers would, in effect, contribute both to their own accounts and pay for the benefits of current retirees under the existing defined benefit program. The resulting incremental transition costs must be financed. If transition costs are financed by borrowing or with projected budget surpluses, the effects on Social Security participants would be mitigated, but the positive effects of pre-funding on national saving could be neutralized in the near term by additional public borrowing.

Sustainable solvency is an important criterion in assessing reform proposals but may require trade-offs between short-run and long-run gains. Further, it is not the only criterion by which to evaluate reform proposals. The economic and financing considerations that achieve sustainable solvency should be measured against equity and adequacy concerns as well.

Criterion 2: Balancing Equity and Adequacy in the Benefit Structure

The current Social Security system's benefit structure is designed to address the twin goals of individual equity and retirement income adequacy. Individual equity means that there should be some relationship between contributions made and benefits received (that is, rates of return on individual contributions). Retirement income adequacy is addressed by providing proportionately larger benefits to lower earners and certain household types, such as those with dependents (that is, a progressive and targeted benefit structure). Virtually all reform proposals address the concept of income adequacy, but some place a different emphasis on it relative to the goal of individual equity. Differences in how various proposals balance these competing goals will help determine which proposals will be acceptable to policymakers and the public.

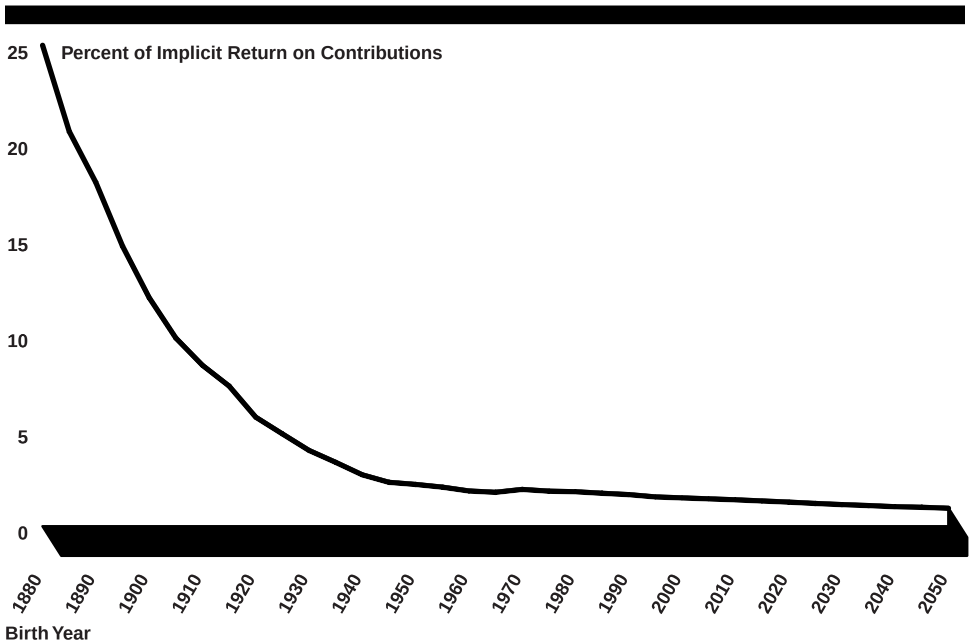
Policymakers could assess this balance by considering the extent to which proposals address the following concerns:

- Adequacy: (1) adequate benefit levels to protect the elderly from poverty and (2) higher replacement rates for low-income workers.
- Equity: (1) reasonable returns on contributions, (2) improved intergenerational equity, and (3) increased individual choice and control.

The weight individual policymakers may place on different concerns would 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 reform proposals emphasizing adequacy considerations might be preferred.

Each proposal for reform will have an impact on individuals and families, whether limited to changes within the current program's structure or whether some portion of the program's financial gap is to be closed through access to equity markets. To restore solvency only via changes to current benefits or current payroll tax revenues reduces the implicit rate of return that future cohorts of beneficiaries will receive on their contributions. (See fig. 7.) This serves to reduce individual equity and, depending on what exact measures are taken, could compromise adequacy as well. To preserve the existing protections and income adequacy for certain types of beneficiaries under this approach, it could be necessary to reduce the benefits of other types of beneficiaries. To avoid such a result, payroll taxes (or the maximum taxable ceiling) might be raised, but this could make current or future workers worse off. Adding the prospect of additional earnings to the system, either from market investment returns or from some other external source, could boost individual equity while reducing the necessity for other changes to the program, depending on how the investment returns or other revenues are shared.

Figure 7: Social Security's Implicit Rates of Return



Note: These estimates do not include all Social Security disability contributions and benefits. They do reflect tax rates that would keep the system in actuarial balance on a pay-as-you-go basis. They use the intermediate assumptions of the 1991 Social Security Trustees' Report.

In considering this balance, it helps to understand that Social Security is currently structured as a defined benefit program and that restructuring this program to include individual accounts would add, in effect, a defined contribution element to the system. Under Social Security, workers' retirement benefits are based on lifetime records of earnings, not directly on the payroll taxes they contributed. Based on the current design of the Social Security program and known demographic trends, the rate of return most individuals will receive on their contributions is declining. In addition, as noted previously, current promised benefits are not adequately funded over the 75-year projection period.

Alternatively, those who propose individual accounts as part of the financing solution emphasize the potential benefits of a defined contribution structure as an element of the Social Security program or financing reform. This approach to Social Security focuses on directly linking a portion of worker contributions to the retirement benefits that will be received. Worker contributions are invested in financial assets and earn market returns; the accumulations in these accounts can then be used to provide income in retirement. Under this approach, individual workers have more control over the account and more choice in how the account is invested. This control might enable individuals to earn a higher rate of return on their contributions than under current law. But, of course, these opportunities for higher returns exist because the investor assumes some measure of risk that the return expected may not actually be realized.

Some reform proposals incorporating individual accounts address the need for protecting individuals and ensuring income adequacy by combining the defined contribution and defined benefit approaches into a two-tiered structure for Social Security. Under such a structure, individuals would receive a base defined-benefit amount with a progressive benefit formula and a supplemental defined-contribution account benefit. The benefit that would be earned through individual account accumulations would either be added to a restructured defined benefit amount (that is, supplement) or subtracted, in whole or in part, from the benefits that would otherwise be provided through Social Security's defined benefit structure (that is, offset). Either approach could require redesigning the benefit structure to ensure the types of protections currently provided by Social Security. Such a structure could include a modified version of the current defined benefit program or could incorporate various types of guarantees based on the current or some alternative benefit structure. Such guarantees would, however, create contingent liabilities and incremental costs for the government.

Clearly, the number of proposals and features can make it difficult to sort out exactly what should be done and what effects various actions would have on individuals and families, although such effects may represent the most important considerations in evaluating reform. It is critical, therefore, that the extent to which proposals achieve solvency—admittedly an easier criterion to measure—not overshadow the balance of equity and adequacy.

Criterion 3: Implementing and Administering Proposed Reforms

Implementation, administration, and public understanding form a third important area to consider. Although some consider these issues merely technical or routine compared with macroeconomic considerations or concerns about benefit adequacy, implementation and administration issues are important because they have the potential to delay—if not derail—reform if they are not considered early enough for planning purposes. Moreover, such issues can influence policy choices—feasibility and cost should be integral factors in the ultimate decisions regarding the Social Security program. In addition, potential transparency and public education needs associated with various proposals should be considered. Reforms that are not well understood could face difficulties in achieving broad public acceptance and support.

Feasibility of Implementation and Administration

Degrees of implementation and administrative complexity arise in virtually all proposed reforms to Social Security. The extent to which these issues present true challenges varies with the degree to which reform proposals step away from current practices. Hence, proposals that would make changes to revenues or to benefits without restructuring the current defined benefit structure of the program are less difficult to implement and less costly to administer than those that would create new tiers of benefits or of beneficiaries. For example, reducing COLAs, either by improving the accuracy of the calculation or by limiting COLA increases directly (such as by capping, delaying, or eliminating the COLA) would not require significant administrative change. Similarly, raising the retirement age, in effect a recalculation of benefits, would not represent a large increase in ongoing administrative costs, although some implementation costs would accrue and would include the costs of educating the public about the changing rules. Both these changes, however, would have a ripple effect on certain private sector pension and saving plans that are integrated with the benefits provided under Social Security. If the private sector plan formulas are not adjusted, these changes would result in additional benefit costs under the private sector plans. Alternatively, to the extent that private sector employers act to adapt their pensions to an altered Social Security benefit, these actions represent private administrative costs as yet unmeasured.

Allowing the government to invest surplus Social Security funds would raise certain implementation issues, the most significant of which are investment vehicle and security selection and shareholder voting rights; relatively less significant concerns regarding cost or complexity would also be raised. However, these issues could prove controversial to resolve because critics have expressed concern about increased government involvement in financial markets and corporate affairs.[5]

But there may be ways that we can alleviate some of the concerns about government investing. One way would be to introduce master trust

[5]Social Security Financing: Implications of Government Stock Investing for the Trust Fund, the Federal Budget, and the Economy (GAO/AIMD/HEHS-98-74, Apr. 1998).

principles for collective investment of base defined-benefit or individual account funds, which would be separate from other government funds. In this regard, we might be able to replicate or piggyback on a model that seems to be working well for federal workers—the Federal Thrift Savings Plan. These existing vehicles might help us limit concerns about the potential for political manipulation of investment decisions and thus foster the credibility needed to build bridges to consensus on reforms.

The greatest potential implementation and administrative challenges are associated with proposals that would create individual accounts. Not all proposals for individual accounts clearly delineate how these accounts would be administered, but those that do vary in three key areas:

- the management of the information and money flow needed to maintain a system of individual accounts,
- the degree of choice and flexibility individuals would have over investment options and access to their accounts, and
- the mechanisms that would be used to pay out benefits upon retirement.

Decisions in these areas could have a direct effect on system complexity and who would bear the costs and additional responsibilities of an individual account system as well as on the adequacy and certainty of retirement income for future retirees. Table 1 provides a snapshot of some of the administrative functions that would accompany any system of individual accounts, the critical decisions associated with each function, and a partial list of the options that could be considered.

Table 1: Design and Administration Issues

Administrative function	Critical decision or trade-off	Options to consider
Managing the flow of information and money	Centralized or decentralized recordkeeping	— Build on current Social Security tax and payroll reporting structure. — Build on employer-based 401(k) structure. — Build on individually controlled IRA structure.
Choosing investment options	Maximizing individual choice or minimizing risk	— Offer a small set of indexed funds. — Offer a broad range of investment options. — Combine the two options by requiring a minimum account balance before a broader range of options is available.
Paying retirement benefits	Maximizing individual choice or ensuring preservation of retirement benefits	— Require lifetime annuities. — Make annuities voluntary, and permit lump sum and gradual account withdrawals. — Combine the two options by requiring annuitization to ensure at least a minimum retirement income, with added flexibility for remainder of account.

Essentially, most decisions about the design of a system of individual accounts amounts to trade-offs between individual choice and flexibility and simplicity and standardization. For example, a centralized recordkeeping system, managed by government, could take advantage of existing systems and economies of scale but would not offer the wider range of alternatives for individuals that a decentralized system would. A system of individual accounts that permitted participants full and unfettered choice of investments would offer an ability to maximize returns but with attendant risk that incomes would not be adequate. Alternatively, a more centralized investment program, with fewer available choices, would be less administratively complex and would protect participants from poor investment selection; but it would also raise the risk that investment decisions could become politicized, depending on the extent of the government's role in selecting investment funds and fund managers. Flexibility in how funds are withdrawn could allow individuals choice in how to manage their own funds but creates administrative complexity and risks leaving diminished capital to support an adequate income throughout retirement. A full assessment of the implications of these trade-offs will be essential to the debate on whether and how to implement individual accounts.

Costs of Implementation and Administration

Although there are costs associated with most Social Security reform proposals, debate has focused largely and correctly on the costs of proposals that involve restructuring for two reasons. First, administrative costs of changes within Social Security's current structure could be relatively insignificant, and adding individual accounts to the structure creates the potential for much higher implementation and administrative costs. For example, there could be substantial start-up costs associated with an individual account system. Second, the risk of higher administrative costs of individual accounts would be borne by individual account holders, directly affecting their benefits. Many have expressed concerns about the administrative costs of individual accounts and how these costs would affect accumulations, especially for the small-account holder. Each of the reform decisions discussed here today can have a significant effect on the costs of managing and administering individual accounts, and it will be important to consider their effect on the preservation of retirement income.

Administrative costs would depend on the design choices that were made. The more flexibility allowed, the more services provided to the investor; the more investment options provided, the higher the administrative costs would be. For example, offering investors the option to shift assets frequently from one investment vehicle to another or offering a toll-free number for a range of customer investment and education services could significantly increase administrative costs. In addition to decisions that affect the level of administrative costs, other factors would need to be carefully considered, such as who would bear the costs and how they would be distributed among large and small accounts.

To some extent, however, the creation of individual accounts could help ease administrative burdens in the future. They would represent an infrastructure that could allow workers to build up additional savings to meet future retirement income and health care cost needs without significant additional implementation and administrative costs. For example, workers not covered by a private pension could choose to contribute more to their individual accounts to augment their retirement savings. Workers might also contribute more to their accounts to help pay health care costs after they retire. The accounts could thereby contribute to overall retirement security, not just retirement income security.

Public Understanding

Regardless of the reform proposal being considered, there will be a need for enhanced public education and information. This effort would not focus on educating the public about choices for Social Security reform; that process began some time ago under congressional and presidential leadership and has raised public consciousness not only regarding Social Security's financing problems but also of the choices we face. Instead, enhanced education and information would serve to explain what changes have been adopted so that participants can adjust their retirement planning accordingly. Retirement planning is, in its nature, a long-term process, and we must give Americans not only the time to adapt their plans to a reformed Social Security program but also the information necessary to do so.

While any change to the Social Security program must be explained to the public, the need would be especially acute if individual accounts were a feature of the chosen reform package. Not only would participants need to be informed of this change, they would also require investor education, especially if individual accounts were mandatory. For example, individuals would need information on basic investment principles, the risks associated with available choices, and the effect of choosing among alternatives offered for annuitizing or otherwise withdrawing or borrowing accumulations from the accounts. This would be especially important for individuals who are unfamiliar with making investment choices, including those with lower incomes and less education, who may have limited investing experience.

Public understanding may not necessarily bring about public acceptance of Social Security reform. But the credibility of any reform package will be enhanced to the extent that the American public understands the changes being made and the impact these changes have on their personal retirement planning.

Conclusions

Restoring solvency to the Social Security system is a formidable challenge. Addressing it in a sustainable fashion today could help us avoid similar challenges in the future rather than leaving difficult choices for our children. The health of our economy and projected budget surpluses offer an historic opportunity to meet these challenges from a position of financial and economic strength. Such good fortune can indeed help us meet our historic responsibility—a fiduciary obligation, if you will—to leave our nation's future generations a financially stable system. We must also move forward to address Social Security because we have other, equally serious obligations before us—compared to addressing the health-care financing problem, reforming Social Security is easy lifting.

Today, I have offered three basic criteria against which Social Security reform proposals may be measured. These may not be the same criteria every analyst would suggest, and certainly how policymakers weight the various elements may vary. But if comprehensive proposals are evaluated as to (1) their financing and economic effects, (2) their effects on individuals, and (3) their feasibility, we will have a good foundation for devising agreeable solutions, perhaps not in every detail, but as an overall reform package that will meet the most important of our objectives.

I believe it is possible to reform Social Security in a way that will exceed the expectations of all generations of Americans. The reports about Social Security's long-term solvency problem and the challenges it represents have caused many Americans to have decidedly low expectations about the future of their Social Security benefits. Many current retirees and those nearing retirement believe that their benefits will need to be cut to restore solvency, while some baby boomers and many generation Xers are doubtful that the program will be there for them when they retire. We believe it is possible to craft a solution that will protect Social Security benefits for the nation's current retirees, while ensuring that the system will be there for future generations. Perhaps the answer is not solely one approach or another—such as defined benefit versus defined contribution. Bridging the gap between these approaches is not beyond our ability. Doing so would represent a major accomplishment that would benefit future generations. It would also help to restore the public's respect for and confidence in its government. GAO and I stand ready to provide the information and analysis that can help the Congress meet this challenge in a way that can exceed the expectations of all generations of Americans.

Mr. Chairman, this concludes my remarks. I would be happy to answer any questions you or other Members of the Committee may have.

Elements for Evaluating Social Security Reforms

Financing Sustainable Solvency

To what extent does the proposal

- restore 75-year actuarial balance?
- create a stable system beyond the 75-year period?
- increase national saving?
- reduce debt held by the public?
- draw on general revenues to finance changes?
- use Social Security trust fund surpluses to finance changes?
- result in a future budget deficit?
- require an increase in taxes?
- create contingent liabilities?

Balancing Adequacy and Equity

To what extent does the proposal

- provide reasonable minimum benefits to minimize poverty among the elderly?
- provide adequate support for the disabled, dependents, and survivors?
- provide higher replacement rates for low-income workers?
- ensure that those who contribute receive benefits?
- provide a reasonable return on investment?
- expand individual choice and control?
- improve intergenerational equity?
- provide an opportunity to enhance individual wealth?
- set reasonable targets as to the percentage of the current and projected economy and the federal budget, represented by these costs?
- provide safety valves to control future program growth?

Implementing and Administering Reforms

To what extent does the proposal

- provide a reasonable amount of time and adequate funding for implementation?
- result in reasonable ongoing administrative costs?
- allow the general public to readily understand its financing structure, thereby increasing public confidence?
- allow the general public to readily understand the benefit structure, thereby avoiding expectation gaps?
- limit the potential for politically motivated investment decisions?

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