Investing the Social Security Trust Funds in Stocks

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The Social Security program is running surpluses that, by law, must be invested exclusively in U.S. Treasury securities. The assets accumulating in the system's trust funds, currently in excess of $900 billion and projected to peak at around $3.8 trillion in the year 2020, are intended to enable Social Security to continue paying full benefits well after payroll tax receipts are no longer sufficient to pay benefits to retirees. One reason why those receipts are expected to fall below the system's obligations is the impending retirement of the baby boom generation--the enormous cohort of citizens born between 1946 and 1964. By 2031, the ratio of Social Security beneficiaries to workers is expected to increase from today's 30 per 100 workers to 50 per 100 workers. In addition, longer lifespans largely attributable to improvements in health care will increase the financial pressures on the system.

One proposal for easing those pressures is to diversify the holdings in the trust funds from safe but low-yielding Treasury securities into stocks, which historically have generated much higher investment returns. Indeed, trust fund diversification is an important element of President Clinton's Social Security reform plan. The rationale is that the change would enable the trust funds to grow more rapidly and pay out benefits further into the future. (Under current projections, the trust funds will be depleted in the year 2032. Thereafter, revenues would be sufficient to pay 75 percent of promised benefits). Depending on assumptions about the rate of growth in the stock market, the overall size of the trust funds, and the portion of them that would be invested in stocks, diversification could add anywhere from two to 20 years to the lifespan of the trust funds.

It should be noted that neither President Clinton's proposal nor anyone else's relies exclusively on trust fund diversification to strengthen the finances of Social Security. The centerpiece of the President's plan is an infusion of $2.8 trillion over the next 15 years--or about 62 percent of the projected federal budget surplus over that period--into the trust funds from the general fund of the Treasury. About $600 billion of this amount would be invested in stocks, while the remainder would be used to retire publicly held debt. The administration estimates that shifting additional money to the trust funds would delay the date when they would become depleted from 2032 to 2049. The investment in the stock market, which under the president's plan would increase incrementally and would never exceed 15 percent of the value of the trust funds, would add five more years.

Allowing the Social Security trust funds to invest in equities has significant consequences for the U.S. economy, the federal budget, and the Social Security system.

How much would diversification strengthen Social Security?

The projected annual rate of return on U.S Treasury securities held in the Social Security trust funds is 2.7 percent, after inflation. In contrast, stocks generated an annual return of about 7 percent above the inflation rate from 1900 to 1995. If past serves as prologue and

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stocks continue to significantly outperform Treasuries in the future, diversification would bolster the trust funds.

Several variables will affect the extent to which diversification ultimately strengthens Social Security:

> Actual rates of return. Century Foundation Research Fellow Dean Baker, in a paper titled "Saving Social Security with Stocks," points out that stocks may not grow as rapidly in the future as they have in the past if consensus forecasts for slower future economic growth turn out to be accurate. Social Security's trustees project that the U.S. economy will expand at an annual rate of less than 1.5 percent a year over the next 75 years, far below historical levels. The main reason for this decline is that the workforce is expected to grow much less rapidly than in the past. Since slower economic growth implies that corporate profits will increase more slowly, stocks may not be able to maintain 7 percent real returns in the future.
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> The share of the trust funds to be invested in stocks. The Clinton administration has proposed limiting the portion of the Social Security portfolio that could be invested in stocks to 15 percent. Many state and local pension funds, in contrast, allocate as much as half their assets to stocks. More extensive investment in stocks would create the possibility of higher returns for the portfolio as a whole, but it would also expose the trust funds to greater risk. During a bear market, a portfolio half-invested in stocks would be more likely to decline in value than one with only 10 percent in equities.
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> Time frames. During particular periods when stocks perform poorly, diversification may leave the Social Security trust funds with less than they would have if they had remained fully invested in Treasury securities. From 1968 to 1978, for example, the market fell 44.9 percent in real terms. During the twentieth century, average stock prices have failed to appreciate over three different 20-year stretches. But over longer time frames, stocks have consistently outperformed other investments. Because current projections indicate that the trust funds will not face a shortfall until 2032, market ups and downs over such a lengthy period would be more likely to leave a diversified trust fund with more reserves than one solely invested in Treasuries.

Would government ownership of stocks lead to unwelcome political interference in the investment markets?

Federal Reserve Board Chairman Alan Greenspan and others object to diversifying the Social Security trust funds because they believe politics will inevitably intrude on decisions about how the money is invested. Greenspan argues that instead of seeking the highest returns, the managers of the funds will be constrained from investing in companies that arouse political controversy--say, tobacco companies or firms accused of discrimination or union busting. Because the trust funds have the potential to become the largest single shareholder in the entire stock market, the ultimate fear is that the government could significantly affect whether shares of different companies rise or fall--undermining the idea of freely operating markets.

Treasury Secretary Robert Rubin and others respond that the scenario Greenspan fears can be avoided by erecting barriers between Congress and the management of the trust funds. Those barriers would include creating an independent board, much like the Federal Reserve itself, to oversee the trust funds. Its members would be appointed by the president and confirmed by the Senate, serving staggered 14-year terms and shielded from dismissal

from office for political reasons. In addition, the power of the board could be limited to selecting fund managers who would be required to make only passive investments in securities that represent broad market averages--so-called "index mutual funds." Moreover, Congress could require the board to waive its voting rights on shares in the trust funds' portfolio to prevent any efforts to influence the management of any company. Perhaps the strongest evidence that Social Security could keep politics out of the process of investing in stocks is the experience of the Federal Thrift Savings plan of the Federal Employees Retirement System, which covers 2.3 million government workers. Since 1984, the plan has invested in three different index funds, including a stock fund, without taking any action that has reflected a political consideration. Francis Cavanaugh, who was executive director of the agency responsible for administering the Federal Thrift Savings plan from 1986 to 1994, has said that though many individuals and groups have attempted to influence the investment decisions of the fund, the barriers against such forces have proven sufficient. Of course, Social Security's assets are many times larger than the $66 billion in the Federal Thrift Savings plan, making it a far more conspicuous target for political activists.

Some state and local government retirement funds, most notably CALPers in California, play active roles in corporate governance. But many other government pension plans are required to behave as completely passive investors. And even CALPers's energy is usually focused on maximizing shareholder value rather than imposing political-based demands on companies. If Congress decides that the Social Security trust funds should be diversified, examples like the Federal Thrift Savings plan and other passive government retirement plans would be the most suitable models.

Would the trust funds' purchase of stocks cause the market to become overvalued, running the risk of a disastrous crash in the next century as the assets are liquidated?

As large as the Social Security trust funds are expected to become, they would still be a relatively small fraction of the value of the entire stock market. Based on the assumptions of the 1997 report of the Advisory Council on Social Security, gradually investing up to 40 percent of the Social Security trust funds would produce a stock portfolio of an estimated $1 trillion (in 1996 dollars) in 2020. Today the capitalization of the U.S. stock market is about $12 trillion, and it will grow to something like $40 trillion by 2014 according to the advisory council forecasts. Under President Clinton's plan, which would limit the trust funds' stock holdings to 15 percent of assets, Social Security's share of the market would be between 3 percent and 4 percent, according to actuary Stephen C. Goss of the Social Security Administration. In contrast, state and local pension funds held about 9.5 percent of corporate equities in 1996. Keep in mind, as well, that Social Security's investment in the stock market would occur gradually--no more than 0.3 percent of overall stock market capitalization in any year. Social Security would not suddenly come to Wall Street with a trillion dollar stake to place on the table. Similarly, the liquidation of shares in the next century to pay benefits to retired baby boomers would be gradual.

Would transaction and administrative costs reduce the benefits of diversification?

The administrative and transaction costs of individual investment accounts like 401(k)s, IRAs, and other plans where each investor has a specified amount of money invested in his or her name can add up to about 20 percent. Tracking the value of each account, switching funds from investment to investment upon request, sending updates to investors, and so

forth is expensive. In contrast, a large pension fund serving many members who are not

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directly in control of a specified amount incurs negligible costs. In the case of the Federal Thrift Savings plan--the best existing equivalent of a diversified Social Security trust fund--administrative costs amount to a scant 1/10th of 1 percent of assets.
Investing trust fund assets in equities would have the immediate effect of decreasing the federal budget surplus (or increasing a deficit if there is one in that year). That's because current accounting rules consider stock purchases to be a federal outlay, just like spending on roads or tanks. In contrast, the current practice of investing excess payroll taxes in Treasury securities adds to the federal surplus (or reduces deficits). Under President Clinton's plan, the contributions to the Social Security trust funds from general revenues would be counted as government expenditures even when they were not used to buy stocks. The rationale for this rule is that those contributions would be earmarked to retire publicly held federal debt, substituting government-owned debt held by the trust funds in its place.

The administration claims that its plan would reduce the share of publicly owned government debt from about 45 percent of the economy to just 7 percent by 2014--a level last reached in 1917. Reducing the government's debt to the public, the administration and many economists argue, would promote investment and economic growth by 1) injecting capital into the economy through the purchase of government securities and 2) reducing competition that private bond-issuers face in raising funds, lowering their borrowing costs and interest rates generally. The additional Treasury securities in the trust funds would insure that, in the future, the government would have to meet its obligations to Social Security before appropriations were made to other priorities. These changes, in combination with others that Clinton has proposed, would soak up the entire projected surplus.

What would be the impact on the economy of diversifying the trust funds into stocks?

There is no reason why shifting a share of the trust fund reserves from Treasury securities into stocks would either increase or decrease economic growth. The change would not directly affect national saving, investment, capital stock, or production. It is possible that government borrowing rates might have to rise slightly to induce private investors to buy the securities that the trust funds would be eschewing for stocks. And private savers might earn slightly lower returns because their portfolios would contain fewer common stocks and more government bonds--those that the trust funds no longer purchased. Still, most analysts believe that these effects would be almost undetectable.

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