

**Issue Brief**  
**American Academy of Actuaries**  
**December 2000**

**Social Security Reform:  
Trust Fund Investments**

*The long-term solvency of the U.S. Social Security program is a much-debated public issue. Some proposals to shore up the program call for maintaining the current defined benefit structure and investing part of the trust funds in equities instead of government bonds. In this way, the program might capture the historically higher returns from common stocks, helping to strengthen its financing in a way that avoids cutting benefits or raising taxes. Such investments in the private sector could have far-reaching implications. This nation has always tried to avoid substantial government ownership or control of private companies, mindful of possible adverse impacts on individual firms and on the economy. Before moving any program assets into stocks, lawmakers would need to consider and resolve several issues.*

***Note:** This is an update of an issue brief originally published in summer 1998. The new version includes figures from the 2000 Social Security Trustees' Report.*

The American Academy of Actuaries is the public policy organization for actuaries practicing in all specialties within the United States. A major purpose of the Academy is to act as the public information organization for the profession. The Academy is non-partisan and assists the public policy process through the presentation of clear and objective actuarial analysis. The Academy regularly prepares testimony for Congress, provides information to federal elected officials, comments on proposed federal regulations, and works closely with state officials on issues related to insurance. The Academy also develops and upholds actuarial standards of conduct, qualification and practice, and the Code of Professional Conduct for all actuaries practicing in the United States.

The following members of the Social Insurance Committee participated in the revision of this issue brief which was originally published in Summer, 1998: Bruce D. Schobel, FSA, FCA, MAAA, Chairperson; Edward E. Burrows, FCA, MAAA; Ronald Gebhardtshauer, FSA, FCA, MAAA, MSPA; Eric J. Klieber, FSA, MAAA, MSPA; Adrien R. LaBombarde, ASA, MAAA; Richard G. Schreitmueller, FSA, FCA, MAAA; Ronald L. Solomon, ASA, MAAA; Eric Stallard, ASA, MAAA; Cori E. Uccello, FSA, MAAA

AMERICAN ACADEMY OF ACTUARIES  
1100 Seventeenth Street NW 7th Floor Washington DC 20036  
Tel 202 223 8196 Fax 202 872 1948

Richard C. Lawson., Executive Director  
Noel Card, Director of Communications  
Tom Wilder, Director of Public Policy

© 2001 The American Academy of Actuaries, All Rights Reserved.

## 1. Background

Since the beginning of the U.S. Social Security program, its financing has been close to a pay-as-you-go basis. This means that virtually all costs are covered from current tax revenues, with excess income plus investment earnings held in a government trust fund. However, during the 1990s, the trust fund gradually built up substantial assets – a trend that is expected to continue until most of the “baby-boom” generation has retired. Actuarial projections based on the intermediate assumptions of the 2000 Social Security Trustees’ Report indicate that the trust fund will grow from about \$1 trillion in 2000 to \$6 trillion in 2025. Then in 2025, assets begin to plummet until the trust funds are projected to be exhausted in 2037.

Some analysts advocate building up even greater assets over the next few decades, with the goals of funding in advance a greater portion of the program’s accrued obligations and avoiding a roller-coaster pattern of trust fund buildup followed by insolvency. The desirability of such additional funding and the transition to a long-term target level of advance funding are beyond the scope of this discussion.

Under current law, Social Security trust fund assets are invested in nonmarketable special-issue U.S. government securities, which represent loans to the U.S. Treasury’s general fund. Current projections of ongoing budget surpluses by the Congressional Budget Office and the Office of Management and Budget suggest the possibility that Treasury may be able to pay off all the *publicly held* debt by the time the baby boomers retire. Under those projections, assets held in government trust funds for Social Security and other programs would still be invested in government bonds up to that time, i.e., Treasury would not pay off any of the *internally held* debt. We do not consider here the further possibility that continued budget surpluses after the publicly held debt is eliminated would require the Social Security trust funds to use investment vehicles other than Treasury securities. Thus, we assume that a decision to shift any of the trust fund assets into common stocks would be based on a Social Security financing rationale and would cause Treasury to sell more of its debt securities to outside lenders.

Historical data show that common stock investments have generally yielded much higher long-term returns than U.S. government securities. Increasing the return on trust fund assets thus might help strengthen Social Security financing in a way that does not cut benefits or increase taxes, thereby giving Social Security taxpayers a better deal. But this nation has always steered clear of substantial government ownership or control of private companies, mindful of possible adverse impacts on individual firms and on the free-market economy.

## 2. Economic Issues

Some proposals for Social Security reform would gradually invest up to 40 percent of the trust fund assets in common stocks. The government-controlled trust funds would over time accumulate a large portfolio of private equity securities and reduce their purchases of government debt. The effects on the national economy are difficult to predict, but in general, unless Social Security investment in stocks led to new savings and capital formation, causing increases in productivity, the net result would likely be no more than a reallocation of the sources of investment in the economy, with any gains for Social Security offset by losses in other sectors.

A large body of opinion holds that investing Social Security trust fund assets in equities will have no impact on interest rates and overall levels of investment. Under this scenario, the greater supply of government bonds in the public securities market due to the shift in trust fund investment toward equities tends to raise the interest rates on government bonds, making them more attractive to buyers. At the same time, the trust fund purchases of stock tend to raise the price of stock, thus reducing the dividend yield

and the overall future yield on stock. The non-governmental sector (including the general public) reacts by reallocating its investments, reducing its ownership of equities and increasing its ownership of government debt, thus returning interest rates and equity yields to their original equilibrium levels. The result is no net change in interest rates, stock yields or total investment in the economy, only a shift in ownership among the different types of securities. While Social Security's finances might improve due to higher long-term yields on equity investments, programs in the non-governmental sector that require long-term financing, such as private retirement plans, might become more costly because a greater proportion of their assets is invested in government debt than would otherwise be the case.

Other analysts believe investment of trust fund assets in private equities will translate into additional private capital that generates increased productive capacity, and thus output, for the entire economy. For this scenario to unfold, one or a combination of the following must occur:

1. The non-governmental sector maintains its investment in equities at the same level as before while purchasing additional government debt to make up for the shift in investment of Social Security assets from government debt to equities. This would require a reduction in current consumption by the non-governmental sector.
2. The non-governmental sector pays additional taxes to make up for the shift in investment of Social Security assets from government debt to equities. This would also require a reduction in current consumption by the non-governmental sector.
3. The government reduces its own consumption (i.e., spending).

Proponents of this latter scenario expect such reductions in current consumption to be temporary because the resulting increase in economic growth would eventually enable both the governmental and non-governmental sectors to increase consumption while maintaining a high level of investment. Skeptics hold that the market has already achieved the balance between investment and consumption that is desired by the society as a whole, and no artificial boost to investment can improve long-term economic results.

### **3. Investment Issues**

How could the trust funds own a large amount of common stock without government interference in the private economy? Few if any public officials propose that Uncle Sam should play favorites in selecting securities to buy and sell, or in exercising ownership rights to vote on corporate management issues. Basing investment decisions partly on political objectives could reduce investment returns and adversely affect economic growth. Yet serious political problems will constantly arise in making investment decisions about companies whose products or practices are controversial. Accordingly, to avoid making such decisions, the federal employees' Thrift Savings Plan (TSP) has used index funds since its inception in 1987. By automatically investing across a broad range of private securities under tight statutory control, the TSP index funds have enjoyed high investment returns and very low expenses without getting involved in politics.

Some observers point to the TSP model as proof that Social Security could avoid political interference by using index funds. One may question this conclusion, noting that Social Security is far bigger than the TSP in terms of assets, participants and public sensitivity. Under either program, lawmakers can always vote to override statutory controls that are designed to prevent political interference in the investment process; this temptation to interfere would tend to grow in proportion to the size of the stock portfolio. Another potential problem is that index funds held by Social Security and others could become so dominant that stock prices no longer reflected business reality or provided an incentive for management to perform.

What about proxy voting? The size and nature of Social Security would seem to make impractical the TSP practice of delegating proxy voting to any one outside fund manager who serves participants as a fiduciary. The use of multiple fund managers might mitigate this problem. Concentrating voting control in a government official or agency seems inappropriate. One answer is for the government to refrain from exercising voting power, directly or indirectly, with respect to any stocks held by Social Security. Another strategy with the same effect would require the government to vote its proxies in proportion to the votes cast by other owners.

Defining an index to be used for Social Security would require great care to avoid market distortions or abuses. Adding a given stock to the Social Security index fund would boost the price of that stock, while deleting a stock would have the opposite effect. For example, the index might include essentially all publicly traded U.S. companies and thus discourage some economically advantageous corporate mergers and spinoffs involving foreign companies.

Stocks generally offer greater long-term return on investment but also have greater risk and volatility than Treasury securities. How would policymakers and the public react to unexpected gains or losses in equities held by Social Security? Short-term market fluctuations represent another source of temptation for elected officials to interfere with any statutory formulas established for investing and managing equity funds.

#### **4. Transition Issues**

Any large-scale shift of investments to the private sector would need to be carefully planned to minimize shocks to the market. Dumping large amounts of money into the market could sharply drive up prices, forcing Social Security to pay too much for its stocks. This effect may be unavoidable, regardless of the pace at which the trust funds acquire stock, if the purchases can be anticipated because they are scheduled to occur without regard to market conditions.

The Social Security program is expected to have serious financial problems when the large postwar baby-boom generation reaches retirement age. Under the intermediate assumptions of the 2000 Trustees' Report, Social Security's outgo is projected to exceed its tax revenue beginning in 2015. Whenever outgo exceeds tax revenue, Social Security is forced to sell assets. No matter how these assets are invested, such drawdowns may have adverse economic consequences. Liquidation of equities held by Social Security just when baby boomers may also be drawing down their retirement savings could substantially depress stock prices. The possible outcomes need careful study to avoid unintended macroeconomic effects.

#### **5. Conclusion**

Investing Social Security trust fund assets in common stocks might yield greater returns and thus help strengthen financing in a way that does not cut benefits or raise taxes. However, this shift of assets would have a significant impact on the financing of the Social Security program, as well as unpredictable effects on the national economy and on individual private firms.

Lawmakers should consider the following questions before authorizing private investment of Social Security's assets:

- What will be the impact of equity investments by Social Security on the national economy and capital markets, on government financing and on trust fund assets as the trust funds accumulate equities? And what will be the effects if the program is not reformed and assets are liquidated after 2015?

- How will the Social Security investments be structured to prevent undue government influence on markets?
- How will the government deal with issues of proxy voting and corporate governance?
- How will the American public and the government respond to gains and losses in equity values that are bound to occur?