

INVESTING THE ASSETS OF THE SOCIAL SECURITY TRUST FUNDS IN EQUITY SECURITIES: AN ANALYSIS

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[Editor's Note: In the current public policy debate on Social Security reform, it has been proposed that a portion of the Social Security Trust Funds be invested in the equities markets as a way of providing additional income to the Social Security program. In this paper, Dr. Lawrence White analyzes the proposal and points out the difficult issues it raises—including who would bear the risk related to the investments, what political influence might be exercised in the choice of investments, and the impact of governmental ownership of a substantial amount of stock in a number of large U.S. corporations. The Institute is pleased to publish Dr. White's analysis as a contribution to this ongoing debate.]

Executive Summary

The U.S. Social Security (OASDI) program faces serious long-run funding problems. Though the current annual cash-flow surpluses of the program are positive, they are projected to become negative around 2013. Among the policy remedies being considered for the program is a proposal to have the Social Security Administration (SSA) invest a portion of its Trust Funds directly in the equity securities of U.S. corporations.

¹ This paper is part of a larger research program on the Social Security program conducted jointly with Stephen Figlewski and Paul Wachtel, who provided valuable comments on an earlier draft.

The investment of the Trust Funds in equities is sometimes portrayed as an easy or costless fix for the program. Closer examination, however, reveals a much more complex problem, with many difficult questions and issues:

- Since the OASDI program is on a pay-as-you-go funding basis, any diversion of the OASDI Trust Funds' assets or future surpluses into equity investments would increase the Federal Government's deficit on the remainder of its operations. In turn, this would mean that the Government would have to sell more debt to the general public, raise taxes, and/or reduce other expenditures by a commensurate amount.
- If the equity purchases simply accomplish a swapping of assets between the OASDI Trust Funds and the general public and the U.S. economy's national saving rate is unchanged, then there is a serious question as to whether there has been any net gain from the perspective of the overall economy.
- The historical returns of equity securities (and their margin over Treasuries) may not be sustained in the future, so that the net revenue gain to the Trust Funds may be less than expected. In addition, the returns on equity investments — even for a well-diversified portfolio—entail substantially greater variability than the returns on government debt. Who should bear the burden of this greater riskiness?
- What should be the portfolio composition of the SSA's equity investments? How broadly diversified should it be? Should the portfolio include (and thereby favor) only large companies? What about smaller companies? Start-ups? What about other forms of investments besides equities?
- What political influences might be brought to bear on the SSA's investment choices—influences that raise the real possibilities of a reduction in the returns on the Trust Funds' investments? What would be the consequences of the OASDI Trust Funds' acquiring significant ownership stakes (e.g., 5-10% of outstanding shares) in a large number of U.S. corporations? How would (should) the SSA handle corporate governance questions? How should the Board of Trustees of the OASDI Trust Funds deal with potential conflict-of-interest problems?

These questions and problems certainly justify a close examination of the proposal or of any close variants on it. And they suggest that alternative mechanisms for allowing equities investments (or investments in other financial instruments) to become a part of the OASDI program should be given serious consideration.

I. Introduction

The U.S. Social Security program—more technically, the Old-Age, Survivors, and Disability Insurance (OASDI) program—faces serious long-run funding problems.² Though the current annual cash-flow surpluses of the program are positive, they are projected to decline around the year 2005 and to become negative around 2013.

Among the policy remedies being considered for the program is a proposal to have the Social Security Administration (SSA) invest a portion of its Trust Funds directly in the equity securities of U.S. corporations.³ The primary purpose of this remedy would be to increase the revenues of the Trust Funds and thereby diminish the payroll tax increases and/or benefits reductions that would otherwise be necessary to bring the program's expenditures into balance with its revenues.

The investment of the Trust Funds in equities is sometimes portrayed as an easy or costless fix—a “free lunch” or “no brainer”—that will increase the revenues of the Trust Funds, with little or no cost to the rest of the U.S. economy. Alas, a close examination of the possibility of the SSA's investing in equities reveals a much more complex problem, with many difficult questions and issues: The investments

A close examination of the possibility of the SSA's investing in equities reveals a much more complex problem, with many difficult questions and issues: The investments would not be costless; the array of potential investments create difficult problems of choices; and the prospect of a major agency of the Federal Government's acquiring a significant stake in the ownership of a wide range of American corporations raises many troubling issues of undue and unproductive government influence and conflicts of interest with respect to private sector activities.

² Thorough discussions of the OASDI program and its problems can be found in C. Eugene Steuerle and Jon M. Bakija, *Retooling Social Security for the 21st Century: Right and Wrong Approaches to Reform*. Washington, D.C.: Urban Institute Press, 1994; and Peter A. Diamond, David C. Lindeman, and Howard Young, eds., *Social Security: What Role for Reform?* Washington, D.C.: National Academy of Social Insurance, 1996. A shorter and less technical discussion can be found in Stephen Figlewski, Paul Wachtel, and Lawrence J. White, “The Future of Social Security: It's Worse than You Think,” *SternBusiness*, Fall 1995.

³ See, for example, Edith U. Fierst, “Social Security's Future,” testimony before the Subcommittee on Social Security and Family Policy, Senate Finance Committee, March 25, 1996.

would not be costless; the array of potential investments create difficult problems of choices; and the prospect of a major agency of the Federal Government's acquiring a significant stake in the ownership of a wide range of American corporations raises many troubling issues of undue and unproductive government influence and conflicts of interest with respect to private sector activities. Here, as is generally true in the policy world, free lunches are scarce.

This paper will explore these questions at greater depth.⁴ The intent here is not to provide definitive answers but, instead, to raise and clarify questions and issues. We conclude that the OASDI program does face serious funding problems—indeed, the program's fiscal problems will occur much sooner than most commentators have acknowledged. Some combination of higher payroll taxes, reduced benefits, *and* equity investments are the likely solution. But there are alternative ways that the equity investments (or other investments) could be undertaken—the proposal to have the SSA undertake those investments is not the only way⁵—and the substantial questions and problems that would accompany the SSA's actions must be acknowledged and addressed. At a minimum, these problems indicate that the alternative methods for permitting equity investments to become a part of the OASDI program should be given serious consideration.

II. The Social Security (OASDI) Funding Problems

The OASDI program is funded on a “pay-as-you-go” basis. The current payroll taxes of workers and their employers are *not* directly invested in identifiable assets, and retirees' benefits are *not* paid from the sale or liquidation of earlier invested assets. Instead, the “contributions” of current payroll taxes are largely paid directly to current retiree beneficiaries, and the remainder is transferred (loaned) to the U.S. Treasury and effectively becomes part of the general revenues of the Federal Government, thereby helping to fund the Government's other activities. In calendar year 1995, for example, payroll tax revenues to the OASDI were approximately \$365

⁴ This paper will focus entirely on the OASDI program and not address the Medicare program.

⁵ At least two alternatives have been identified, both allowing for some measure of individual choice and discretion: One would create a limited variety of index funds (operated or contracted-out by the Federal Government), with OASDI participants' being able to allocate a portion of their contributions among the index funds, much as the Federal Government's retirement plan for federal employees (the Thrift Savings Plan) currently operates; the other would allow individuals a wide range of choice among investments, much as IRA, Keogh, and 401(k) plans currently operate.

billion;⁶ benefit payments were approximately \$332 billion. The surplus (less about \$3 billion in administrative expenses) was used to help fund the other operations of the U.S. Government; in essence, the surplus was used to reduce the revenues-minus-expenditures shortfall of the remainder of the Government's operations.

As this description indicates, the OASDI program is not a "defined contribution" plan (with an individual's contributions' being invested in specified assets, and his/her retirement benefits' being linked directly to those contributions and the subsequent returns on those investments). Instead, the OASDI program is best characterized as a "defined benefit" plan: The Social Security Administration maintains a record of an individual's wages, and his/her eventual retirement benefits are based on those wages. The benefits are linked only loosely to the payroll taxes paid by the individual and his/her employer. (The loose linkage arises because of legislated changes in benefits and payroll tax rates over the program's history and because of the substantial insurance and redistributive elements that are also inherent in the structure of the OASDI program.)

Further, this defined-benefit program is badly underfunded. With most of the current contributions being used to pay for current retirement benefits, only modest annual surpluses have been potentially available for investment. But these surpluses have not been invested in a diversified portfolio of assets representing real claims on the U.S. economy. Instead, as was described above, they have been transferred (loaned) to the Treasury and used to help fund the other activities of the Federal Government. Though the Treasury has issued bonds to the OASDI Trust Funds in recognition of the past annual surpluses (and of interest credited to those bonds), these bonds are simply an expression of the obligation of the U.S. Government—and, ultimately, the U.S. taxpayer—to the Trust Funds. But the OASDI program is already an obligation of the U.S. Government (and thus the taxpayer). Accordingly, the bonds do not directly add any extra element of financial support to the program.⁷ The payment of future benefits relies entirely on future tax collections: the OASDI

⁶ These data have been provided by the SSA. Many discussions of OASDI revenues show a larger annual revenue figure—\$400 billion, which includes \$35 billion that is credited to the OASDI Trust Funds by the U.S. Treasury as interest on the U.S. Government debt obligations held by the OASDI Trust Funds. This credited interest, however, is an internal transfer within the Federal Government and does not change the size or nature of the OASDI program's long-run cash-flow funding problems.

⁷ The bonds may provide some indirect support, since they represent the program's past surpluses (and interest on the surpluses), which have been transferred (loaned) to the Treasury and used for general Federal Government expenditures; the Congress may feel a special obligation to repay (from general tax revenues) these past transfers.

program's payroll taxes, and general tax revenues to repay to the program the past surpluses (and interest) represented by the Trust Funds' bonds.

If no changes are made in the currently mandated schedules of payroll taxes, retirement ages, and benefit payouts, the future demographic structure and likely income levels of the U.S. population imply that the annual cash-flow surpluses of the OASDI program will rise modestly in the next few years, reach a plateau, and then begin to decline around 2005.⁸ By around 2013 the program's annual payroll tax revenues will be less than expenditures.⁹ In this latter year the fiscal assistance that the OASDI program provides to the rest of the Federal Government will cease, and the OASDI program will begin to *add* to the federal deficit. This latter year is also a crucial point for the OASDI program, since it is the first year in which the SSA will have inadequate tax revenues and will have to begin selling bonds from its portfolio.¹⁰

Because abrupt changes in the rules and schedules of the OASDI program are generally considered to be unfair to current retirees or to those who are close to retirement, changes in the program (e.g., changes in retirement ages or benefits) are usually made well in advance of their actual impact, and gradualism is key.¹¹ But gradualism and long lead times mean that any changes require a considerable amount of time before their fiscal consequences are felt.

Accordingly, if the OASDI program is to be maintained as a stand-alone and self-sufficient program, changes and reforms will have to be made as soon as possible. These are likely to include some combination of the delaying of retirement ages, reductions in benefits (e.g., through a downward revision in the linkage between future benefits and the Con-

⁸ These estimates are derived from *The 1995 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds*, April 3, 1995; estimates based on 1996 data are likely to be quite similar. All of the predictions of this paper are based on the "intermediate" predictions of the SSA. Even the optimistic predictions of the SSA provide the program with only slightly more leeway.

⁹ Because of the interest that the Treasury credits to the Trust Funds on the latter's holdings of Treasury bonds, the reported annual surplus of the OASDI program will continue until 2020.

¹⁰ It is important to note that 2013 is appreciably sooner than 2029, when the SSA's sales from its Trust Funds' bond portfolio will exhaust the Trust Funds. After 2029, the Treasury will have to sell bonds to the public to support the shortfalls of the OASDI program. But from the perspectives of the fiscal effects for the Federal Government and the impact on the U.S. economy, there is no difference between the SSA's bond sales (between 2013 and 2029) and the Treasury's sales (after 2029).

¹¹ An exception to this presumption for gradualism has been the Congress's willingness to tax OASDI benefits, at relatively short notice.

sumer Price Index), increases in payroll taxes, and/or investing some of the existing OASDI Trust Fund assets and future OASDI annual surpluses in equities. It is this last possibility on which we shall now focus—specifically, on the possibility that the SSA itself might do the investing.

III. Investing Part of the OASDI Portfolio in Equity Securities

Let us suppose that the Social Security Administration were itself to invest a portion of the OASDI Trust Funds and of future annual surpluses in the equity securities of U.S. corporations, as a way of increasing the future revenues of the OASDI program (and also providing the Trust Funds with real claims on the U.S. economy).

On first impression, this possibility appears attractive. The broad stock market averages have historically earned average annual returns (dividends plus appreciation) of approximately 10-12% per year,¹² substantially above the interest on long-term Treasury bonds (which has been credited to the Trust Funds' holdings). The OASDI program's future revenues (including capital gains) would increase, the future values of the Trust Funds would be higher, and the Trust Funds would contain real claims on the U.S. economy that could eventually be liquidated to help pay benefits to retirees.

Unfortunately, the problem is substantially more complex. Specifically:

- Since the OASDI program is on a pay-as-you-go basis, any diversion of future surpluses into equity investments would mean that the OASDI surpluses would not be available to reduce the Federal Government's deficit on the remainder of its operations. In turn, this would mean that the Government would have to sell more debt to the general public, raise taxes, and/or reduce other expenditures by a commensurate amount. Similarly, any conversion of the Trust Funds' existing assets into equities necessitates the selling of Treasury bonds to the general public, effectively increasing the size of the budget deficit (unless it is offset by reductions in other Government expenditures and/or increases in taxes). In essence, these equity purchases would simply bring forward in time the fiscal problems for the Federal Government that would otherwise occur in 2005 or 2013.

¹² The specific annual returns reported depend on the specific index and time frame that are used for the calculation. It is important to note that inflation accounts for 3-4% of that return, so that real (inflation-adjusted) returns have been around 7-8%.

- If the equity purchases simply accomplish a swapping of assets between the OASDI Trust Funds and the general public—the Trust Funds would shed some Treasury bonds (selling them to the general public) and gain some equity securities (buying them from the general public)—and the U.S. economy’s national saving rate is unchanged, then there is a serious question as to whether there has been any net gain from the perspective of the overall economy.
- The historical returns of equity securities (and their margin over Treasuries) may not be sustained in the future, so that the net revenue gain to the Trust Funds may be less than expected. The returns on equity investments—even for a well-diversified portfolio—entail substantially greater variability than the returns on government debt. Who should bear the burden of this greater riskiness?
- What should be the portfolio composition of the SSA’s equity investments? How broadly diversified should it be?
- What political influences might be brought to bear on the SSA’s investment choices? What would be the consequences of the OASDI Trust Funds’ acquiring significant ownership stakes (e.g., 5-10% of outstanding shares) in a large number of U.S. corporations? How would (should) the SSA handle corporate governance questions? How should the Board of Trustees of the OASDI Trust Funds deal with potential conflict-of-interest problems?

The following sections will address these points in greater detail.

IV. The Consequences of Pay-as-You-Go Financing for Equity Investing

With its pay-as-you-go financing structure, the OASDI program’s tax revenue contributions from current workers and their employers are largely used to pay benefits to current retirees. The relatively small annual cash-flow surpluses of the program are transferred (loaned) to the Treasury and are used to help cover the other operations of the Federal Government. The Treasury credits the OASDI Trust Funds with Treasury bonds in recognition of these loans and of interest on past bonds.

Accordingly, any diversion of future annual surpluses to equity investments would reduce the help that the OASDI program would otherwise provide in covering the fiscal deficits that the Federal Government is running on its other operations. In turn, the Government would have to float commensurate amounts of debt, raise taxes, and/or reduce expenditures to compensate for the reduced OASDI transfers. Similarly, if the Social Security Administration were to begin transforming existing Trust Fund assets into equity securities, this would mean additional debt sales to the public, unless the Federal Government commensurately raised taxes and/or reduced other spending.

In essence, then, a program of having the SSA invest in equity securities—either from future annual surpluses or from transformations of existing Trust Fund assets—would bring forward in time the fiscal problems for the remainder of the Federal Government’s operations that would otherwise arise in 2005 or 2013.

V. National Saving Rates, and the SSA’s Investments in Equities

It could be argued that the ability of future U.S. populations to fund the consumption of resources by future retirees depends fundamentally on future real income levels, which in turn depend partially on prior years’ saving rates and on the productive investment of those savings. In this view, the OASDI program should not be analyzed as a stand-alone entity but instead should be seen as an integrated part of the nation’s overall efforts to save, invest, and subsequently support the consumption of its retirees.¹³ Accordingly, in this view, the success of any program of investing OASDI assets in equities would rest on whether the nation’s saving rate concomitantly increased.

Before offering a critique of this “integrationist” view, let us lay out the two extreme scenarios that would illustrate “failure” or “success” by this standard.

The “failure” scenario runs as follows: Suppose that, as an accompaniment to the Social Security Administration’s use of the OASDI program’s annual surpluses to purchase equity securities, the Federal Government does not alter its other expenditures or taxation but simply sells commensurately more debt to the public, so as to make up for the loss of the OASDI transfers; similarly, the Government does not alter its spending or taxes in response

¹³This view can be found, for example, in Barry P. Bosworth, “Fund Accumulation: How Much? How Managed?” in Diamond, et al., op. cit.

to sales of bonds from the OASDI Trust Funds. In this case, as a first approximation, only a shuffling of Treasury bonds and equity securities between the Trust Funds and the general public has been accomplished; after the Trust Funds' equity purchases (from the public), the Trust Funds hold more equity securities and fewer Treasury bonds than otherwise would have been the case, and for the general public the opposite is true. But national saving has not been increased directly.¹⁴

The "success" scenario can be described similarly: Suppose instead that, as an accompaniment to the SSA's purchases of securities, the Federal Government reduces other (non-investment) expenditures by a commensurate amount. Resources are thereby released for alternative uses and can be devoted to productive investment. National saving (and investment) has increased, with the prospects of higher future productivity and incomes for the U.S. economy.¹⁵

Accordingly, whether the investment of the Trust Funds in equity securities causes an increase in national saving depends on the Federal Government's concomitant decisions with respect to its remaining operations.

But is an increase in national saving a correct barometer of the "success" of an equities investment program? Though the "integrationist" view is technically correct with respect to the *financial* capability of a society to support the consumption of its retirees, this view ignores the *political-economy* realities of the advantages of having a separate retirement program, with its separate funding mechanism. Though higher future incomes might increase the potential ability of a population to fund its retirees' consumption, there is no necessary link between that ability and the actual willingness of workers to tax themselves at higher rates (even though their after-tax incomes might be higher than today) so as to support concurrent retirees. Further, any increases in payroll taxes would mean higher labor costs for

¹⁴ There might be some indirect effects on saving rates through the changes in yields on equities and Treasuries that would have to accompany these transactions; the SSA's purchases of equities would cause prices to be higher and returns to be lower than they otherwise would be, and the sales of Treasury bonds would have the opposite effects. But these indirect effects on saving rates would likely be small.

¹⁵ This success scenario is in terms of a commensurate reduction in other Federal expenditures. If, instead, an increase in other Federal taxation were to occur (that would similarly reduce the fiscal deficit on the Government's other operations), the consequences for national saving would depend on the concomitant behavior of the private sector with respect to saving. Some commentators have even questioned whether a reduction in the Federal Government's other expenditures would affect national saving and thus whether the method of funding the Social Security program has any effect on national saving. See Robert J. Barro, *Macroeconomics*, 4th edn. John Wiley & Sons: New York, 1993, pp. 387-388.

employers and/or lower wages for workers, distorting employers' labor-capital utilization decisions and workers' employment-search decisions, discouraging employment expansion (and encouraging off-the-books activities).

Accordingly, a modification to the OASDI program that increases its revenues from non-Federal sources (i.e., that involves something more than just increasing the interest that is credited to OASDI's holdings of Treasury debt), even if it does not increase national saving, could be considered a "success" in reducing the future financing pressures on the OASDI program and damping future distortions in labor markets.

Nevertheless, the basic insight of the "integrationist" view is important to consider: In the pay-as-you-go financing world of the OASDI program, the shifting of the OASDI Trust Funds' assets into equity securities would not be a "free lunch." In the absence of an increase in national saving, the shuffling of assets would mean that the higher returns (but also higher risks—see the following section) to the OASDI Trust Funds from its holding of equity securities would be balanced by lower returns (and lower risks) earned by the general public on its reshuffled portfolio (which would contain more government bonds).

VI. Portfolio Risk

Though the historical returns of equity investments relative to Treasury bonds have been quite attractive, there is no guarantee that this attractive margin will persist in the future. Indeed, the "equity premium puzzle" is one with which finance economists continue to grapple.¹⁶ To the extent that average equity returns become less attractive in the future, the revenue gains to the OASDI Trust Funds will be less than anticipated.

Further, it seems likely that the extremely public decisions of the Social Security Administration in investing the OASDI Trust Fund assets in equities (and also in eventually

In the pay-as-you-go financing world of the OASDI program, the shifting of the OASDI Trust Funds' assets into equity securities would not be a "free lunch."

¹⁶ See, for example, Rajnish Mehra and Edward C. Prescott, "The Equity Premium: A Puzzle," *Journal of Monetary Economics*, March 1985; George M. Constantinides, "Habit Formation: A Resolution of the Equity Premium Puzzle," *Journal of Political Economy*, June 1990; and Chris I. Telmer, "Asset-Pricing Puzzles and Incomplete Markets," *Journal of Finance*, December 1993.

liquidating those equity investments) would cause the returns on the SSA's portfolio to be lower than for an otherwise similar but smaller and more private investor. The securities markets will be able to anticipate when the SSA will be buying (and prices will be bid up beforehand) and to anticipate the SSA's sales as well (and prices will be bid down beforehand). The SSA is likely always to be buying at unfavorably high prices and to be selling at unfavorably low prices, thereby reducing its expected returns.

Equally important, the attractive average returns of equity investments are accompanied by higher levels of variability in returns—even for the broadly diversified portfolios of the market indexes—than is true for government debt. In recent decades, the annual returns on equity investments (broad market indexes) have been negative about a quarter of the time. The negative annual returns have been as great as 26%. As recently as October 1987 the stock market declined by about 25% within a few days (and by about 33% over a few weeks).

Since the SSA as an equities investor ought to have a “buy-and-hold” long-run perspective, relatively short-run variability ought not to be of great concern. But there have been times when unfavorable returns have persisted for extended periods. From the late 1960s until the early 1980s—a period of well over a decade—the stock market averages showed little overall growth (and experienced substantial variability in the intervening years). Farther back in history, the stock market crash in the autumn of 1929 was followed by three more years of declines, which wiped out 90-95% of equity values; the stock market indexes regained their 1929 highs only in 1954—twenty-five years later!

The risks of equities investments in the aggregate cannot be avoided; someone will have to bear those risks. However, if the U.S. Government remains as the ultimate guarantor of benefits to OASDI program retirees, then a decision to have the SSA invest in equities implies that taxpayers collectively will be shouldering more of those risks. The forced

If the U.S. Government remains as the ultimate guarantor of benefits to OASDI program retirees, then a decision to have the SSA invest in equities implies that taxpayers collectively will be shouldering more of those risks. The forced socialization of those risks onto taxpayers—many of whom may not want this added burden of risk and would not choose it for themselves—is not an obvious net gain in social policy.

socialization of those risks onto taxpayers—many of whom may not want this added burden of risk and would not choose it for themselves—is not an obvious net gain in social policy.¹⁷

VII. Portfolio Choices—The Risk-Return Dimension

The discussion concerning the Social Security Administration’s investing in equity securities usually involves suggestions that these investments should take the form of broadly based index funds, so as to ensure adequate diversification.¹⁸ Sometimes specific references are made to investments in “the S&P 500.” The SSA’s portfolio choice problems would thus appear to be quite simple. Unfortunately, the questions of diversification and risk-return tradeoffs for the SSA’s portfolio are considerably more complex and do not have easy answers.

The Standard & Poor’s 500 (S&P 500) Index is a stock market index that tracks the composite price performance of a group of 500 of the largest corporations in the U.S. A decision to direct the SSA’s investments toward the 500 companies that compose the S&P 500 would yield a broadly diversified portfolio in terms of industrial fields and thus would achieve a relatively low-variance outcome.¹⁹

But why should the SSA restrict itself to only the very large companies in the U.S. economy? The SSA could considerably widen its portfolio by including all of the stocks in the “Wilshire 5000” index, which includes the S&P 500 companies and over 5,000 additional smaller companies. Or the SSA might try for a portfolio of all traded stocks in the U.S. economy. But the inclusion of these smaller companies’ stocks in the SSA’s portfolio will imply a higher-return-but-higher-risk outcome. Should that be the SSA’s preferred outcome?

Further, the historical record indicates that an improved risk-and-return outcome (i.e., higher average returns *and* lower variability) can be achieved by devoting 20-30% of the SSA’s portfolio to the equities of companies that are headquartered outside of the U.S. and

¹⁷ By contrast, proposals to allow individuals to control the allocation of portions of their OASDI contributions would allow individual choice with respect to the willingness to bear risk; at least one such proposal includes the option for an individual to remain wholly within the traditional Social Security system.

¹⁸ See Fierst, *op. cit.*

¹⁹ This was the choice that was made, for example, for the equities investment alternative available to Federal Government employee participants in the Government’s Thrift Savings Plan.

that are traded on exchanges outside of the U.S. How far should the SSA's portfolio choices extend in this direction?

In addition, why should the SSA restrict itself only to investments in equity securities? Why not invest also in the debt securities of these companies (domestic and foreign)? Mortgage-backed debt securities? Credit-card debt securities? The debt issued by foreign governments? What about direct investments in real estate? In precious metals? In “collectibles”? What about investments in human capital? Are there ways that the SSA can invest in human capital, in addition to its investments in financial capital? Student loans? Loans to vocational schools, colleges, universities? Should the SSA be investing in human capital?

In sum, there are a large number of very serious portfolio allocation questions that need to be addressed.²⁰ A clear specification of the risk-return tradeoff goals for the SSA is necessary before these portfolio allocation decisions can be made. The “easy” decision—invest in the S&P 500—is not obviously the right answer to these questions.

As a related problem, decisions need to be made as to what fraction of the OASDI assets should be devoted to these equity (and possibly other) investments. Should all of the future annual surpluses (including credited interest) be invested in equities? Just the annual cash-flow surpluses? Should a fraction of the existing Trust Fund assets be devoted to equities? Should there be a long-run target as to the fraction of the Trust Fund assets that should be invested in equities? How should that target be determined? How quickly should that target be achieved? What would be the consequences for the equity markets (and for the Trust Funds' returns), as well as for the Federal Government's deficit and debt-flotation problems, of overly rapid transformations of the Trust Funds' bonds into equities?

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²⁰ Again, proposals to allow personal choice in the allocation of portions of individuals' OASDI contributions would avoid many of these problems, although some of them would be resurrected in the regulations and guidelines that would likely accompany any such alternative.

Again, proper consideration of risk-return tradeoffs—this time from the perspective of the overall Federal Government—is necessary for these determinations.²¹ And, again, the simple response of “invest in the S&P 500” does not provide the answer to any of these larger allocation questions.

VIII. Portfolio Choices—The Political Dimension

The prospect of the Social Security Administration’s investing relatively large sums in equity securities (and possibly in other instruments as well) unavoidably raises the question of political influences on the SSA’s portfolio choices—beyond the resolution of the difficult risk-return problems that were outlined in the previous section. Will the SSA be subject to political influences with respect to its portfolio choices? Should it be?

These questions are unavoidable and must be addressed for at least two reasons: First, the investments will be undertaken by a major instrumentality of the U.S. Government. And, second, the sums could easily become quite large. One potential scenario, which has the OASDI Trust Funds’ achieving a target of 40% invested in equities by the year 2014, indicates that the Trust Funds’ equities portfolio in that year would be about a trillion dollars (in 1996 dollars)!²²

Even the risk-return choices discussed in the previous section have an implicit political dimension. For example, a decision to restrict the SSA’s investments to equity shares in the S&P 500 is a policy that favors large companies over small ones and equity security investments over all others. Is this politically appropriate? An improved risk-return position can be achieved by having the SSA devote 20-30% of its equity portfolio to foreign companies. Is this politically appropriate?

²¹ This larger perspective suggests a theoretical (albeit politically impossible) curiosity: Perhaps the SSA should be a net short-seller of U.S. equities! The argument to support this position would be as follows: Since the payroll tax revenues of the OASDI program and the performance of the U.S. stock markets are likely to be positively correlated (i.e., they are both likely to rise and fall with the performance of the overall U.S. economy), a short position in the stock market would be negatively correlated with the OASDI program’s tax revenue flows. Consequently, if the SSA were interested in hedging or smoothing out the variability of those tax revenue flows, the proper strategy would be to combine short positions in equities with those flows. See the *Report of the Technical Panel on Trends and Issues in Retirement Saving*, 1994-95 Advisory Council on Social Security, August 14, 1995.

²² This scenario has been developed by the technical staff of the SSA, which is advising the 1995-96 Advisory Council on Social Security.

The temptations for political intervention—beyond the establishment of the fiduciary obligations of the managers of the Trust Funds and the delineation of the proper risk-return choices—will clearly be substantial. And it is easy to see how the rationales for political intervention into the SSA's decisions would be stated: The SSA's investments are being made, in an important sense, with public monies, and hence public purposes should be served. The operations of markets, including financial markets, are riddled with imperfections, especially in their neglect of social needs. It is the obligation of government in all ways—including the use of OASDI program funds—to serve these public purposes and to remedy these deficiencies of markets.

A major difficulty with such rationales is that they become quite open-ended, and limits become quite difficult to establish. Even if the SSA were to limit itself to an equities-only investment policy (which itself is an explicit or implicit political choice), the following political considerations are obvious ones:

- Should large companies be favored (as would be true for an S&P 500 policy)? Why discriminate against smaller companies?
- Should investments in initial public offerings (IPOs) be permitted? Venture capital efforts?
- Should investments in foreign companies be permitted?
- What about U.S. companies that invest substantial sums abroad?
- What about tobacco companies?
- What about companies that have been convicted of law violations?
- What about companies with poor social policies toward their employees (domestically or abroad)?
- What about high-technology companies? What about low-technology companies?
- Might significant Trust Fund holdings of overseas investments influence the Federal Reserve's conduct of exchange rate policy? Should it? Would there be perceptions or fears of such influence, even in the absence of any actual influence?

The specter of political influences on the SSA's portfolio choices raises the real possibilities of a reduction in the returns on the Trust Funds' investments. So long as the Federal Government remains as the guarantor of benefits to OASDI program retirees, taxpayers will

bear the ultimate burden of the extra risks and reduced returns that political influence may bring.²³

The experiences of the management of state and local governments' employees' pension funds are not encouraging ones.²⁴ There have been clear instances in which political influences on some of these funds have led to misguided investments and undue losses for the funds. A number of states have guidelines for their pension funds that encourage some types of investments (e.g., investments that focus on projects or companies located in that state) and discourage other types of investments (e.g., investments in foreign companies or in companies that are extensively involved abroad or in specific countries), as compared with those that would conform to a "prudent person" fiduciary approach. Statistical studies of the annual returns yielded by state employee pension funds in the late 1980s and early 1990s have shown that the returns are significantly lower when the funds' trustees and managers are subject to greater political influence.²⁵ And a number of state legislatures have raided their employees' pension funds when fiscal conditions were perceived to be tight.

A similar set of problems and issues arise in the context of corporate governance. The sizable equity portfolio that the SSA would amass would unavoidably thrust it into the role of a significant shareholder of a very large number of companies. For example, under the scenario mentioned above, in which the SSA's holdings in 2014 would amount to about a trillion dollars (in 1996 dollars),

The specter of political influences on the SSA's portfolio choices raises the real possibilities of a reduction in the returns on the Trust Funds' investments.

²³ Again, these political influence problems do not arise in the context of proposals to allow personal choice in OASDI contribution allocations, though some of these problems may resurface in the regulations and guidelines that would likely accompany such alternatives. Similarly, the corporate governance problems and conflict-of-interest problems discussed below do not arise in the context of the personal choice alternatives.

²⁴ For a thorough discussion, see Roberta Romano, "Public Pension Fund Activism in Corporate Governance Reconsidered," *Columbia Law Review*, May 1993.

²⁵ See Romano, *op. cit.*; Olivia S. Mitchell, "Public Pension Governance and Performance: Lessons for Developing Countries," Working Paper No. 9, Institute for Labor Market Policies, School of Industrial and Labor Relations, Cornell University, May 1993; and M. Wayne Marr, John R. Nofsinger, and John L. Trimble, *Economically Targeted and Social Investments: Investment Management and Pension Fund Performance*. Charlottesville, Va.: Research Foundation of the Institute of Chartered Financial Analysts, 1996.

this sum would likely be about 7% of the value of the group of S&P 500 companies in that year.²⁶ If the SSA had amassed its portfolio through a policy of investing only in the S&P 500 companies, it would thus hold about 7% of the shares of each of these 500 companies. (Even if the SSA expanded its investment policies to the Wilshire 5000, its trillion dollar portfolio would still constitute about 4.6% of the value of those companies' shares.)

With such ownership stakes, the SSA would be the largest shareholder in many, if not most of these companies. How should it vote its shares when issues of corporate governance arise? How should it choose among potential members of corporate boards of directors? How should it vote when takeover battles arise? When dissident shareholders propose various reforms? These are choices and decisions that are unavoidable: To abstain from voting is itself an explicit choice and decision, since abstentions usually reinforce the power of incumbent managements; but a policy that generally buttresses incumbent managements is not likely to be consistent with the fiduciary obligations of the SSA to seek maximum returns on its investments.

It is easy to see how political influences could come to bear on the SSA—both in how its general policies with respect to governance issues are established and in how they are applied in particular corporate instances. Again, a possible outcome of these political pressures would be general policies and specific applications that would cause the returns on the SSA's portfolio to be lower. And, again, the ultimate bearers of this burden would be U.S. taxpayers.

The experiences of the states is again not encouraging.²⁷ Until recently, state pension fund managers have been passive on corporate governance issues, thus favoring incumbent managements. Only in the past few years have a few state pension funds—most notably the California Public Employees Retirement System (CalPERS)—become more aggressive in their stances on these issues. It is worth noting that a 1989 report commissioned by Governor of the State of New York explicitly recommended that state pension funds should generally support incumbent managements in takeover disputes (and should consider the local

²⁶ This percentage was determined by compounding the year-end 1995 stock market valuation for the S&P 500 companies—\$4.6 trillion—by the same annual real rate of return of 7% for equities that was used by the SSA staff to arrive at its trillion dollar estimate of the OASDI Trust Fund's holdings of equities in 2014.

²⁷ See Romano, *op. cit.*

impacts of their investment and voting decisions).²⁸ Though the report's recommendations were not enacted into law, they attracted substantial attention and continue to receive notice.²⁹

Finally, the SSA's substantial and extensive equity ownership positions may create potential conflict-of-interest problems for some of the OASDI Trust Funds' most senior officials—its Board of Trustees. Of the six Trustees, three are the Secretaries of the Treasury, of Labor, and of Health and Human Services. At various times these individuals will surely have knowledge of impending events—e.g., government contracts, legal actions to be initiated or settled, regulations to be issued or modified—that could have significant financial consequences for companies whose shares will be owned by the OASDI Trust Funds. How should these individuals resolve the conflicts between their obligations to administer their Departments in an effective fashion and their fiduciary obligations to the Trust Funds? The answers are far from clear.

In sum, the problems and questions that arise with respect to likely political influences over the SSA's potential portfolio choices and corporate governance decisions, as well as the prospects for conflict-of-interest problems for half of the OASDI's Board of Trustees, are substantial and troubling. They surely raise doubts about the wisdom of a policy that centralizes in the SSA (or in any other government agency) the portfolio choices for the OASDI program.

IX. Conclusion

The Social Security (OASDI) program does face serious long-term funding problems; indeed, the problems are likely to arise considerably sooner than most commentators have suggested. But a widely discussed proposal that is designed to increase the OASDI Trust Funds' revenues and thus help delay or defer the financial pressures on the program—the proposal to allow the Social Security Administration to invest a portion of the Trust Funds' assets in U.S. corporate equity securities—is not the easy solution that a casual discussion might convey. The proposal raises a large number of difficult and troubling questions and problems, including those of portfolio choices, political influences, and conflicts of interest.

²⁸ See New York State Industrial Cooperation Council, "Our Money's Worth," The Governor's Task Force on Pension Fund Investment, June 1989.

²⁹ See Fierst, *op. cit.*

These questions and problems certainly justify a close examination of the proposal or of any close variants on it. And they suggest that alternative mechanisms for allowing equities investments (or investments in other financial instruments) to become a part of the OASDI program should be given serious consideration.



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