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SHOULD A PORTION OF SOCIAL SECURITY BENEFITS BE INVESTED IN EQUITIES?

By Robert Greenstein[1]

In his State of the Union address, President Clinton proposed investing about 15 percent of Social Security reserves in the equities markets. Over the next 15 years, approximately $600 billion of budget surpluses would be invested in this manner on behalf of Social Security. The investment of these funds in equities markets would enable Social Security to earn higher rates of return and meet its long-term obligations without having to reduce benefits (or raise taxes) as much as would otherwise be the case.

This Administration proposal has sparked considerable controversy. This analysis examines some of the issues in the controversy.

Would Government be investing in the market and controlling private companies?

Critics of this proposal usually refer to it as "government investment" in the market. They warn of investments being made on a political rather than an economic basis.

Virtually all parties to this debate concur that no Congressional or executive branch involvement should be allowed in investing Social Security reserves in equities. As a result, the Administration's proposal is designed to preclude such involvement. The proposal would *remove* management of a portion of the trust-fund reserves from the executive branch and Congress and transfer it to an independent, non-political, professional management board structured so the board would be beyond Administration and Congressional control. This independent board, the members of which would be expected to have substantial experience in pensions and investing, would in turn contract with private fund managers selected through competitive bidding. These managers — which could include entities such as Merrill Lynch, Vanguard, or State Street Bank — would do the investing of a modest portion of Social Security reserves in broad index funds in the equities markets.

The investment consequently would be done by these private-sector pension managers, not by the government. Treasury Secretary Robert Rubin recently commented that "there [are] really two layers of protection" against political interference in this proposal. He noted "there'll be an independent body that will oversee the investment of the funds, and then the funds themselves will be invested by private sector money managers, not by the government. The government will be involved absolutely not at all in the investment."[2]

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To ensure the independence of the professional management board that would select the private fund managers, the board would be structured like the Federal Reserve Board or the Federal Retirement Thrift Investment Board, the entity that oversees the investment of the funds that federal employees deposit through the Thrift Savings Plan. Federal Reserve governors serve staggered 14-year terms and cannot be removed for political reasons. The same type of approach would be used here. In addition, both the Fed and the Federal Retirement Thrift Investment Board are independent of Congress and the White House financially. They secure the revenues they need for operating expenses from very small charges on the investments they oversee; they are not dependent on actions of Congress or the President to secure their operating funds. That would be the case here as well.

With this structure, the Fed has successfully maintained its independence for decades in setting monetary policy; it, not Congress or the executive branch, establishes those policies. Since its creation in 1986, the Federal Retirement Thrift Investment Board has similarly maintained its independence and not been subject to political meddling. As Francis X. Cavanaugh, the Board's first executive director, has noted, Congress designed the board to be insulated from both political interference and corporate decision-making, and this design has worked.[3]

The Federal Retirement Thrift Investment Board also provides a model for how the Administration's proposal would work in another way. Equity investment by the Thrift Investment Board is limited to a stock index fund; the Board does not pick and choose among companies or sectors of the economy. The same would be true under the Administration's proposal. Equity investment would be limited to passive investment in very broad index funds, with neither the independent board nor the private-fund managers having authority to add or delete companies from the indices.[4]

The specter of a government behemoth — or of cadres of government bureaucrats wielding awesome market power for political purposes, making or breaking companies, and applying pressure to firms that are out-of-favor such as tobacco companies and businesses with which the government is engaged in legal disputes — appears to be based on misunderstanding of the Administration's proposal. The proposal would afford no opportunity for politicians to block investment in firms of which they disapprove.

The executive branch and Congress would be walled off from the investment process, just as they are walled off from Federal Reserve Board decisions on interest rates. In addition, the independent board overseeing the investment of Social Security trust fund reserves would itself have relatively little discretion or authority. Its functions would be restricted by law to selecting the private fund managers through competitive bidding (and possibly selecting the broad indices that could be used). Furthermore, while some critics have voiced concerns that the government might use the Social Security trust funds's ownership of stock to cast votes to influence corporate behavior, this, too, would be ruled out under the proposal; the board would be denied authority to vote the shares of companies that the trust funds hold. (See page 11 for a discussion of this issue.)

Critics Seek to Make Proposed Equity Investment Appear Larger Than it Would Be

Some opponents of trust-fund investment have sought to portray its dimensions as being larger than they actually would be. These critics cite figures on the total dollar value of equities the trust fund would hold several decades from now *without adjusting these figures for inflation.* These critics cite as the source for their data an analysis prepared by the Social Security actuaries. The actuaries' report shows, however, that in 1999 dollars, trust-fund investment would not exceed $750 billion even when earnings on the equity holdings were reinvested. The actuaries' report also shows that the amounts invested in equities would never exceed 15 percent of trust-fund reserves and would never constitute more than a very small share of U.S. equities markets.

The Independence of Thrift Savings Plan Investments from Political Interference

A recent *New York Times* article on the Clinton Social Security plan included an interview with Francis X. Cavanaugh, first executive director of the Federal Retirement Thrift Investment Board, which oversees the Thrift Savings Plan's investments. The *Times* reported that when was asked whether "the Government can invest in stocks without becoming bogged down in political shenanigans or corporate meddling, Cavanaugh replied: 'Can it be done? It's been done. We did it.' "

The article continued: "Strong legislation protects the [Federal Retirement Thrift Investment Board] from political pressure, [Cavanaugh] said. Corporate meddling is precluded because the commercial bank selected to manage agency investments also votes its shares on matters like takeovers and executive compensation. The only factor the bank can consider in casting its votes, Mr. Cavanaugh added, is what is best for retirees.

" '...The question is not can it be done. The question that should be asked,' [Cavanaugh] said, 'is whether the Congress, having protected three million Federal employees from political manipulation of their retirement funds, will be willing to extend that same protection to the 150 million beneficiaries of Social Security.' "[a]

In recent testimony Alicia H. Munnell, a Boston College economist who is a former senior vice president at the Boston Federal Reserve Bank and a former member of the President's Council of Economic Advisers, made a similar point. She noted that the Thrift Savings plan "has steered clear of any issues of social investing. TSP designers insulated investment decisions by setting up an independent investment board, narrowing investment choices, and requiring strict fiduciary duties. The TSP also operates in a political culture of noninterference. Its creators made clear from the beginning that economic, not social or political, goals were to be the sole purpose of the investment board. The TSP has perpetuated this norm by refusing to yield to early pressure to invest in 'economical targeted investments' or to avoid companies doing business in South Africa or Northern Ireland."[b]

[a] "Social Security Investment Plan Raises a Debate," *New York Times*, January 24, 1999, p. 16.

[b] Testimony of Alicia H. Munnell, before the House Ways and Means Committee, January 21, 1999.

In fact, while the *structure* of the new board would resemble that of the Federal Reserve in that the board would consist of members who were appointed to long, staggered terms and could not be removed for political reasons, the board's authority would be far more circumscribed than that of the Fed. The board would have only the rather mechanical function of selecting fund managers through competitive bidding.

Indeed, the structure and authority of the board would be essentially the same as that of the federal investment board established under partial privatization legislation that Senators Gregg and Breaux and Reps. Kolbe and Stenholm have introduced. The individual accounts that their legislation would create would be administered centrally, with the funds in these accounts invested by a board or institution managed by federal appointees. The board would select private fund managers and possibly the index funds to be used. *Its role and function would be virtually identical to those of the board the Administration has proposed.*

Still another safeguard could be erected by requiring the fund managers that invest the trust-fund reserves to pool the Social Security funds they are investing with other funds they are handling on behalf of private clients. This would provide another layer of insulation against political interference. Any alteration in investments for reasons other than maximizing rates of return would provoke the wrath of the private clients whose funds have been pooled with the Social Security funds. The Federal Thrift Investment Retirement Board employs this approach.

This structure should place the investment of trust-fund reserves beyond political interference. In some ways, this proposal is best understood as a proposal to professionalize the management of Social Security reserves, diversifying the trust fund's investments so American workers can get a better return and moving the management of reserves not held in Treasury bonds outside the political realm and beyond the reach of elected officials.

Legislation establishing these safeguards could, of course, be altered by a subsequent Congress. But so, for that matter, could the legislation establishing the independence of the Federal Reserve Board and the Federal Retirement Thrift Investment Board — and that has not occurred. If it is politically taboo for Congress to intrude upon the workings and decisions of the Fed, decisions that have far greater economic consequence than those this new board would make in selecting private investment managers, it would likely be even more taboo for Congress to interfere with the professional management of the Social Security pension reserves of nearly 150 million workers and retirees. (A recent *Washington Post* article by Brookings Institution senior fellows Henry Aaron and Robert Reischauer explores these issues further. The article is reprinted at the end of this analysis on page 14.)

Would investing Social Security reserves in equities pose large risks for beneficiaries?

Suppose the stock market fell sharply and remained down for a number of years. If part of Social Security had been replaced by individual accounts, such a development would likely depress the retirement incomes of millions of workers. It should, however, have little effect on retirement income under the Administration's proposal.

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The Social Security actuaries estimate that even after Social Security stops running annual surpluses, payroll tax revenues will remain sufficient to finance 70 percent to 75 percent of promised benefits. (This percentage will rise if, as the Administration has proposed, additional Social Security changes are made on a bipartisan basis so Social Security solvency is restored for the next 75 years.) Under the Administration's proposal, the Social Security system would retain the substantial majority of its reserves in Treasury bonds. These bond holdings would equal the full cost of several years of Social Security benefits. Between the ongoing revenue from payroll taxes, the interest and dividends earned on bonds and equities, and the revenue from redeeming bonds, the Social Security system would be able to ride out an extended stock market downturn without having to sell off stocks when stock prices were down. The trust fund would not need to cash in stocks during those periods, since it could finance benefits through payroll tax revenues and the redemption of Treasury bonds.[5]

This is precisely the result that corporate and public-employee pension funds seek by diversifying their assets. They place a portion of their portfolios in equities to take advantage of the higher rate of return that stocks provide over the long term, while placing other portions of their

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portfolios in investments that do not fluctuate in the manner that equities do. This generally enables these pension funds to avoid liquidating stock holdings during "bear markets."

The Administration proposal is quite cautious in this regard, involving very modest holding of equities. When the proposal was fully in effect, 14.6 percent of Social Security reserves — about one dollar in every seven in the reserves — would be invested in equities. By contrast, state and local public employee pension funds invest more than 60 percent of their assets in equities. Large corporate pension funds place more than 40 percent of their assets in equities. The Federal Reserve System's defined-benefit pension plan invests 65 of its assets in equities.[6]

To be sure, this approach is not without *any* risk. The stock market could fall sharply and not rebound for decades, although history suggests that is unlikely. Should that occur, modifications in the Social Security benefit and revenue structure would be needed. But the decisions concerning what modifications to make in the structure would be reached democratically through the actions of Congress and the President. Moreover, the burden could be spread broadly across generations and income strata to avoid drastic effects on individual retirees. By contrast, if part of Social Security is replaced with individual accounts and the market plunges and remains down, the effects on retiree incomes would be very uneven, with some individuals being hurt severely and likely subjected to poverty or near-poverty status for many or all of their elderly years.

How would returns compare to those that private accounts would provide?

The main argument advanced for converting part of Social Security to individual accounts is that such an approach would secure a higher rate of return. Investing a portion of Social Security reserves in equities also would secure this higher rate of return and would do so without exposing individual retirees and workers to the risks that individual accounts pose (and without risking the unraveling of the social insurance functions that Social Security provides, which are of particular value to lower-wage workers, widows, divorced women, and the disabled, among others).

In fact, as Brookings economists Robert Reischauer and Henry Aaron have shown, investing a portion of Social Security reserves in equities should yield a *higher* average rate of return than individual accounts. The administrative costs of managing 140 million to 150 million separate individual accounts would be much greater than the administrative costs of Social Security trust-fund investment. The higher administrative costs incurred under a system of individual accounts would eat up a larger portion of the investment earnings, yielding a smaller net return.

Assume that individual accounts would earn the average rate of return in the stock market. If a portion of Social Security reserves are invested in broad index funds, they, too, should earn the average market rate of return. The rate of return that determines the retirement benefits these investments actually can pay, however, is the *net* rate of return — the rate the market provides *minus* the amounts that administrative costs consume.

The Three Approaches to Securing Higher Returns Through Equity Investments

In recent months, three types of Social Security proposals have emerged for making investments in equities markets: 1) proposals to establish privately managed individual accounts; 2) proposals to establish individual accounts that have a limited number of investment choices and are centrally managed through a government-sponsored entity, patterned on the Thrift Savings Plan for federal employees; and 3) passive investment of a portion of Social Security reserves in broad index funds, as the Administration has proposed.

Privately managed individual accounts entail high administrative costs. The best evidence, reflected in the estimates of the Social Security Advisory Council, is that over a 40-year work career, administrative costs would consume an average of approximately 20 percent of the funds in such accounts. This percentage is likely to be higher for the smaller-than-average accounts that low- and moderate-income workers would have. Since some of the administrative costs are fixed and do not vary with the size of the account, these costs would tend to eat up a larger percentage of the funds in small accounts than of the assets in large accounts. Moreover, the 20-percent estimate reflects only the administrative costs and fees for managing these accounts. Converting the accounts to annuities when workers retire would entail additional costs; experts estimate those to average about 10 percent to 20 percent of the value of the accounts. Thus, administrative and annuitization costs could eat up 30 percent to 40 percent of the amounts in these accounts.

To avoid such high costs and to limit investment choices (and thereby reduce risks to individuals somewhat), proposals such as the legislation that Senators Gregg and Breaux and Reps. Kolbe and Stenholm have introduced would establish a system of individual accounts patterned on those available to federal employees under the Thrift Savings Plan. The accounts established through the Thrift Savings Plan are centrally managed by the Federal Retirement Thrift Investment Board, a board of professional appointees nominated by the executive branch and approved by Congress. Federal employees are offered several investment choices, including a stock index fund; the Federal Retirement Thrift Investment Board takes the deposits designated for the stock index fund and contracts with private fund managers who invest these funds. The Gregg/Breaux Kolbe/Stenholm legislation would adopt this model, setting up an independent board that would hire private fund managers to invest the funds placed in the individual accounts the legislation would create.

This is essentially the same system for investing funds as would be used under the Administration's proposal to invest a portion of trust-fund reserves in equities. Any risks of political interference in the investment process consequently would be similar under the Administration proposal and this legislation.

This leads two conclusions. First, if one wants to incorporate investment in equities into the Social Security system, one can do so *without* central management of such investments only if one adopts the approach — privately managed individual accounts — which entails very high costs that substantially reduce the retirement income the accounts can provide. Such an approach also imposes greater risk on individuals.

Second, a system of centrally managed individual accounts would use the same type of institutional structure to make investments as the proposal to invest a portion of trust-fund reserves in equities. Because a system of centrally managed individual accounts would entail substantial administrative costs to maintain and service nearly 150 million separate accounts, this approach entails costs that, while much lower than those of privately managed individual accounts, still significantly exceed those of trust-fund investment. A system of centrally managed individual accounts also would place more risk on individual beneficiaries than trust-fund investment would.

Using the official estimates of the Social Security Advisory Council, the fees that stock mutual funds charge, and the experience of other countries with private-accounts systems, Aaron and Reischauer have demonstrated that under a system of privately managed individual accounts where individuals can select freely among different types of assets, the administrative costs of managing the accounts would consume an average of about 20 percent of the funds in the accounts.[7] By contrast, the administrative costs associated with investing a portion of Social Security reserves in equities markets are projected to consume *less than one percent* of the amounts invested.[8] The net rate of return should consequently be higher under trust-fund investment than under private accounts.[9]

Would trust-fund investment result in excessive trust fund ownership of companies?

If investment of a modest share of trust-fund reserves in equities is approved, the legislation authorizing this investment could establish a low percentage limit on the proportion of the overall equities market that the trust fund's investments are allowed to constitute. The legislation also could set a very low cap on the percentage of the shares of any individual firm that trust fund's investments can represent.

Under the Administration proposal, trust-fund investments would equal slightly less than four percent of the equities market.[10] This is less than half the 10-percent share of the market that state and local public employee pension funds hold (and is the same or slightly less than the share of the equities market that Fidelity holds). The investment of public-employee pension funds in the market has not disrupted market operations.

Moreover, the board overseeing these investments would apportion the resources to be invested among the private fund managers it selects. It is likely that no single fund manager would handle trust-fund investments exceeding one percent of the market. By comparison, the funds that Fidelity invests equal four percent of the markets, while the investments the 10 largest private-sector fund managers handle all exceed one percent of the market.[11]

The Voting of Shares

Under the Administration's proposal, the legislation authorizing trust-fund investment also would establish procedures to ensure the independent board had no ability to influence corporate decisions by exercising voting rights on shares the board holds. These voting rights would be "sterilized" so they have no effect on corporate decision-making.

This can be accomplished in any of several ways. The legislation could adopt the approach the Federal Retirement Trust Investment Board employs; that board assigns voting rights to the private fund managers it selects through competitive bidding and requires these managers to vote shares solely in the economic interests of the shareholders. No political criteria may enter into the voting decisions. Alternatively, the legislation authorizing trust-fund investment could assign voting rights on shares the Social Security trust fund holds to the private fund managers but require the shares of each company to be voted in the same proportions that all other shares of that company are voted, thereby nullifying or "sterilizing" the effect of the trust-fund voting rights. The legislation also could simply require that voting rights not be exercised.

Brookings economists Robert Reischauer and Henry Aaron have shown that investing a portion of Social Security reserves in equities should yield a higher average rate of return than individual accounts.

The same issues regarding voting rights would be encountered under the partial-privatization legislation that Senators Gregg and Breaux and

State and Local Pension Funds, Equity Investments, and Political Interference

"Using a very comprehensive definition, a 1993 study for Goldman Sachs reported that economically targeted investment totaled less than 2 percent of total state and local pension fund holdings. Data from a 1996 survey by the Government Financial Officers Association show no evidence that state and local pension plans are sacrificing returns. Similarly, most of the divestiture activity, which centered on firms doing business in South Africa, ended in 1994."

Testimony of Alicia H. Munnell,
Boston College, before the House Ways and Means Committee, January 21, 1999

From a recent *New York Times* report:

"State legislatures have occasionally ordered pension funds to abstain from certain investments — in companies doing business in South Africa during apartheid and, more recently, in tobacco companies. But most state pension funds with strong professional leadership have avoided interference by special interests, said Ian Lanoff, who ran the Labor Department's compliance program under ERISA, the Federal law governing private pensions, in the Carter Administration and who now specializes in pension law in Washington.

"He cited the refusal by New York City's pension funds to help bail the city out in its fiscal crisis in the mid-1970's and later refusal of Michigan public pension funds to help rescue the Chrysler Corporation. More recently, he said, the largest public pension funds have been largely successful in resisting efforts to ban investments in Northern Ireland and in companies involved in Holocaust reparations disputes.

"ERISA requires pension funds to base investment decision solely on the best interests of retirees, Mr. Lanoff said. Most states have taken ERISA principles and applied them to their own plans. Similar standards would help insulate a Social Security fund even further from political interference, he said."

"Social Security Investment Plan Raises a Debate," *New York Times*, January 23, 1999, p. 16

"...tobacco divestiture has been adopted by only two or three funds out of approximately 1,200 state and municipal government-managed trust funds."

Letter of Ian D. Lanoff,
Washington Post, February 8, 1999.

Reps. Kolbe and Stenholm have introduced. As noted earlier, their bill would establish an entity overseen by federal appointees and modeled on the Federal Retirement Thrift Investment Board to manage centrally the investment of hundreds of billions of dollars in individual accounts.

Would trust-fund investment cause a stock market bubble?

Another question that has been raised is whether the proposed trust-fund investment would pump so much money into equities markets that it would cause a stock-market bubble that could burst, injuring investors and the economy. This is highly unlikely.

Under the proposal, the investment of a portion of trust-fund reserves in equities markets would occur gradually over 15 years. Even at full implementation, the infusion of trust-fund reserves into equities markets would be small, totaling less than four percent of the market. Moreover, the amounts the trust fund would shift into the market each year would equal only about *one-quarter of one percent* of total market assets. This is a much smaller addition to the markets than private investors have been making in recent years and is much too small to cause serious market distortion. Treasury Secretary Robert Rubin has observed: "I think in terms of the impact on the market, [the trust fund investment] would really be of very little consequence compared to all else that's going on in the stock market in any given year."[12] Moreover, similar amounts would flow into equities markets under proposals to convert part of Social Security to individual accounts.

It also should be noted that to the extent federal policy decisions result in an increase in the amount of money flowing into equities markets, this will occur largely as a result of policies that boost national saving and pay down the debt held by the public, not because of trust-fund investment. Such policies would significantly increase the amount of private saving available for investment in equities. The effect that these policies would have on the amount of capital flowing into financial markets would be several times as large as the effect of investing a modest portion of trust-fund reserves in equities.

Would trust-fund investment cause the interest rates the federal government pays for Treasury bonds to rise substantially?

Another question that has been raised is whether investment of a modest portion of Social Security reserves in equities rather than Treasury bonds would cause the rates the federal government must pay for Treasury bonds to rise substantially. Here, also, the answer appears to be no.

If a portion of trust-fund reserves that otherwise would be used to purchase Treasury bonds is invested in equities instead, the Treasury would have to sell to private investors the bonds the trust fund otherwise would hold. The Treasury might need to offer somewhat higher interest rates than would otherwise be the case to attract these additional investors. The one significant study on this matter, however, estimates that if a portion of Social Security reserves are invested in equities, the interest rate the Treasury will have to pay for the bonds it issues will be only about one-tenth of a percentage point higher than would otherwise be the case.[13]

Moreover, the need to sell more Treasury bonds to private investors to replace bonds the Social Security trust funds otherwise would hold *also would occur under proposals to shift a portion of Social Security payroll tax revenues into individual accounts*. Under partial privatization approaches as well, the Social

Security trust fund would hold fewer Treasury bonds, causing the Treasury to have to sell more bonds to private investors.

Finally — and of no small importance — the Administration proposes to devote more than 60 percent of projected budget surpluses over the next 15 years to paying down the publicly held debt. As a result, the overall volume of bonds the Treasury would need to issue to investors would decline sharply even if a portion of trust-fund reserves are invested in equities. At the end of fiscal year 1998, debt held by the public equaled 44 percent of the Gross Domestic Product. The Office of Management and Budget and the Treasury project that under the Administration's proposals, including the trust-fund investment proposal, debt held by the public would fall to seven percent of GDP by 2014, which would be its lowest level in nearly a century (since 1917). Since the overall volume of Treasury bonds sold to investors would be much smaller than it is today, the real interest rates that the Treasury would have to pay to attract a sufficient number of investors to buy the bonds it offers would be lower than these rates are today.

(The fact that the interest rates the Treasury pays on its bonds will fall as the publicly held debt shrinks is another reason why it is important to permit the Social Security trust funds to diversify their investments. If the debt held by the public declines substantially and the interest rates the Treasury pays on bonds fall as a result, the interest rates the Social Security trust fund gets on the Treasury bonds it holds will decrease, reducing trust-fund income. Fairness should dictate that the Social Security trust funds be able to share in the economic gains the trust funds have made possible by making trust-fund reserves available to pay down the debt and boost national saving. At a minimum, the trust funds should not be injured by this economic progress. If the trust funds are permitted, however, to invest only in Treasury bonds — the yields for which are declining — Social Security beneficiaries will be injured and placed at a disadvantage relative to other investors.)

Investing a portion of trust-fund reserves in equities should have a positive effect on the federal budget.

Isn't the investment of a portion of trust-fund reserves in equity markets an "asset swap?"

Some, including Alan Greenspan, have pointed out that investing a portion of trust-fund reserves in equities does not benefit the overall economy since it would not increase national saving. The trust funds would receive higher rates of return from having a portion of their reserves invested in equities rather than lower-yielding Treasury bonds, but other investors would purchase the Treasury bonds the trust funds otherwise would have bought and secure modestly lower returns as a result. There consequently would be something of an "asset swap" — the trust funds would hold fewer Treasury bonds than would otherwise be the case, replacing a portion of them with equities, while other investors would hold somewhat fewer equities and more Treasury bonds than they otherwise would.

Although this point is correct, it often is misunderstood. *The same effect would occur if a portion of payroll tax revenues were shifted from the Social Security trust funds to individual accounts*. Since the trust funds would have fewer resources under these individual-accounts approaches, they would purchase fewer Treasury bonds. The Treasury would have to sell more bonds to other investors, who in turn would receive somewhat lower returns. The result, here also, would be an asset swap.

Thus, the fact that the investment of a portion of trust-fund reserves in equities would not itself boost the economy is not relevant to weighing the advantages and disadvantages of trust-fund investment versus other Social Security proposals. The trust-fund investment proposal is not designed to boost national saving; it is designed to provide average workers, who tend to have little in the way of other financial assets, an opportunity to secure better returns. Moreover, by boosting the income the trust funds earn on their revenues, the proposal seeks to reduce the magnitude of the Social Security benefit reductions or tax increases that otherwise would be needed to make Social Security solvent over the long term.

Various approaches to Social Security reform can result in a long-term boost to the economy. To promote long-term growth, a Social Security plan must increase national saving and decrease current consumption. This can be achieved under either privatization or trust-fund investment proposals *if* budget surpluses are used to reduce the debt the federal government owes to the public or to promote saving in other ways (such as through the Universal Saving Accounts the Administration has proposed). Similarly, reducing benefits or raising taxes — and saving the revenue that such actions produce — should boost the economy over the long term. Whether one invests a portion of trust-fund reserves in equities, uses them to establish individual accounts, or follows neither route is not what determines whether a Social Security plan promotes saving and generates somewhat stronger long-term growth.

What is the effect on the budget?

Investing a portion of trust-fund reserves in equities should have a positive effect on the federal budget. If the trust funds earn higher returns, they will receive more revenue. This added revenue would be secured without cutting other programs, raising taxes, or borrowing. As a result of the added revenue, either Social Security benefits would not have to be reduced as much over the long term as otherwise would be the case or other parts of the budget would not have to be squeezed as much (or taxes raised as much) to secure the added funds needed to avoid substantial Social Security benefit reductions.

A corporate or public-employee pension fund manager who invested solely in bonds and had no holdings in equities would probably be discharged.

Conclusion

Virtually all private pension funds and state and local public-employee pension funds diversify their investments, taking advantage of the higher long-term rates of return that equities markets provide. A corporate or public-employee pension fund manager who invested solely in bonds and had no holdings in equities would probably be discharged.

Social Security, the basic pension plan for most ordinary American workers, should not continue being barred from diversifying its portfolio on behalf of its millions of beneficiaries. Management of Social Security reserves should be modernized and strengthened by moving a portion of it out of the executive branch and under an independent, professional institution that is insulated from politics and follows the types of management and investment principles — including diversification of investments — that private-sector pension funds employ. Investing a modest share of Social Security reserves in equities would strengthen Social Security's financial position to the benefit of future generations and reduce the magnitude of the Social Security benefit reductions or tax increases otherwise needed.

Notes:

1. This analysis benefitted from the comments and ideas of Henry Aaron, Alicia Munnell, Peter Orszag, Kathryn Olson, Wendell Primus, and Ellen Nissenbaum.

2. Interview with Secretary Robert Rubin on Good Morning America, January 21, 1999.

3. See "Social Security Investment Plan Raises a Debate," *New York Times*, January 24, 1999, p. 16.

4. A stock market index is a measurement of the return on a particular group of stocks. For example, the Standard and Poor's 500 index measures the average performance of the stock of the 500 largest publicly traded corporations. One of the broadest indexes is the Wilshire 5000, which measures the average performance of virtually all publicly traded stocks; more than 7,000 firms are represented in this index. The Administration's proposal envisions use of a broad index such as the Wilshire 5000 rather than an index like the S&P 500 that covers only the largest companies.

   Under passive index investing, as is done by the managers the Federal Retirement Thrift Investment Board selects and as would occur under the Administration's Social Security proposal, a fund manager purchases and holds the shares of all firms included in a particular index. The fund manager may not delete firms included in the index or invest in firms not reflected in the index. The fund manager thus cannot pick and choose among companies for political or other reasons.

5. Some Congressional opponents of trust-fund investment have argued that the trust fund would have to sell off significant amounts of equities in years before 2055. This argument rests on a dubious assumption — that nothing would be done either now or in the decades to come to restore Social Security solvency, except for the Administration's proposed transfer of 62 percent of current surpluses to the trust fund and the investment of one-fifth of these transferred funds in equities. Under such an assumption, the nation would stand idly by and watch Social Security go insolvent in 2055 and would have to cash in all of the trust fund's equity holdings in the years before then in order to continue paying full benefits until 2055. The Administration's proposal is to couple the transfer of funds to Social Security with changes that would be worked out on a bipartisan basis to restore Social Security solvency for at least 75 years. So long as such additional measures are taken, the trust funds should not need to cash in substantial equity holdings in the years before 2055.

6. To gain a sense of how limited the risks from the Administration's proposal would be, consider the following. In 2030, Social Security payroll taxes will be financing about three-quarters of Social Security benefits. The other quarter of benefits must be financed from Social Security reserves. Since 85 percent of these reserves would be in bonds and 15 percent in equities, only about four percent of Social Security benefits would be financed by redeeming equities if the bonds and stocks the trust fund held were redeemed in equal proportions. (About 25 percent of the benefits would be financed by redeeming bonds and stocks. Some 15 percent of the trust fund's bond and stock holdings would be in stocks. Multiplying 15 percent by 25 percent equals about four percent of Social Security benefits.) Now suppose the stock market plunges, falling 30 percent. This would affect only about one percent of Social Security benefits, since a 30 percent loss in value for the four percent of benefits financed by redeeming equity holdings would equal a 1.2 percent loss in benefits overall (30 percent times four percent equals 1.2 percent). Moreover, even this modest reduction of about one percent of benefits could be avoided by holding on to equities and redeeming a modestly larger number of Treasury bonds instead during the stock-market downturn.

7. See Henry J. Aaron and Robert D. Reischauer, *Countdown to Reform: The Great Social Security Debate*, Century Foundation Press, 1998, pp. 85-88, and testimony of Henry J. Aaron before the Senate Budget Committee, July 23, 1998. See also statement by Peter Diamond, AARP Concord Coalition forum on Social Security, Albuquerque, July 27, 1998, and testimony of Peter Diamond before the Social Security Subcommittee of the House Ways and Means Committee, June 18, 1998. For a summary of this work, see Kilolo Kijakazi and Robert Greenstein, "How Would Various Social Security Reform Plans Affect Social Security Benefits?," Center on Budget and Policy Priorities, September 1998. The administrative-cost estimates cited here do not apply to individual accounts that are centrally managed and in which only a few types of investment choices are permitted, such as individual accounts patterned on those administered by the Thrift Savings Plan.

8. Under the Administration's proposal, the investment of a portion of trust fund reserves in equities would be handled in a manner similar to that which the Federal Thrift Savings Plan uses to make equity investments — through use of private fund managers and index funds. For every $100 in assets invested in equities, the TSP pays only about one cent per year in management fees; this amounts to an administrative cost of one-hundredth of one percent. Over a worker's 40-year work career, an annual charge on one hundredth of one percent would consume about two-tenths of one percent of the funds invested.

9. Henry Aaron stated this point succinctly in recent testimony. Aaron wrote: "The management of Social Security reserves would earn the average return generated by common stocks, which has exceeded that on bonds by an average of several percentage points per year. If individuals invested in common stocks, they too would earn the average return on common stocks. But their net return would be reduced by the sizeable administrative costs of managing more than 140 million mostly quite small individual accounts. By comparison, the administrative costs involved in managing investment of Trust Fund reserves in equities would be minuscule. Because administrative costs would be smaller, investment of part of the trust funds in equities would yield higher returns than individual accounts, while protecting beneficiaries from the risks they would bear under a system of individual accounts." Testimony of Henry J. Aaron, Senate Budget Committee, January 19, 1999.

10. The estimate made by the Social Security actuaries that the proposed trust-fund investments would equal slightly less than four percent of the equities market could prove to be a bit high. The actuaries conservatively assumed that the total size of the equities markets will grow in the future at the same rate as the Gross Domestic Product. If the size of the equities markets grows at a faster pace than GDP, the trust-fund investments would constitute a smaller share of the market than the actuaries have projected.

11. At the end of 1997, Fidelity held 3.95 percent of the U.S. equities market. See "America's Top 300 Money Managers," *Institutional Investor*, July 1998, p. 87.

12. Interview with Secretary Robert Rubin, Good Morning America, January 21, 1999.

13. Henning Bohn, "Social Security Reform and Financial Markets," in Steven Sass and Robert Triest, eds. *Social Security Reform: Links to Saving, Investment, and Growth*, Federal Reserve Bank of Boston, 1998.

1.This analysis benefitted from the comments and ideas of Henry Aaron, Alicia Munnell, Peter Orszag, Kathryn Olson, Wendell Primus, and Ellen Nissenbaum.

2.Interview with Secretary Robert Rubin on Good Morning America, January 21, 1999.

3.See "Social Security Investment Plan Raises a Debate," *New York Times*, January 24, 1999, p. 16.

4.A stock market index is a measurement of the return on a particular group of stocks. For example, the Standard and Poor's 500 index measures the average performance of the stock of the 500 largest publicly traded corporations. One of the broadest indexes is the Wilshire 5000, which measures the average performance of virtually all publicly traded stocks; more than 7,000 firms are represented in this index. The Administration's proposal envisions use of a broad index such as the Wilshire 5000 rather than an index like the S&P 500 that covers only the largest companies.

Under passive index investing, as is done by the managers the Federal Retirement Thrift Investment Board selects and as would occur under the Administration's Social Security proposal, a fund manager purchases and holds the shares of all firms included in a particular index. The fund manager may not delete firms included in the index or invest in firms not reflected in the index. The fund manager thus cannot pick and choose among companies for political or other reasons.

5.Some Congressional opponents of trust-fund investment have argued that the trust fund would have to sell off significant amounts of equities in years before 2055. This argument rests on a dubious assumption — that nothing would be done either now or in the decades to come to restore Social Security solvency, except for the Administration's proposed transfer of 62 percent of current surpluses to the trust fund and the investment of one-fifth of these transferred funds in equities. Under such an assumption, the nation would stand idly by and watch Social Security go insolvent in 2055 and would have to cash in all of the trust fund's equity holdings in the years before then in order to continue paying full benefits until 2055. The Administration's proposal is to couple the transfer of funds to Social Security with changes that would be worked out on a bipartisan basis to restore Social Security solvency for at least 75 years. So long as such additional measures are taken, the trust funds should not need to cash in substantial equity holdings in the years before 2055.

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