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Should Social Security Invest In The Stock Market?

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The Wall Street Journal features an online debate on whether the Social Security trust funds – which currently hold only special-issue government bonds – should instead seek out higher returns by investing in stocks. On the Pro side is Boston College economist Alicia Munnell, director of the Center for Retirement Research; arguing Con is Michael Tanner, a senior fellow at the Cato Institute (and, full disclosure, my former boss from when I worked at Cato in the early 2000s).

They both make some solid points. But it's a short piece. And, inevitably, the points they make aren't precisely those that I'd make. So here are a few extra thoughts on investing the Social Security trust funds that I think add something to the debate.

State and local pensions have a hard time investing in risky assets. For Social Security, it would be even harder. Most defined benefit pension plans – including both private sector pensions and state and local government employee pensions – calculate their annual required contributions based on a formula that accounts for the ups and downs of their investments. If the pension's investments fall in value, then contributions in following years will have to be higher. That's been a problem for state and local governments because they can't meet the required payments. Even today, eight years past the end of the Great Recession, nearly half of state and local pensions don't receive their full annual contribution.

But for Social Security it could be even worse, because – unlike most other traditional pensions – there's no automatic balancing for Social Security financing. Social Security has been underfunded since the mid-1980s and Congress has done precisely nothing to fix the problem. And there's nothing in the law that requires Congress to act. Investing the trust fund in stocks would add more volatility to Social Security's finances, but with no requirement that Congress act to address that volatility.

In fact, stock investment could make Congress's procrastination even worse: Congress current doesn't act on reform, even while *knowing* that nothing will change the demographics that are driving Social Security's insolvency. But investing the trust fund in stocks could give Congress the *hope* that high returns could rescue the plan, thereby creating another incentive not to act.

Social Security investment in stocks is designed to avoid making tough choices today. In the *Journal*, Munnell states: "No one wants to create the impression that Social Security selling a $100 bond and buying a $100 stock would automatically improve the program's finances. So the accounting must be done on a risk-adjusted basis, with gains reflected only after they occur." I'll disagree slightly: with the exception of Munnell, pretty much *everyone* who favors trust fund investment creates the impression that holding stocks would automatically improve Social Security's finances. In fact, I've never seen a reform plan that includes trust fund investment that doesn't do precisely what Munnell says no one wants to do.

What Munnell herself proposes is sensible: fix Social Security with a combination of tax increases or benefit cuts and then invest part of the trust funds in stocks. If stocks produce higher returns than bonds, we then credit those gains to the trust funds and Social Security's finances will improve. Presumably we can then either lower tax rates or raise benefits.

But I've never seen an actual plan that treats Social Security investment in stocks this way. Every real reform plan I've seen uses the higher expected returns on stocks as a way to *avoid* either tax increases or benefit cuts. That avoidance takes place by assuming that stocks produce a high return each and every year while ignoring risk. Say, the 2014 version of Rep. John Larson's Social Security reform plan would have invested 25% of the trust funds in stocks. The plan then raises taxes to fill the rest of the 75-year funding deficit. What happens if stocks don't produce the expected rate of return? Social Security is no longer solvent.

We could get the same stock market exposure much more simply. Tanner raises the danger that government ownership of company stocks could become politicized, with Social Security choosing its investments based on criteria other than whether the stocks produce good returns for the taxpayer. This concern seems legit: let's face it, in today's America *everything* is politicized. Do you think Donald Trump would wish to invest the Trust Fund outside of the U.S.? Would Democrats want to invest in companies that worsen global warming? Would Congressmen insert riders into legislation to favor local companies? We can't say for certain that they'd succeed; maybe the center would hold. But I'm pretty sure they'd try.

But if we want Social Security to have some exposure to stock market risk and return, we could simply fund Social Security using capital gains taxes. If the stock market goes up Social Security gets more money; when the stock market falls, Social Security gets less money. Boom, done. If we added a capital gains tax on top of the existing payroll tax, that would be like raising taxes to buy stocks for Social Security. If we substituted a capital gains tax for part of the existing payroll tax, that would be like proposals to borrow money to invest in stocks. Either way, we can achieve the goals of higher risk and higher returns without actually having Social Security purchase stocks.

For most Americans, there isn't much point in Social Security holding stocks. A small number of Americans rely almost totally on Social Security in retirement. An even smaller number of retirees are so rich that they'll rely almost totally on their own investments. But the rest of us will have a mix of Social Security and investment income in retirement. Social

Security is safe but pays a low return, like a bond; investments in 401(k)s and other retirement accounts tend to have higher risk but pay higher returns. Most people can have the mix of risk and return they want simply by altering how much of their 401(k) they invest in stocks. If Social Security shifts from stocks to bonds, it will have more risk and a higher expected return. Say, in expectation the trust funds will last longer, but there's also a bigger chance that they'll run out in the short term.

How would most people react to rising Social Security risk? Probably by reducing the risk of their non-Social Security investments, say by shifting their 401(k) portfolio from stocks toward bonds. If we assume that they're already taking the amount of risk they want to take, then this is what you'd expect. The end result is that most people won't be any better or worse off than they'd otherwise be. Investing Social Security in stocks doesn't by itself create any new wealth or new income. It shifts part of Americans' holdings of stocks from households to the government, and in turn would leave households holding fewer stocks and more bonds. There will be some distributional impact, in the sense that poor people without any personal savings would have some exposure to the stock market, which is probably a good thing. But overall, it's not that big a deal. And shifting our national investment portfolio around isn't something you'd immediately think of as a solution to the problems that population aging imposes on the Social Security program.

So what's the takeaway from these points? That investing the Social Security trust funds in the stock market isn't a top-tier reform solution. Maybe it wouldn't politicize investments, maybe it would. Maybe it would help a bit through higher returns, but maybe it would hurt by enabling Congress to avoid the real tough choices that need to be made. Overall, I think the biggest danger of trust fund investment isn't the financial risk or the chance that government will politicize its investments. It's that the prospect of higher investment returns enables the predictable Congressional habit of doing nothing on Social Security. By itself, that's a problem.