MarketWatch

Should the Social Security fund be invested in the stock market? It's complicated

Alicia H. Munnell and Michael D. Tanner

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There isn't a lot of common ground between the detractors and proponents of investing some of the Social Security trust fund's assets in stocks.

On the one side are those who can't believe anyone would even consider such an idea; on the other side are those who say the detractors are overreacting. After all, no one is proposing that 100% of the Social Security kitty be plowed into stocks, or used for day trading, they say.

What the two sides generally do agree on is that the Social Security trust fund needs shoring up: According to a trustees' report from last year, the fund is on track to run dry around the mid-2030s, at which point the program would be able to pay out only about 75% of promised benefits.

The idea of having the government invest some Social Security assets in stocks—which is separate from the "privatization" notion of allowing citizens themselves to do the investing—isn't new. In the 1990s, during a historic bull market, President Bill Clinton floated the idea, saying it could help the long-term solvency of Social Security. (He drew laughs at a public forum by conceding it would be a tough sell since Americans "believe the government could mess up a two-car parade.") He eventually dropped the idea.

President Bill Clinton floated the idea of investing some Social Security assets in stocks.

Nearly 20 years later, the trust fund still needs help. And the debate over what to do remains as contentious as ever.

Alicia H. Munnell, director of the Center for Retirement Research at Boston College, argues that it would reduce the need for benefit cuts or tax increases. Michael D. Tanner of the Cato Institute says the government should stay out of the stock market.

YES: It should reduce the need for benefit cuts or tax increases

By Alicia H. Munnell

Investing some of the Social Security trust fund in stocks would likely increase investment returns, improve the program's long-term financial outlook and reduce the need for benefit cuts or tax increases. Nevertheless, the proposal makes some people crazy. Here's why it shouldn't:

Starting with defense

First, no one thinks that investing in stocks is a free lunch. Stocks are riskier than bonds, so shifting some Social Security assets from low-risk, low-return Treasury bonds to high-risk, high-expected-return stocks would expose the program to greater financial risk. This risk, however, has to be balanced against the likelihood of a larger trust fund and thereby less need for benefit cuts or tax increases to shore it up down the road. Economists also make a theoretical argument that the plan would especially benefit the young—who haven't yet accumulated much financial wealth—by enabling them to invest in high-yielding financial assets without direct exposure to market risk.

*Social Security's current trust fund is rapidly declining, which means that it wouldn't matter much what it was invested in.*Alicia H. Munnell, director of the Center for Retirement Research at Boston College

Second, no one wants the Social Security trust fund to control the stock market. Even if the entire trust fund was plowed into stocks, it would account for only a fraction of the market. And that isn't even what's being proposed. Those pushing to diversify Social Security's holdings have called for investing only a portion of the trust fund in stocks. The typical proposal would increase the percentage of the trust fund invested in stocks by 2 to 3 percentage points annually until stocks accounted for 40% of total Social Security assets.

Third, no one wants members of Congress lobbying Social Security to buy shares of companies in their districts. That's why proponents of stock investing suggest such investments track a broad market index such as the Wilshire 5000, W5000, -0.46%Russell 2000 RUT, -0.59% or S&P Composite 1500. SP1500, -0.49% In terms of corporate governance, the voting rights associated with trust-fund shares could be handled in one of three ways: not voted at all, voted in a pattern that reflects the votes of other common shareholders, or delegated to the individual portfolio managers, which is the practice of the federal government's Thrift Savings Plan.

Finally, 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.

Moving to offense

OK, that's enough defense. So what do we know about how stock investment would have affected Social Security's finances historically and how it would likely contribute prospectively?

Historically, the answer is easy. Whether stock investment had started in the early 1980s or late 1990s, trust-fund assets would be significantly higher than they currently are, despite the bursting of the dot-com bubble in 2000 and the financial crisis in 2008.

Looking forward requires a little work, as detailed in a recent paper I co-authored.

First, Social Security's current trust fund is rapidly declining, which means that it wouldn't matter much what it was invested in. So the assumption is that the government raises taxes enough to eliminate the long-term deficit and invests a portion of the emerging trust fund in stocks. The second assumption is that stock returns going forward will average 6.8% annually rather than the historical 9.5%. Based on these assumptions, the 50th percentile of 10,000 simulations shows that, after 75 years, a portfolio with stocks produces a healthy ratio of trust-fund assets to benefits, while a trust fund invested all in bonds is exhausted. Even at the 25th percentile, the trust fund shows no evidence of running out of money.

Moreover, the research shows that Social Security investing in stocks is unlikely to disrupt the market. If Social Security had begun investing in equities in the early 1980s, the trust fund today would hold about 4% of the market value of U.S. equities. The simulations going forward suggest that stake would decline slowly to less than 2% as stock-market growth outpaces growth in the trust fund, which also holds bonds. As a point of comparison, state and local government pension plans currently hold about 6% of total stocks. Social Security wouldn't take over the stock market!

In short, policy makers should include investing Social Security's assets in equities on their list of options when constructing a comprehensive package to restore long-run balance to the program.

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NO: Let's keep the government out of the stock market

By Michael D. Tanner

There is no question that Social Security needs reform. With more than $32 trillion in unfunded liabilities over an infinite horizon, Social Security quite simply cannot pay future promised benefits with existing taxes.

Much of the program's problems stem from its pay-as-you-go nature, under which it is little more than a transfer payment from young to old, without any sort of investment. Transitioning to a funded system, where contributions were invested, makes sense.

*Investing even part of the trust fund in the stock market would allow the U.S. government to purchase if not a controlling then a commanding share of virtually every major company in America.*Michael D. Tanner, Cato Institute, Washington

Yet allowing the government itself to invest, either directly or indirectly, the roughly $2.9 trillion Social Security trust fund would be an enormous mistake.

First, it is hard to see how this would actually take place. The bonds in the Social Security trust fund aren't actual assets, but merely claims against future general revenues (that is part of Social Security's funding problem). To invest those funds in other assets, the Social Security Administration would first have to redeem those bonds for cash. With the U.S. running a deficit and already $20 trillion in debt, finding money to redeem the bonds likely would require either additional taxes or borrowing or both.

But even if a financial workaround could be found, the federal government should stay out of the stock market.

The total value of all stocks traded on the New York Stock Exchange is roughly $21 trillion, meaning the funds available from the trust fund would be about 14% of stock value. It is easy to see, therefore, that investing even part of the trust fund in the stock market would allow the U.S. government to purchase if not a controlling then a commanding share of virtually every major company in America.

Powerful influence

Even if the investment was done indirectly through an index, government decision makers would acquire property rights in corporate enterprises. Either they would exercise their rights, thus creating a direct political influence in the management of private enterprises, or they would give up the voting rights and other privileges, thus indirectly enhancing the power of existing shareholders.

In either case, ownership of the enterprises would be powerfully influenced by political agents, and the entire arrangement would be financed by the taxpayers.

With ownership comes control. What if a company whose stock is purchased by the Social Security trust fund decides to move its operations overseas? Would President Trump, or a future president, remain indifferent to the plight of the company's workers? Would he or she not be tempted to use the president's financial leverage? What about environmental concerns? Workers rights? Political contributions? What about companies that make adult movies, tobacco products or sugary soft drinks? The potential list of targets for government mischief is endless.

Would it make a difference if the government purchased existing index funds from a third party, such as an investment company?

Not really. Although the index fund would provide a layer of insulation between the government and companies whose stocks were purchased, the problems of control wouldn't be completely avoided. First, the government would acquire control over the index-fund manager itself and thus indirect control over the corporations. If index fund A controls the majority of shares in company B, and the government controls the management of fund A, the government can control the company.

Another way

Even if the government doesn't attempt to exercise corporate control, there is reason to be concerned about allowing index-fund managers to use taxpayer money to increase their ownership of corporate America.

In essence, it is being proposed that the federal government use tax money to pick corporate winners and losers. It is difficult to imagine a more egregious proposal for "corporate welfare."

Those who see stock investing as a potential cure for Social Security's woes aren't all wrong. It is true that private investment would earn substantially higher returns than the current pay-go system, even under conservative projections. However, there is a way to capture the rewards from those higher returns without the risks of getting government itself involved in the investment business.

Why not allow younger workers to invest for themselves a portion of their payroll taxes in personal accounts? Let's rely on consumer choice rather than top-down management.

Michael D. Tanner is a senior fellow at the libertarian Cato Institute in Washington and author of several books on public policy.