Social Security Trust Funds Should Invest in Equities

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Equity investing could improve federal budgeting, spread investment risk, and reduce reliance on the payroll tax

The more that I think about Social Security financing and the market risks associated with 401(k) investment, the more I think that the Social Security trust funds should invest some of their assets in equities. Such a strategy could 1) make it more difficult for Congress to use surpluses in Social Security to cover deficits in the rest of the budget; 2) allow people to hold risky assets in a place where gains and losses could be smoothed over time; and 3) reduce reliance on the payroll tax. The argument against such an approach is that government might interfere in private sector decisions. But that seems unlikely: U.S. public plans already hold considerable equity investments and Canada currently invests half of the assets in the Canada Pension Plan (CPP) in equities – neither arrangement appears to create any problem.

The time is approaching when Congress will have to find a solution to Social Security's 75-year deficit. The most likely strategy is to reduce benefits somewhat and to raise the payroll tax. That combination will produce a new round of trust fund buildup. The economic rationale for such a buildup is that it will increase national saving and investment so that when the time comes to pay benefits, the economy will be bigger than otherwise and the burden of the benefits relatively smaller. The problem is that if Congress uses the annual surpluses from Social Security to cover deficits in the rest of the budget, no real saving occurs.

Investing in equities could eliminate this temptation, because investment of trust fund assets in corporate equities would be considered an outlay. Under current practices, if Social Security generates a surplus of $100 billion and the rest of the budget generates a deficit of $150, the deficit is $50 billion. If Social Security were to invest its $100 billion in equities, this 'expenditure' would wipe out the program's surplus and the deficit would be $150 billion. Thus, equity investment would make it more difficult to use surpluses in Social Security to mask deficits in the rest of the budget.

The second advantage of investing the trust funds in equities is that it allows people to hold their risky assets in a place where gains and losses can be smoothed. People need to have some equities in their portfolios to achieve reasonable rates of asset accumulation. But holding equities directly exposes them to market risk. Placing equities in the trust funds would allow people to realize gains smoothly over time as higher returns reduce the need for payroll tax contributions. Of course, the risky side of equity investment requires government to create clearly defined procedures for allocating benefit cuts and tax increases over generations when returns are persistently lower than projections.

The third advantage of equity investment is that, if the expected returns materialized, reliance on the payroll tax could be reduced. This would free up an important revenue source for financing Medicare.

The major opposition to investing the trust funds in equities centers on concerns about government interference with the allocation of capital in the economy and with corporate activity. This does not seem like a serious problem. First, if solvency were restored immediately and half the trust fund balances were invested in equities, Social Security would never hold more than about 8 percent of total equities. This is well below the 11 percent share held by state and local pension plans – a level that does not seem to have raised any concerns. And Canada invests the CPP assets in private sector investments and that seems to be working smoothly.

In short, investing the Social Security trust funds in equities is at least worthy of a conversation.