Based on projections contained in the 1995 report of the trustees of Social Security, the Old-Age, Survivor’s, and Disability Insurance (OASDI) trust funds will fall below the “safety level” in the year 2030. As has been well publicized, the actuarial soundness of the Social Security system is threatened by a basic demographic-structural problem—namely, a secular rise in the ratio of social security recipients to wage earners or the “dependency ratio.” The dependency ratio was .29 in 1995 but is forecasted to rise to .50 by the year 2030, meaning that whereas today there are (approximately) three wage-earners paying into the system for every one beneficiary, the ratio falls to two to one by 2030. Social Security is probably the most popular federal program in the U.S. (not to mention our most effective anti-poverty strategy). The problem for reformers is this: How can the system be placed once again on a sound actuarial basis without damaging the political support the program enjoys—particularly among younger and middle-age income earners?

The ratio of discounted social security benefits to discounted taxes paid (by both employers and the employee) is what economists call the “money’s worth ratio” since it provides a measure of whether the program is worth participating in (for middle-income persons—meaning, average career earnings of $25,000 per year measured in 1995 dollars—retiring today, the ratio is 0.80). Restoring balance to the Social Security system while maintaining money’s worth ratios for younger cohorts is especially problematic. With respect to the former objective, raising the payroll tax is one potential solution. Another option is to index the Normal Retirement Age (now 65, but rising to 67 for the cohort reaching age 62 in 2022) to life expectancy, a policy recently adopted by Sweden. Unfortunately, both of these options would likely result in a long-run decrease in the money’s worth ratio for individuals in middle and upper income brackets.

A proposal that may be gaining support entails allocating some proportion of OASDI trust funds for investment in private bonds and equities (as things currently stand, the funds are allocated solely in Treasury debt). The historical record reveals that the return to investment in private securities is higher than the return to investment in public securities. Moreover, the conventional view of analysts that the stock market is the place to be for long term investor is borne out by past performance—stocks have outperformed
bonds in every 22-year interval during this century. A simple example can illustrate the advantages which might derive from expanding the range of assets which are held in federal trust funds. Suppose that $50 billion in Social Security trust funds previously held in federal government bonds with a yield of 6.7 percent were allocated for the purchase of high-grade corporate bonds with a yield of 7.1 percent. Though at first blush the yield differential appears small (if not negligible), over a period of 15 years the cumulative premium to investing in private bonds would be equal to (approximately) $8.4 billion. The same $50 billion invested in equities with a total annual return of 8.5 percent would produce a cumulative premium over government bonds of nearly $34 billion over 15 years—which would reduce the tax revenues required to keep the system sound by an equivalent amount. No wonder so many economists and politicians have become enamored of this idea. After all, shouldn’t federal trust funds realize a long-run rate of return which is comparable to that of university endowments, private pension funds, or even the California State Employees Retirement System (Calpers)? Though the arguments in favor of investing OASDI trust funds in private securities are persuasive, there are several possible drawbacks that policy makers will have to consider. First of all, the past does not always provide an accurate guide to the future. That is to say that there is no guarantee that the private security premium will hold up in future decades. Second, Treasury issues have the advantage of being a “safe” investment since they are backed by the full faith and credit of the U.S. government. In fact, the equity premium is a measure of the compensation that wealth-holders require to hold comparatively riskier portfolio assets.

Would the policy outlined above be tantamount to playing a game of roulette with the retirement funds of workers, many of whom are counting on Social Security as their primary source of retirement income? Wall Street professionals and finance professors say no. They argue that it is possible to have a “conservative” portfolio with a substantial position in private securities—so long as the portfolio is well diversified. Legislation permitting OASDI trust funds to hold private securities would, at the stroke of the pen, make the federal government the single largest “player” on Wall Street—with upwards of $1 trillion available to allocate among a bewildering array of financial assets.

Should Social Security trustees be in the business of picking stock market winners? Economists are fearful of Beltway politicization of the investment process and its potentially undesirable consequences for resource allocation. They argue that Social Security should be, like many private individuals and institutions who retain a third party (or trustee) to manage their portfolios, a “passive” investor. Options presently under review include the hiring of a private money management firm or the investment of OASDI monies in stock index mutual funds.