Testimony by Alicia H. Munnell

Chairman Grassley, Senator Breaux, members of the Committee, I am delighted to have the opportunity to appear before you today to discuss the important topic of the impact of stock market investment on the Social Security program.

As you know, all three groups on the Social Security Advisory Council proposed investing a portion of Social Security funds in equities, albeit through quite different mechanisms. Thus, the question seems not to be whether it is desirable for government-mandated retirement saving to be invested in equities but rather whether this should occur under the auspices of the current defined-benefit Social Security system, or in the context of one of the individual account arrangements.

It is important to keep in mind that this is not a debate over whether or not to prefund Social Security obligations. All three Advisory Council plans involve a substantial buildup of reserves. How much to prefund is an important question. It raises tough issues of how heavily to burden this generation in order to improve the welfare of future generations. Undoubtedly eliminating Social Security's financing gap will produce some prefunding. But that is not the topic for today's hearing. The question today assumes some prefunding and a desire to invest in equities and asks if this is better done in the central Social Security trust funds or in individual accounts.

My conclusions are as follows:

1. Investing some portion of Social Security in equities is a good idea.

- It allows the young and those with little wealth to have access to the higher returns afforded by a diversified portfolio.

- By spreading risk more widely, it increases the efficiency of capital markets and reduces the risk premium.

2. Equity investment through mandatory IRA-type accounts puts retirement income at risk, would be very costly, and may well not be technically feasible.

- The significant investment risk associated with equities would make retirement income very uncertain, dependent on when individuals buy and sell their stocks.

- Mandatory IRA-type accounts would be extremely costly. The lowest estimate is 100 basis points per year, which reduces total accumulations over a 40-year work-life by 20 percent. Data from the United Kingdom and Chile suggest that costs could be even higher.

- Account holders would inevitably pressure Congress for access to these accounts for worthy purposes such as medical expenses, education etc., leaving retirees with inadequate retirement income.

- In the absence of mandatory annuitization, individuals risk outliving their retirement reserves or living unnecessarily frugal lives in order to conserve their resources.

3. Equity investment through 401(k) or Thrift Savings Plan approach buys you nothing and raises costs.

- For those concerned about government involvement, this approach requires that the government designate appropriate equity funds and retain control of investments.

- This approach would double the cost of the current Social Security system.

- This approach introduces the political risk that individuals will get access to their funds before retirement and end up with inadequate retirement income.

- This approach introduces unpredictability into retirement income and reduces disability benefits.

4. Investing in equities through the Social Security trust funds is the most sensible strategy.

- Keeping investments together and maintaining a defined benefit structure enable the system to spread risks across the population and over generations, ensuring predictable retirement incomes.

- Pooling investments and eliminating individual choice keeps transaction and reporting costs to a minimum, ensuring higher net returns on equity investments than individual accounts.

- Setting up independent investment board, investing in a broad index, and delegating voting rights to fund managers should avoid any interference with private sector activity.

Let me explain my reasoning behind these conclusions.

I. The Case for Investing Social Security Trust Funds in Equities

Let me make clear from the outset that the case for investing the trust fund in equities does not rest on the claim that such a portfolio shift would increase saving or investment in the economy as a whole. To a first approximation higher returns in Social Security would be offset by lower returns in the rest of the economy. If all we are talking about is a portfolio shift, then you might ask, "Why bother?"

The reason that all three groups of the Social Security Advisory Council recommended equity investment is that they were caught in a dilemma. They were faced with a system that had drifted out of long-run balance. They were also faced with the fact that many younger workers and workers in future generations would receive low or even negative returns on their Social Security. They quickly recognized that any move to close the financing gap by raising taxes or cutting benefits would only worsen the rate-of-return calculations. The solution to which all three groups resorted, in one form or another, was to find a new source of revenue. That new source was the higher expected return on equity investment.

In my view, allowing government-mandated retirement saving to be invested in equities is a good idea. Many young people and others with little wealth are not particularly risk averse, but they have no mechanism for taking advantage of higher-risk/higher-return equity investment. Those covered by private pension plans and state and local pensions have their contributions invested in balanced portfolio that includes a significant equity component. But more than half the work force, primarily the lower paid, are not covered by supplementary pensions and therefore do not have access to equity investment. The Social Security program is the only place where they can earn the higher returns. Broadening Social Security's investments to include equities would provide participants with a more appropriate portfolio and allow them to earn higher returns on their contributions.

From an economist's perspective, spreading the risk associated with equities more widely, by adding low-income and young workers to the risk bearing pool, also has beneficial implications for the economy. Spreading a given amount of risk among more people increases the efficiency of capital markets and lowers the risk premium. If borrowers can borrow at lower rates, they will be more willing to undertake risky investments.

While the economics argue clearly for a diversified portfolio for Social Security, the question is whether this is better accomplished through the central trust funds or individual accounts.

II. How Would Individuals Fare Under Different Mechanisms For Investing In Equities?

To answer this questions requires considering how individuals would be affected by risks under alternative arrangements, how much would different approaches cost, and how would people protect themselves against outliving their resources.

Risk Bearing

With regard to risk, it is useful to think of two types of risk that individuals face in their retirement investments. The first is market risk, which includes both risk of return during the accumulation phase and interest rate risk associated with the purchase of an annuity. Many people have done simulations showing how unpredictable people's retirement incomes will be if their benefits reflect their individual investment decisions. One study by Gary Burtless of the Brookings Institution showed that benefits could vary from 20 percent of pre-retirement earnings to 100 percent of pre-retirement earnings depending on when individuals retired. Attempting to eliminate this variation would require constant tinkering with contribution rates.

Under Social Security's defined benefit plan, even if the aggregate trust funds were invested in equities, individuals could avoid most of the risk. They do not have to cash out their holdings at any particular time and they would receive a defined benefit under the program. If the market were down temporarily relative to expectations, the trust fund and investment earnings would be low. But the Social Security trust funds would be quite large by that time and even a substantial--but temporary drop--in the stock market should not require a benefit cut or tax increase. In other words, the government should be in a good position to weather fluctuations by either using some trust fund reserves or borrowing temporarily.

The discussion so far has assumed that equities continue to earn a real return of roughly 7 percent and has focused on the implications of variations around that mean. The second type of risk could be called "equity premium risk"--that is stock market returns turn out to be lower than those experienced in the past. This is quite possible. But the issue is whether such a decline would be more disruptive if equities were held in separate accounts or in the trust funds. In both cases income would be inadequate to finance future benefits; the question is who would bear the residual risk. As constructed, individuals under the individual account proposals would simply have to live with lower benefits. In contrast, the implication of retaining the current system is that younger workers would be required to pay higher taxes. In all likelihood neither extreme would emerge in the political process. The pure market outcome under the individual arrangements would probably be mitigated by some taxpayer contributions to bolster benefit levels; the defined benefit commitment would probably be modified by dividing the shortfall between beneficiaries and workers. No one has the answer to how the economy would respond if the equity premium declined, and it is unclear whether the possibility of a decline argues for individual or collective arrangements.

Transaction Costs

A second factor that requires careful consideration when assessing alternative ways to invest in equities is transaction costs. The Advisory Council estimates that a truly individual approach would cost 100 basis points per year. A 100-basis point annual charge reduces total accumulations and benefits by roughly 20 percent over a 40-year work life. The 100-basis-point estimate includes the cost of marketing, tracking, and maintaining the account but does not include brokerage fees. If the individual does not select an index fund, then transaction costs may be twice as high. Indeed, costs actually experienced in Chile and the United Kingdom, both of which have systems of individual accounts, have been considerably higher than the Advisory Council estimate. The comparable cost for investing in equities through the trust fund is estimated to be 1 basis point a year. This would reduce asset accumulations and benefits by less than 1 percent.

The Issue of Annuities

The third factor to consider when deciding to invest in equities through the central trust funds is the question of transforming accumulated reserves into annuities. Without such a transformation, individuals stand a good chance of out living their savings. But costs are high in the private annuity market, because of adverse selection: people who think that they will live for a long time purchase annuities, whereas those with, say, a serious illness keep their cash. Moreover, the private annuity market would have a hard time providing inflation adjusted benefits. In contrast, by keeping everyone together and forcing them to convert their funds to annuity, social security gets around the problem of adverse selection and is in a good position to provide inflation-adjusted benefits.

Putting together market risk, transaction costs, and annuity considerations suggests that individuals would almost certainly fare better if equities were held centrally in the Social Security trust funds than if they were held in individual accounts.

III. Is Investing through the Social Security Trust Funds Feasible?

Feasibility involves two issues: the impact of trust fund accumulations on financial markets and the potential impact of large trust fund investments on the business sector.

Impact on Financial Markets

The starting point for answering that question is to determine whether the investment of Social Security in equities would overwhelm and destabilize the market. For example, if the trust funds were going to hold 50 percent or more of all equities, this would eliminate the need for further analysis. On the other hand, if the magnitudes are manageable, then we need to address other issues.

The Social Security Administration actuaries present estimates of the build-up of equity holdings under each of the three Advisory Council plans. To determine the impact on capital markets requires estimating the growth rate of total equity holdings. If the real value of total equities grew at the rate it grew over the period 1952-95 (5 percent), and if 40 percent of Social Security trust fund assets were invested in equities as recommended under the Maintenance of Benefits plan, then Social Security trust fund holdings would equal roughly 5 percent of the total market in 2020. (The IA proposal would produce equity holding of 3 percent and the PSA plan holdings of 11.1 percent.) In other words, the total equity market is likely to grow fast enough to absorb without much disruption the build up of equity reserves in the trust funds.

Even if such an accumulation would not disrupt the markets, could it have a substantial effect on relative rates of return, perhaps driving up government borrowing costs? The portfolio restructuring should have some effect. The equity premium should decline to reflect the increased efficiency of risk bearing in the economy. Some movement would also be expected in interest rates. The one study that has estimated the effect on relative returns concluded that the shift to equities in the trust funds would lower the equity premium by 10 basis points and, and raise the interest on Treasury securities by roughly the same amount. With current levels of federal debt, this increase in Treasury rates should have a relatively small effect on the unified budget. As the economy grows and the debt declines, the effect should be negligible.

Impact on the Business Sector

But many people are concerned that Social Security investment in equities could lead to government interference with the allocation of capital in the economy and with corporate activity. At this point, it is important to emphasize that these concerns, to the extent that they are valid, should apply equally to the IA and MB proposal. Under the IA proposal the government would hold individual contributions in defined benefit accounts and designate a series of index equity funds for investment. Hence, questions about which stocks to include in the indexes, and how shares are to be voted are just as much issues for the individual account proposal as for the centrally managed approach.

Public pension funds provide a range of evidence regarding the desirability of allowing Social Security to invest in equities. Supporters point to the success of federal plans. The federal Thrift Savings Plan has established a highly efficient stock index fund. The plan also has steered clear of any issues of social investing--that is, investing in projects with less than market returns for a given level of risk. Divestiture of stocks for social or political reasons has also not been an important problem. It has addressed the concern about government control of private corporations by pushing proxy decisions down to the level of the individual portfolio managers.

Opponents point to state and local pension funds. Indeed one does see pressure from investment boards or states for state and local pension funds to undertake investments that serve other interests, often at a sacrifice in return. State and local funds have also been pressured to divest certain stocks in order to demonstrate that they do not support some perceived immoral or unethical behavior.

My view is that such pressures are less likely to occur at the federal level. Much of state-local plan activity is conducted in relative secrecy, while Social Security investments would be subjected to much public scrutiny. In any event, any loss in return, undesirable as it may be, would probably be trivial compared to the savings in transaction accounts of administering a single fund as opposed to roughly 200 million individual accounts. Nevertheless the issues of social investing and corporate governance are the major arguments that can be used against investment in equities and they have raised considerable concern.

IV. How Would Social Security Investment Affect the Federal Budget?

One final note on how investment in equities would affect the federal budget. Under current budget rules, investment of trust fund assets in equities would be considered an outlay. This has two implications. First, it would reduce the reported federal surplus. The economic implications would be very different, of course, than a comparable reduction occurring as a result of a tax cut or spending increase. But reducing the reported surplus would be a mechanism to remove the temptation to spend the surpluses.

The second implication is that investing in equities would force a separation of Social Security from the rest of the budget. It would make it much harder for the government to mask the deficit in the non-social-security portion of the budget. This is crucial for the assumption made at the beginning of these remarks--namely, that prefunding can be accomplished equally well through the Social Security trust funds and individual accounts. Only by reporting the deficit for the non-social-security portion of the budget separately and focusing the political debate on that number can we expect the trust funds to accumulate assets in a manner that could increase national savings. Investing the trust funds in equities would be very useful in this regard.

V. Conclusion

Let me conclude. Investing the trust funds in equities appears to be a feasible strategy. It is also desirable on economic grounds. It would improve the distribution of risk bearing in the economy. It would enhance support for the Social Security program. It is true that higher returns for Social Security would result in lower returns elsewhere in the economy. But raising returns in Social Security and lowering them in private pension plans has significant distributional implications. Social Security provides proportionately higher benefits to low-wage workers, most of whom have no private pension coverage.

The other very important economic consideration is transaction costs. Estimates from the U.S., Chile, and U.K. suggest that pure individual accounts could reduce total accumulations by 20 percent. The comparable figure for trust fund investment in equities would be less than 1 percent. These numbers dwarf any estimated losses that might arise from accepting less than market returns, if some form of social investing should occur.

Although concern about government interference in private sector could probably be addressed through a careful structuring of the investment arrangements, this concern remains the major source of opposition to trust fund investment in equities.

On balance, my view is that investing the trust funds in equities is desirable on economic grounds and merits serious consideration.

The more important argument for investing Social Security reserves in equities is that it would level the playing field for Social Security vis-a-vis other retirement programs. It would allow a higher payoff on people's basic pension contribution. This is not an issue of public relations. Disadvantaging Social Security in the arena of public opinion can end up hurting low-wage workers. These are the workers who benefit from Social Security's benefit progressive structure and who are generally not covered by private pension arrangements. If the role of Social Security's progressive defined benefit plan were diminished, the retirement income of many low-wage workers would be put at risk.