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Social Security Trust Funds - Presentation at AEA session: In Memoriam: Robert Eisner  
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Bob Eisner ended his book on Social Security (Social Security: More, Not Less) with these words:

“Our Social Security system ain’t broke. There is no excuse for emasculating it in the guise of fixing it. And there is certainly no justification for socking the elderly. They should be helped. Old age is hard enough.”

I agree with Bob that it is important to fix and strengthen Social Security, and it is far better to preserve its current overall structure than to move, in part or in whole, to a defined contribution mode. Where I found myself disagreeing with Bob, before his book and in it, was in his approach to thinking about the Trust Funds.<sup>1</sup> In the book, he wrote:

“... the prospective “shortage” in the Social Security Trust Funds is an accounting matter. It can be eliminated by any one of a number of simple and reasonable changes in accounting. ... As long as the payroll tax rates and the schedules of benefits remained the same, it would make no economic difference if the separate Trust Funds accounts were eliminated.”

He did recognize some relevance in the politics of the Trust Funds, albeit somewhat grudgingly:

“Some argue that it would make a political difference, that benefits are somehow more secure if they are charged to these special accounts ... Since much of the public probably believes this and would be alarmed if the special accounts were eliminated, it is best to keep them. And it is best to continue to finance them with clearly earmarked taxes.

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<sup>1</sup> There are separate OASI and DI trust funds, although Congress generally treats them as if they were one.

There is no reason, though, to restrict them to the proceeds from the current 12.4 percent payroll tax.”

He went on to propose restoring actuarial balance by dedicating other tax revenues to Social Security and/or crediting the Trust Funds balances with a higher rate of interest. He concluded this section with:

“Since the Trust Funds accounts must apparently be maintained for political reasons and in the interest of public confidence, it would be useful to adopt one or several of the measures just indicated to keep the account “solvent” into the indefinite future. But any forecasts of future shortfalls in these accounts are in no way a justification and should not be an excuse for either reducing benefits or raising taxes.”

Today, I want to begin with a brief consideration of Bob’s apparent view that the Trust Funds don’t matter except because of public misunderstanding. Then I will discuss two questions about the Trust Funds that are important in framing the issues in Social Security reform. What difference has it made for national savings that the 1983 legislation generated a period of annual cash flow surpluses, and so a steadily rising total Trust Fund? What difference would it make in the future if part of the Trust Funds were invested in stocks and corporate bonds?

### **I. Are the Trust Funds merely accounting entities?**

As a matter of positive political economy, a view that "the Trust Funds are merely accounting entities" is surely wrong. The reported values in the Trust Funds have a profound effect on legislated outcomes, and it was the intent of the founders to have it so. The purpose of earmarking revenues for a program is precisely to change the political economy of future legislation about the program. While Trust Funds are not protected by the Constitution, and no asset is protected from increased taxation, the Trust Funds are protected by the political interests of those affected by the program. For example, the evolution of the highway trust fund, financed by a gasoline tax, seems to have eventually

resulted in larger expenditures on highways, although some of the revenues were diverted to other transportation spending when the highway needs were not so great and the political clout of the beneficiaries was limited. Social Security is different now on both counts. Putting general revenues into the Trust Funds, for example, by crediting a larger interest rate on the debt outstanding, will likely change future taxes and/or benefits. To claim the Trust Funds don't matter is tantamount to claiming that some rational agent is a political dictator. As long as we have a political process (which we know can not satisfy rationality consistency conditions) then these decisions do matter - they affect future legislation. The legislative process has hysteresis – pure reversals of policy are usually hard to legislate (with the Medicare Catastrophe legislation being an interesting counterexample).

So I take the Trust Funds and their actuarial projections to be important players in determining political outcomes. And, based in part on current projections, I think that there is a case for legislating now both future tax increases and future benefit cuts relative to current law. That seems to me a route to a fairer intergenerational pattern of taxes and benefits as well as adequate benefits for an aging population. And, unless it is a way to head off a folly like a large income or estate tax cut, I would prefer to restrict earmarked revenues to the payroll tax. I suspect that part of my disagreements with Bob were a consequence not of different views on political economy, but on macroeconomics – his Keynesianism did not seem to include as much of the Samuelsonian neoclassical synthesis as mine does.

## **II. What difference has it made for national savings that the 1983 legislation generated a period of annual cash flow surpluses, and so a steadily rising total Trust Fund?**

A common analysis of the Social Security surpluses is that they did not increase national savings because the rest of the federal budget was in larger deficit than Social Security was in surplus. This is often worded as Social Security “financed the deficit.” This mode

of analysis is surely erroneous as a method, and, what is more, I think it is wrong in its conclusion.

In a mechanical sense Social Security financed part of the deficits. That is, there was a net cash flow to the Treasury as a consequence of the 1983 legislation, which can be called “financing the deficit.” More significant is that the cash flow financed the deficit in the sense that there was less borrowing from the public than if that cash flow were not present and neither taxes nor other spending changed. That is, to analyze the impact of any piece of legislation one needs to specify a counterfactual. If the correct counterfactual is that nothing else would have changed, then the Social Security surplus was fully saved within the federal budget (although it may have changed private savings). That is, the unified budget deficit was smaller than it would have been without the surpluses generated by the 1983 legislation. But implicit in the claim that the surplus was not saved is the reverse counterfactual – that the level of borrowing from the public would not have changed if the 1983 legislation had not generated a surplus. If this were the correct counterfactual, then the Social Security surplus generated an equal and opposite effect on the balance of the rest of the federal budget.

My reading of the attempts to grapple with the deficits in the 80’s and early 90’s is that there was enormous resistance to both increasing taxes and cutting spending, with the deficit the outcome of limits on the attempts to change these two variables. The exact size of the unified budget deficit (and the Social Security surplus was very small compared with the unified deficit) played little or no role in the budgets that actually passed. The fact that political discussion cited the unified deficit is not important; what is important is whether spending would have been less or taxes more if the unified deficit was a little larger because the Social Security surplus was not present. I think not, but one can not be sure.

Today, with a shift in the focus of popular discussion from the unified budget to non-Social Security budget balance (or, more precisely, the on-budget balance, which is slightly different), one might make the reverse inference that all of the surplus henceforth

will be saved. That too is too facile a conclusion, and one needs to model the budget process more carefully in order to have the counterfactual (or probability distribution of counterfactuals) that one most believes in. I am inclined to think that much, but probably not all of future Social Security surpluses would add to government savings. And I think that was true of the surpluses since 1983.

There is a similar logical error in the frequent assertion that the Trust Funds make no difference since using the assets in the Funds requires the government to raise that money in some other form. The argument is often presented roughly as follows:

When the baby-boomers retire, the government will use the assets in the Trust Funds to finance part of benefits. So the Treasury will have to change taxes or spending or borrowing from the public, just as it would if there were no Trust Funds buildup.

Therefore there would not be any difference made by the buildup of the Trust Funds.

Again, one can not analyze the future differences caused by Social Security without considering how large the Treasury debt in the hands of the public would be otherwise. If there were no Trust Funds buildup, and no change in other taxes and spending, then total borrowing from the public would be larger by the amount not built up in the Trust Funds. The increase in borrowing from the public at the time that benefits paid exceed revenues would be added to a higher level of debt. This would make a difference in the annual budget since a greater stock of debt implies a greater flow of interest costs. In OLG models there are real effects from debt that “we owe to ourselves” in terms of both capital accumulation and government budgetary constraints.

### **III. What difference would it make in the future if part of the Trust Funds were invested in stocks and corporate bonds?**

There are two contradictory responses to this question that one sees. Sometimes the irrelevance of the Trust Funds, discussed above, is related to the fact that the Trust Funds hold “only” Treasury debt – or, more colorfully, government IOU’s. This suggests that a change in portfolio would totally change the analysis since the assets would be “real,” not

“mere IOU’s.” On the other hand, some see little effect from Trust Fund portfolio diversification since a change in portfolio, given the level of cash flow surplus, is “merely an asset swap.”

A setting in which there is no effect from a change in portfolio is that of a representative agent OLG model when Social Security works as a defined contribution system. (Or an infinitely lived representative agent model where even the intergenerational risk sharing of a defined benefit system does not matter.) In this setting, anything done by Social Security for the representative agent is undone on the rest of the portfolio by that agent (unless undoing is prevented by short sales constraints and an extreme portfolio). The conclusion of no effect also needs the assumption that the portfolio change does not affect other government spending or taxes.

But in this dimension the US economy does not resemble a representative agent model – either OLG or infinitely lived. Many US workers have so little financial wealth that they would be unable to undo the portfolio choice of Social Security given short sales constraints. And most of them wouldn’t try to do it even if they could. In such a setting the portfolio choice of Social Security can matter for such agents and, in the absence of perfectly elastic supplies or demands, a significant change in the Social Security portfolio will change asset prices (rates of return) and so matter for other agents as well.

Why are there people with no investment in stocks and so no ability to offset a change in portfolio? To me, the most important reason is the lack of wealth, which is the basis of a model that I have analyzed together with John Geanakoplos. A second reason for some is the high “cost” of figuring out how to invest, which is the basis of a model analyzed by Andy Abel. I find this reason far less important. A third reason is that some people have a misunderstanding of the risk-return tradeoff and avoid stocks as “too risky.”

Conversely, there are no doubt people too heavily invested in stocks because they do not understand the risk-return tradeoff. Particularly, right now.

But, as I said, I think the biggest issue is that of people without significant financial wealth. For these people, we need to ask whether they are so risk averse that a retirement portfolio without stocks is optimal. I suspect the answer is no. So, on average, I think that expected utilities would be increased by some Trust Fund investment in stocks (and corporate bonds) that affected benefits similarly to a defined contribution system. But Social Security is a defined benefit system, so we also need to ask how Congress will adapt Social Security to differences in portfolio outcomes (which must be considered in a setting where Congress is also required to adapt Social Security to realizations of other economic and demographic variables). If Congress does a decent job, then the intergenerational risk-sharing potential of a defined benefit system represents an a fortiori case for a diversified portfolio. If Congress reacts with delay (plausible) and concentration of response on small numbers (implausible – Congress tends to spread out both pain and benefits when legislating for a major program), then the case is weakened. I am inclined to think that the case is slightly strengthened – but it is impossible to be sure. It is also the case, as analyzed by Kent Smetters, that this may involve shifting some Social Security costs into the future (in expected value terms). I say may since we need to consider two elements of political economy – the timing of legislation and its content. Acceptance of Trust Fund diversification is likely to make the political process easier and so make it more likely that we get legislation sooner, but that legislation is likely to shift more costs onto the future. Thus the expected change is unclear. And small intergenerational shifts do not have an obvious welfare sign, depending on how much economic growth and demographic improvement one anticipates.

So much for the direct impacts. What about the indirect impacts? An increased demand for stocks and corporate bonds and decreased demand for Treasury bonds is likely to decrease the risk premia on stocks and corporate bonds. Plausibly this will play out in changes in all three rates of return – decreases in returns to other assets and increases in government borrowing rates - although Henning Bohn's analysis suggests that such effects will be small. The increase in the government interest rate (together with a political separation between Social Security and non-Social Security budgets) requires some changes in government budgeting – taxes or spending. The decrease in the cost of

funds is likely to increase both investment demand and savings supply and the willingness to take on risk. Changes in interest rates and expected returns will also change the prices of long-lived assets, creating capital gains and losses. Different scenarios lead to different conclusions as the change in the interest rate or the change in the level of investment might be the most important in terms of valuing long-lived risky assets. That is, there is the possibility that by switching to stocks, Social Security lowers the price of stocks since the interest rate rise lowers prices more than the reduced supply of stocks to private investors increases it.

My conclusion is that some Trust Funds portfolio diversification is worth trying. I think it is more likely to have good than bad economic and political effects.

And to end as I began, it is too bad that Bob is not still here to fight the good fight against exchanging our current structure for defined contribution accounts.