

STATEMENT BY

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Mr. Chairman, I welcome this opportunity to discuss the investment policies of the Social Security trust funds, and the effects of these policies on the financial status of the funds. Senator Proxmire has proposed legislation that would align the yields of securities held by the trust funds with interest rates currently available to other investors in federal securities. I will comment on the potential effect of this proposal on trust fund balances and its advantages and drawbacks relative to other investment practices that might be pursued by the Social Security Board of Trustees.

CURRENT CONCERNS WITH TRUST FUND BALANCES

The Social Security system is a matter of concern today for two reasons. First, the balance in the Old-Age and Survivors Insurance (OASI) trust fund--the largest of Social Security's trust funds--has declined rapidly in recent years. The OASI fund would have become unable to meet all of its benefit payments in 1982 had not Public Law 97-123 been enacted. That legislation permits the OASI fund to borrow from the Disability Insurance (DI) and Hospital Insurance (HI) trust funds until December 31, 1982. Although the OASI fund may then borrow reserves sufficient for six months of benefit payments, this action would only postpone the funding problems until July 1983. Even if the interfund borrowing authority were extended indefinitely, the problem of insufficient balances in all three trust funds would occur sometime in 1984. Under current Congressional Budget Office (CBO) projections, the combined reserves of the OASI, DI, and HI funds will fall below 12 percent of annual outlays during fiscal year 1984, and begin fiscal 1985 at less than 8 percent. This will create serious cash flow problems for the trust funds (see Table 1).

TABLE 1. PROJECTIONS OF SOCIAL SECURITY TRUST FUND OUTLAYS, INCOMES, AND BALANCES (By fiscal year, in billions of dollars)

	1981	1982	1983	1984	1985	1986	1987
Old-Age and Survivors Insurance							
Outlays	122.3	138.8	152.7	168.4	184.8	201.9	219.9
Income <u>a/</u>	121.6	127.6	142.9	149.1	167.8	185.1	201.2
Year-End Balance	23.8	12.6	2.8	-16.6	-33.5	-50.5	-69.1
Start-of-Year Balance (as percent of outlays)	20.1	17.2	8.3	1.7	-9.0	-16.6	-22.9

Disability Insurance							
Outlays	17.3	18.5	19.3	20.0	20.4	21.0	22.2
Income <u>a/</u>	13.0	21.6	19.2	28.7	35.7	41.6	46.6
Year-End Balance	3.4	6.4	6.2	14.9	30.2	50.8	75.1
Start-of-Year Balance (as percent of outlays)	44.4	18.3	33.1	31.2	73.1	143.6	228.5

Hospital Insurance							
Outlays	29.3	34.3	39.9	46.2	52.9	60.4	68.9
Income <u>a/</u>	32.9	37.2	41.0	45.1	50.3	57.7	63.1
Year-End Balance	18.1	21.0	22.1	21.1	18.4	15.7	10.0
Start-of-Year Balance (as percent of outlays)	49.5	52.8	52.6	48.0	39.8	30.5	22.8

Combined OASI, DI, and HI							
Outlays	168.8	191.6	211.9	234.6	258.2	283.3	311.0
Income <u>a/</u>	167.4	186.3	203.1	222.8	253.8	284.4	310.9
Year-End Balance	45.3	40.0	31.2	19.4	15.1	16.1	16.0
Start-of-Year Balance (as percent of outlays)	27.7	23.7	18.9	13.3	7.5	5.3	5.2

SOURCE: CBO estimates based on baseline assumptions used for S. Con. Res. 92, as passed by the Senate on May 21, 1982, modified for 1982 cost-of-living adjustment of 7.4 percent.

NOTE: Minus sign denotes a deficit.

a/ Income to the trust funds is budget authority. It includes payroll tax receipts, interest on balances, and certain general fund transfers. Income in 1983 reflects interfund transfers as authorized under Public Law 97-123.

A second reason for concern with the growth of Social Security outlays arises from efforts to cut the size of total government spending and to reduce the federal deficit. Social Security outlays have increased from 2.3 percent of GNP in 1960 to a projected level of about 6 percent of GNP this year. They now represent more than one-fourth of the total federal budget, and nearly 35 percent of nondefense spending. Continued rapid growth in Social Security outlays, combined with the proposed growth of defense expenditures, will make it difficult to reduce federal spending and move toward a balanced budget.

Although the Congress acted last year to reduce outlays from the trust funds by approximately \$21 billion for fiscal years 1982 through 1986, further steps will have to be taken in order to continue paying all benefits in a timely fashion. The Congress could increase trust fund balances either by reducing outlays or by increasing trust fund income. The OASI, DI, and HI funds rely on payroll tax receipts for the bulk of their income; interest payments on reserves make up about 2 percent. The Proxmire bill, S.1528, focuses on increasing the interest income received by the trust funds.

CURRENT INVESTMENT PRACTICES

The current investment practices of the Social Security trust funds--including Supplemental Medical Insurance (SMI)--are determined in part by law and in part by guidelines established by the Department of the Treasury. Under the provisions of the Social Security Act, all trust fund monies not

immediately required for the payment of benefits or administrative expenses must be invested in obligations that are guaranteed by the U.S. government. The Secretary of the Treasury, who is the Managing Trustee, must invest in special public-debt obligations--"special issues" available only to the trust funds--except when he determines that the purchase of marketable government securities is "in the public interest." Interest rates on new special issues are set by law at the average current yield on all marketable Treasury securities not due or callable for at least four years. The maturities of new special issues are to be determined "with due regard for the needs of the trust funds." Finally, the Social Security Act specifies that special-issue obligations are redeemable at par plus accrued interest regardless of market prices of comparable securities, whereas any marketable securities sold by the trust funds must be sold at their market prices.

In practice, the Treasury has purchased marketable securities only rarely; they now constitute less than 7 percent of total trust fund holdings. Maturities for new special issues have been chosen so that approximately the same percentage of all special-issue holdings within a trust fund will mature in each of the next 15 years. Although the Managing Trustee has authority to redeem special-issue obligations at any time at par, the Treasury has followed a policy of not using this option except when it has been necessary to redeem bonds in order to meet benefit payments. When bonds must be redeemed in order to meet payments, those special issues closest to maturity are cashed in first and, if there are bonds of differing rates maturing in the same year, those with the lowest rates are redeemed first. Investment practices for certain other trust funds such as the Civil Service Retirement fund are similar to those for Social Security.

The policy of investing trust fund balances in relatively long-lived securities has meant that, as interest rates rose rapidly in recent years, the average yield to the trust funds has lagged behind market rates. During the 12-month period ending June 30, 1981, the average yield on the holdings of the trust funds was 9.1 percent compared with an average 91-day Treasury Bill rate of 13.0 percent and an average market yield on long-term government bonds of about 11.7 percent. Because the funds have received lower-than-current-market rates of interest, it has appeared to some observers that the funds have provided an implicit interest subsidy to the Treasury.

Defenders of the current practices point out that the reverse can be true—average yields to the trust funds can exceed current market rates when interest rates fall. Moreover, when interest rates are rising, the current privilege of redeeming outstanding special issues at par offers a substantial financial advantage to the trust funds relative to other investors in government securities. For example, \$483 million in 7-1/8 percent 1992 special-issue bonds were redeemed at par in March 1982; at the same time, marketable 7-1/4 percent 1992 bonds were being purchased on the New York exchange at only 65 percent of face value. In essence, this constitutes a general-revenue transfer to the trust funds that may offset the effect of lower-than-current-market yields.

ALTERNATIVE INVESTMENT POLICY OPTIONS

The relatively low interest rates received by the trust funds have prompted a rethinking of current investment practices. One possibility would be to design an investment policy whose chief goal was to maximize the investment income received by the trust funds, subject to reasonable concern for their safety. Indeed, Senator Proxmire's bill would require that trust fund balances be invested in U.S. government issues "so as to secure the maximum possible interest yield, commensurate with the safety of the trust funds." The bill as introduced would permit the trust funds to continue to purchase special-issue securities. In addition, to maximize income, it would require redemption of low-yielding special issues at par and reinvestment in new higher-yielding special issues both upon enactment and whenever interest rates rose in the future. If interest rates were to fall, the trust funds would have the advantage of continuing to receive the higher rates until those special issues matured.

Initially, enactment of S.1528 would increase trust fund yields because it would require the Trustees to redeem the existing low-yielding portfolio at par, and to reinvest the reserves either in special-issue bonds or in marketable government securities at current rates. In addition, in periods of rising interest rates, S. 1528's redemption policy would raise the cost of the Treasury borrowing from the trust funds relative to the cost of borrowing from the general public. Finally, if the trust funds invested in marketable securities rather than special issues, they could experience either capital gains or capital losses, depending both on whether interest rates decline or rise and on whether short- or long-term securities are acquired.

A different approach, recommended by the General Accounting Office (GAO) in 1975, would treat trust fund reserves as if they were in a government savings account. The trust funds would no longer hold specific government securities, but rather would have their funds deposited in an account with the Treasury. Interest paid on this account would equal the current market yield on all outstanding government securities, determined on a daily, weekly, monthly, or other basis. Existing holdings of special issues would be redeemed at par, but marketable securities would be held until maturity.

If the GAO proposal was implemented immediately, the average yield on the trust funds would increase substantially. If there was a significant decline in interest rates, however, future trust fund yields could be lower than those under current law.

Implementation of this investment alternative would retain some subsidy from the Treasury to the trust funds. First, the initial redemption of special-issue holdings at face value would continue the current favorable treatment of the trust funds compared with other lenders. Second, an interest rate based upon all outstanding marketable government securities would generally be higher than a short-term rate. Thus, the trust funds would benefit from including long-term rates in the interest calculation without taking any of the risks associated with long-term investments.

A variant of the GAO proposal would have interest paid to the trust funds computed on the basis of rates on short-term government securities only. Since the trust funds must be able to withdraw reserves whenever necessary to pay benefits, they more closely resemble holders of short-term than long-term government securities.

POTENTIAL EFFECTS ON TRUST FUND INCOME

The potential increase in interest income received by the trust funds under alternative investment policies would depend primarily on the future level of balances and on future interest rate movements. One way to compare different policies is to determine what effect they would have had on interest income in 1981. In the 12-month period ending June 30, 1981, the actual average yield to the trust funds was 9.1 percent, for an interest income of about \$3.9 billion. If the entire portfolio had been redeemed at par and invested in 91-day Treasury bills throughout this period, the corresponding figures would have been 13.0 percent and \$5.6 billion, an increase of 43 percent. Since this was a period of near-record-high interest rates, this estimate represents a reasonable upper bound for what this change in investment policy might imply for trust fund income. But even this increase would have only amounted to about 1 percent of the total income of the Social Security trust funds.

The potential effect of any investment policy on income to the trust funds diminishes as trust fund balances decline. Although an approach similar to the GAO plan might have increased trust fund balances by as

much as \$15 billion over the last 20 years, those were years of relatively large balances and rising interest rates. The current CBO projections of the combined OASI, DI, and HI reserves show balances declining from \$45.3 billion at the end of fiscal year 1981 to \$15.1 billion at the end of 1985. Thus, even if yields were increased, total interest income received by the funds would still decline during this period.

CONCLUSION

In summary, it is worthwhile to reexamine the investment practices of the Social Security trust funds. Of the different options available, those involving a savings account approach appear attractive, both because of their simplicity and because they would align the yields of the trust funds with current Treasury borrowing costs. A change from current investment practices to a savings account approach would initially increase the yields to the trust funds, but the effect on long-term yields would depend on future movements in interest rates. Nevertheless, no investment strategy could increase trust fund income by more than a small percentage or could ensure that the trust funds would continue to pay benefits in a timely manner.