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Social Security: Trust Fund Investment Practices

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Summary

The Social Security Act has always required that surplus Social Security income (i.e., income in excess of its outgo) be invested in U.S. government, or U.S. government-backed, securities. Over the past decade or so, increasing attention has been focused on whether to change this practice in order to increase the program's revenue. This report explains current trust funds investment practices and briefly describes the issues involved in changing how the trust funds are invested.[1] It will be updated periodically.

Background

Social Security is financed primarily by payroll and self-employment taxes, and by part of the proceeds of the income taxation of its benefits. The revenues are deposited in the U.S. Treasury. The program's benefits and administrative expenses also are paid from the Treasury. If Social Security's income exceeds its outgo, by law this "surplus" is credited to the Social Security trust funds in the form of U.S. government securities, but the money itself is used to pay for whatever other expenses the government has. There is no separate pool of money set aside for Social Security. This is not to say that the trust funds are ephemeral; so long as they show a positive balance they represent authority and an obligation for the Treasury to issue benefit checks in those periods when the program's outgo exceeds its income. At the end of December 2003, the trust funds were credited with holdings of $1.5 trillion. By 2006, they are projected to reach two trillion dollars.[2] Section 201 of the Social Security Act provides these guidelines for investment:

[1] This report was written by former CRS analyst Geoffrey Kollmann.

[2] Social Security has two programs – Old-Age and Survivors Insurance (OASI) and Disability Insurance (DI) – with separate trust funds. The amounts cited are for the two trust funds combined.

(1) Funds not immediately in demand for benefits or administrative expenses are to be invested in interest-bearing obligations guaranteed as to both principal and interest by the United States.[3]

(2) Obligations are to be purchased at issue at the issue price or at the market price for outstanding obligations.

(3) The Managing Trustee of the Social Security trust funds (the Secretary of the Treasury) is required to invest in special "nonmarketable" federal public-debt obligations – special issues to the trust funds that are not available to the general public – except where he or she determines that the purchase of marketable federal securities is "in the public interest."

(4) Special issues shall have maturities fixed with due regard for the needs of the trust funds and will pay a rate of interest, calculated at the time of issue, equal to the average market yield on all marketable interest-bearing obligations of the United States that are not due or callable (redeemable) for at least four years.

(5) Marketable federal securities purchased by the trust funds may be sold at the market price and special issue obligations may be redeemed at par plus accrued interest (without penalty for redemption before maturity).

The Treasury Department has determined that the purchase of marketable securities would be in the public interest only when it might serve to stabilize the market for Treasury issues. Since an "unstable market" would be characterized by falling bond prices, purchases of marketable securities at these times would appear to be advantageous for the trust funds. In practice, however, open market purchases have been rare. At the end of 2003, only 0.002% of the combined funds were invested in marketable securities (all in the DI trust fund).

The interest on these holdings is credited to the trust funds semiannually, on June 30 and December 31. It is done by issuing additional federal securities to the funds. In calendar year 2002, net interest totaled $80.4 billion. The effective annual rate of interest on all obligations in the trust funds in calendar year 2002 was 6.4%. The interest rate on special issues purchased by the trust funds in December 2003 was 4.375%.

The maturity dates of newly issued special issues are set by a standardized procedure. Revenues are invested immediately in short-term issues called certificates of indebtedness, which mature on June 30 of each year. On June 30, certificates of indebtedness that have not been redeemed are reinvested into longer term special issue bonds. The maturities of these bonds are from one to 15 years – the goal is to have about one-fifteenth of them mature each year. This means that the average maturity of these long-term bonds is about 7½ years.

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[3] Although not specifically authorized by the Act, the Attorney General has ruled that certain federally sponsored agency obligations may be purchased by the trust funds. Such securities include those issued by the Federal National Mortgage Association, the Government National Mortgage Association, and other federal credit entities. Currently, the trust funds do not hold such securities.

Issues

Although critics have questioned whether this investment policy constrained the trust funds' earnings, over the years various advisory councils, congressional committees, and other groups generally have endorsed it. It has been justified as "ensuring the most safety of principal and stability of interest," and as a way of avoiding intrusion into private markets. It also has been regarded as a way to avoid the political influences that would be inherent in investing outside the U.S. government. Generally, the goal espoused has been to place the trust funds in the same position as any long-term investor seeking a safe rate of return by investing in U.S. securities, and neither advantage nor disadvantage the trust funds relative to these investors or other parts of the government.

For most of Social Security's history, interest income was not a major factor in the program's financing. However, over the past decade or so, growing trust fund surpluses, and the increasing role of interest credited to the funds, have focused attention on the question of alternative investment policies. In the last four Congresses, bills have been introduced that call for replacing the trust funds' nonmarketable government securities with marketable ones. There also have been calls for investing a portion of the trust funds in the stock market. The stock market investment approach was proposed by President Clinton in his January 1999 State of the Union Address. For a full discussion of these issues, see: archived CRS Report 91-129, *Social Security: Investing the Surplus,* and CRS Report RL30571, *Social Security Reform: The Issue of Individual Versus Collective Investment*.