INVESTMENT OF THE SOCIAL SECURITY TRUST FUNDS

T-1704

HEARING

BEFORE THE

SUBCOMMITTEE ON SOCIAL SECURITY

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

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INVESTMENT OF THE SOCIAL SECURITY TRUST FUNDS

FRIDAY, OCTOBER 16, 1981

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON SOCIAL SECURITY,
Washington, D.C

The subcommittee met at 10 05 a m pursuant to notice, in room 1100, Longworth House Office Building, Hon J J Pickle [chairman of the subcommittee] presiding

[Press release announcing the hearing follows:]

[Press release of Oct 5, 1981]

HON J J PICKLE (D-TEX), CHAIRMAN, SUBCOMMITTEE ON SOCIAL SECURITY OF THE COMMITTEE ON WAYS AND MEANS, U S HOUSE OF REPRESENTATIVES, ANNOUNCED TODAY A HEARING ON THE INVESTMENT OF THE SOCIAL SECURITY TRUST FUNDS

Hon J J Pickle (D-Tex), Chairman of the Subcommittee on Social Security of the Committee on Ways and Means, U S House of Representatives, announced today that the Subcommittee will hold a hearing concerning the investment of the Social Security Trust Funds This hearing will be held on Friday, October 16, 1981, at 10 a m , in room H-137 of the Capitol

The Social Security Act provides that the assets of the trust funds are to be invested solely in U S government obligations The funds must be invested in special public-debt obligations of the United States except where the Managing Trustee (the Secretary of the Treasury) expressly determines that the purchase of other government securities is in the public interest These "special issues" must bear an interest rate which is equal to the average market yield of all marketable interest-bearing obligations of the United States with maturities of four years or more

Critics of the current investment policy assert that the trust funds are losing substantial amounts annually because they are earning less as a long-term investment than current short-term rates It is not clear, however, if the investment policy were changed to allow the trust funds to take advantage of current short-term yields, that the average return over an extended period would be greater than under current law The current situation of short-term rates exceeding long-term rates is relatively rare and is likely to change in the future

Even if a change in the investment policy could yield higher returns, it does not directly follow that this change should be made Previous reports of the social security trustees and the various Advisory Councils concerning investment obligations indicate that it has been felt that since the trust funds represent long-term investments and obligations, they should be tied to long-term interest rates

The testimony will assist the Subcommittee in determining the most appropriate investment policy for the Social Security Trust Funds In its hearing the Subcommittee intends to invite the Secretary of the Treasury, who serves as the managing trustee of the Social Security Trust Funds, and other invited witnesses

Chairman PICKLE. The Chair would ask the subcommittee to come to order

If the witnesses will take their seats at the table, we will proceed

In recent months, there has been a renewed focus on the interest income earned by the social security trust funds. The impetus comes from the fact that the trust funds have faced some serious financial difficulties, and still do.

Obviously, it would be both attractive and wise to improve the income to the trust fund in a way that would require neither increased payroll taxes nor benefit reductions if we can do so.

Some words of caution are in order at the outset, however. First, even the most optimistic claims about the amount of money we could gain by improving trust fund interest earnings do not amount to enough to erase the problems we now face.

If trust fund reserves continue to go down in the future, this avenue will provide even less assistance. We need more reserves, pure and simple, before the interest we earn on them can be of sufficient amount to have a major impact.

Second, we should keep in mind that increased income to the trust funds must be paid by the general fund, so we would be in reality making intragovernmental transfers. We would not be creating new money that would reduce the unified budget deficit.

Finally, we must be careful that any changes we suggest will hold up over the long run. What looks expedient now may not prove to be so in the future.

With that said, however, the current policies and practices involving trust fund investments are not inviolate. Over the 45-year history of this program we have tried many different approaches, with the single overriding factor that we have always invested in government securities and we have invested primarily in special issue bonds available only to the trust funds and redeemable at par at any time.

The Social Security Act provides that any funds that are not needed immediately for benefits or administrative costs are to be invested by the Secretary of the Treasury, acting as the Managing Trustee of the social security trust funds.

The act provides both some very tight restrictions on the Secretary which allow him little latitude, if any, in the location of and return on investments, and some very broad discretionary powers concerning maturity dates and redemption practices.

For example, the assets of the trust funds must be invested solely in U.S. Government obligations. The funds must be invested in special public-debt obligations of the United States, except where the Managing Trustee—the Secretary of the Treasury—expressly determines that the purchase of other Government securities is in the public interest.

These "special issues" must bear an interest rate which is equal to the average market yield of all marketable interest-bearing obligations of the United States with maturities of 4 years or more.

On the other hand, however, Congress has granted the Secretary much discretion by stating that obligations purchased by the trust funds "shall have maturities fixed with due regard for the needs of the trust fund." This discretion extends beyond authority to fix maturity dates to authority to specify practices regarding the redemption of trust fund securities.

The principal issue concerning trust fund investments and management is, of course, the rate of return on those investments. This

issue extends beyond consideration of only the statutory interest rate formula and includes policies and practices regarding the assignment of maturity dates to special issues, the redemption of investments, and the purchase of securities other than special obligations.

From the beginning of the program, the general policy goal in this area has been to make the return to the trust funds equitable to both the trust funds and the general fund from which interest payments are made, providing neither special advantage nor disadvantage to the trust funds as compared to other investors in U.S. Government securities.

Today's hearing is the first step in the subcommittee's review of all current policies and practices concerning the investment of trust fund assets. Specifically, the subcommittee is seeking to determine:

(1) The appropriateness of the current statutory interest rate formula in light of both current high interest rates on short-term investments and the fact that many trust fund securities are now held for only short periods before redemption;

(2) The advisability of increasing trust fund purchases of marketable U.S. Government securities in the open market and decreasing purchase of special issues;

(3) The appropriateness of Treasury's policy of establishing maturities for new special issues given the fact that long-term special issues are often redeemed before maturity when trust fund outgo exceeds income, as in the case with the OASI and the DI trust funds today; and

(4) The appropriateness of Treasury's redemption policies which today is resulting in the redemption of the highest yielding special issues while lower yielding special issues are maintained in the portfolio.

That is a rather involved analysis of the problem we face.

We are anxious to hear from the two witnesses this morning. The first will be Mark Stalnecker, the Deputy Assistant Secretary for Federal Finance, and Mr. Robert J. Myers, Deputy Commissioner for Programs, Social Security Administration.

I believe Mr. Myers is scheduled to go first and be our first witness. If that is agreeable to Mr. Stalnecker, we will proceed in that order.

Mr. Myers, welcome to the committee.

STATEMENT OF ROBERT J. MYERS, DEPUTY COMMISSIONER FOR PROGRAMS, SOCIAL SECURITY ADMINISTRATION, DEPARTMENT OF HEALTH AND HUMAN SERVICES

Mr. Myers. Thank you, Mr. Chairman.

I am pleased to be here. I would like to condense my statement. I request that the full statement and attachments be put in the record.

Chairman Pickle. Without objection your request is granted. If you do make reference to it, try to indicate to the committee where and on what page so we might be able to follow you, also.

Mr. Myers. Thank you, Mr. Chairman. What I have done is condense it considerably. I will not read the tables or the attachments.

I am pleased to be here today to discuss the investment policy of the four social security trust funds. Although the investment of the assets is the responsibility of the Secretary of the Treasury, as Managing Trustee, the Social Security Administration has a great interest in this matter. For many years, I have studied the subject with considerable diligence.

Although the interest income of Social Security is not a major factor in its financing—whereas in funded private pension plans investment income is very significant—neither is it of negligible importance. For example, in 1980, the interest income of the trust funds was only 2.46 percent of the total income. However, such interest income was the not insignificant sum of $3.85 billion, which incidentally was 1.5 times as large as the system's administrative expenses.

Since the program began operations, the method of investing the assets has changed little. The trust funds receive the tax income and pay the benefits and administrative expenses. The excess of income over outgo is invested in government obligations, and the interest augments the system's income.

Since 1940, social security taxes have been automatically appropriated to the trust funds as received. Before then, a slightly different procedure was followed.

The investments can be either in special issues or in any other government securities. Some regular issues have been bought—both on the open market and when offered to the public.

Legislation has provided that certain semigovernment issues—such as those of the Government National Mortgage Association, can be purchased, even though not guaranteed, by the Government.

Most investments, however, have been special issues. As of mid-1981, 92 percent of the assets were in special issues. More details are given in attachment A in my formal statement.

Before 1940, special issues bore an interest rate of 3 percent. From then until 1956, they carried an interest rate slightly below the average coupon rate on all interest-bearing obligations outstanding at the end of the month preceding their issuance.

In 1956, the interest basis was changed to the average coupon rate on all long-term obligations issued initially for 5 or more years. In 1960, this interest basis was changed to the average market yield rate on obligations not due or callable for at least 4 years from the date of determination. The historical interest rates of special issues and the durations until their maturity are shown in more detail in attachment B in my formal statement.

For some years, the maturity dates of newly issued special issues have been set by a definite procedure. This was established by the managing trustee, with the agreement of the other trustees—and not by the law.

Specifically, funds available for investment in special issues at times within the investment year, which runs from July 1 to the following June 30, are put in certificates of indebtedness. These certificates mature at the end of the investment year. Such investment into interest-bearing obligations is made very promptly as the taxes are received by the Treasury Department.

Then, on June 30, the proceeds of the certificates are put into long-term bonds with maturity dates of various June 30's, whose durations until maturity are spread, as much as is possible, so that the total portfolio of special issues—including those bonds on hand on the June 30 date—is equally spread over the next 15 years.

When, during the investment year, securities must be sold to meet benefit obligations—which peak at the beginning of the month for the OASI and DI trust funds, but not for the HI and SMI trust funds—this is done by selling first the special issues with the shortest durations until maturity. Thus, any certificates of indebtedness are the first to be so sold. If several securities have the same duration until maturity, those with the lowest interest rate are sold first.

When special issues are thus sold, they are redeemed by the Treasury at their purchase price. This is a feature not available to other purchasers of Federal securities who might wish to sell them. This is a considerable financial advantage to the trust funds, especially in times of fluctuating or rising interest rates—and one that would not be present if the investments were required to be made only in marketable obligations. If the securities were redeemable only on a market-value basis, losses of principal would often be involved, especially when securities with low coupon interest rates are redeemed. Under certain circumstances, relatively unusual, this procedure could produce an unfavorable result for the trust funds as compared with a market-value basis; namely, when the securities to be sold had a higher interest rate than the average market-yield rate at that time.

In summary, however, the procedure followed as to redemption of securities prior to their maturity is an advantageous one insofar as the trust funds are concerned. And it is equitable as well. Further, because of the prescribed rules, it eliminates all elements of conflict of interest insofar as the managing trustee is concerned.

Although there has been some opposition to investing the assets in Government bonds, no positive support has been offered for any other investments, all of which have seemed objectionable for overwhelming reasons.

One possibility would be securities of private concerns. There are several objections to this approach. First, the Government would control a considerable portion of the private economy, which would, in effect, result in socialism by the backdoor method. Another disadvantage would be the need for a far-reaching investment policy to provide an adequate rate of return, with reasonable security of principal. The Government would, in effect, be setting itself up as a rating organization.

Another procedure would be to invest in social and economic activities such as the construction of housing, dams, hospitals, et cetera. This would be open to some objection as Government entry into private fields of activity.

Also, any use of public funds for such purposes should be under the control of the Congress, rather than a social insurance organization.

Accordingly, it may properly be concluded that investment of the assets of the the trust funds can feasibly be invested only in securities of the Federal Government.

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With current high interest rates, the investment results of the trust funds have been criticized. It has been pointed out that, during the year ending June 30, 1980, the effective annual rate of interest earned by the OASDI trust funds was only 8.4 percent, whereas private money-market managers currently earn about 13 percent.

This is not a valid comparison, because it contrasts the investment return of a portfolio of securities purchased over a long period of years with the current, relatively high new issues rate. The interest rates on securities bought by the trust funds in the past were proper and equitable at the time of purchase.

On the other hand, the high interest rates quoted for private money managers are those obtained for securities purchased currently. Any private investment organization which has prudently built up a portfolio over the years would currently have a much lower average rate of return for its total portfolio than for securities bought currently.

In comparing investment managers, one should not simply measure the average rate of return on their total portfolios, but rather other factors should be considered.

The trust funds have been obtaining relatively high interest rates on current investments. For example, the rate on special issues acquired in June was 13 percent. Some $20 billion of new issues were acquired at this rate, with maturities of up to 15 years.

Moreover, as old securities mature and as new higher interest securities are purchased, the average effective rate of return will rise. As compared with the rate of 8.4 percent for the year ended June 30, 1980, the rate for the next year was 8.8 percent. Attachment C in my formal statement shows these effective rates of returns for various years.

The rate of return on the OASDI trust funds in calendar year 1980 was about 8.6 percent. At the same time, the net rate of investment income—before Federal income tax—of all U.S. life insurance companies was 8 percent. Thus, the trust funds had an investment experience closely comparable with that of life insurance companies in the aggregate.

A life insurance company formed in 1980 would, of course, have had a much higher rate of return, because it would be holding only new high-rate investments, but this would not prove that it was a sagacious investor or that the older companies were stupid investors.

It has been proposed that the trust funds be invested only in short-term rather than long-term obligations. At present, this would have the advantage of the high current short-term interest rates. In hindsight—just as with other investment experience—this might have proven to be more advantageous.

The general experience in the past, however, has been that long-term interest rates are somewhat higher than short-term ones, although not at the moment.

Accordingly, over the long run, the long-term interest rate procedure would seem preferable. Attachment D in my formal statement compares the average market-yield rate of all Government obligations with the corresponding long-term rate received by the trust funds on new special issues.

For 1967-81 the interest rate basis used for trust fund investments was higher than the all-obligations rate in 9 years, with 1 year being the same. The average excess was 0.35 percentage points.

Furthermore, the current high interest rates are unlikely to last much longer. With interest rates lower in years ahead, a change now to short-term securities would not be nearly as advantageous to the trust funds as continuing the present procedure and having the very large amount of long-term investments "locked in" at 13-percent interest, as compared with much lower rates that might be obtained in the future.

Another investment strategy recommended occasionally is for trust funds to roll over their assets into those securities with the highest current yield, but only if such yield exceeds that of current holdings. Such a strategy would be very advantageous to social security, but disadvantageous and inequitable to the general treasury, which would pay the increased interest from general revenues. Thus, while the trust funds would do better with such a strategy, higher Federal income taxes or a larger Federal deficit would result. This would be an indirect form of general revenue financing for social security. Then, too, private investors are not given this "best of both worlds" possibility.

The present investment procedures for the trust funds is proper and equitable to both these funds and to the General Fund of the Treasury. Both the insured persons under social security and the general taxpayers—who are, by and large, the same persons—are treated in a fair, equitable and consistent manner.

The rates of return obtained by the trust funds currently are reasonable in light of past investment experience. The appropriate investment procedure is to choose one investment policy and remain with it, rather than attempting to do better by speculating through jumping back and forth among investment strategies.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF ROBERT J. MYERS, DEPUTY COMMISSIONER OF SOCIAL SECURITY FOR PROGRAMS, SOCIAL SECURITY ADMINISTRATION, DEPARTMENT OF HEALTH AND HUMAN SERVICES

Mr. Chairman and Members of the Subcommittee, I am pleased to be here today to discuss the investment policy of the four Social Security trust funds—the Old-Age and Survivors Insurance Trust Fund, the Disability Insurance Trust Fund, the Hospital Insurance Trust Fund, and the Supplementary Medical Insurance Trust Fund. Although the investment of the assets of these funds is, by law, the responsibility of the Secretary of the Treasury, as Managing Trustee of the several Boards of Trustees, the Social Security Administration has, understandably, always taken a great interest in this matter. Then too, during my many years of association with the program, I have studied the subject with considerable diligence.

Although the interest income of the Social Security program is not a major factor in its financing—whereas in funded private pension plans investment income is a very significant element—neither is it of negligible importance. For example, in calendar year 1980, the interest income of the four trust funds was only 2.46 percent of the total income. However, such interest income was the not insignificant sum of $3.85 billion, which incidentially was 1.5 times as large as the administrative expenses of the program.

INVESTMENT PROCEDURES

Throughout the entire period of operation of the program, the method of investing the assets of the trust funds has changed relatively little. In general, it may be said that the trust funds receive the tax income and pay the benefits and administrative expenses. The excess of the income over the outgo is invested in obligations of the Federal Government, and the interest therefrom augments the income of the system.

Since the middle of 1940, the Social Security tax collections have been automatically appropriated to the trust funds as they are received by the Treasury Department. Before then, a somewhat different procedure was followed. The authorized appropriations to the Old-Age Reserve Account (as it was called then) were not specifically to be measured by the taxes collected, but rather were to be "an amount to be determined on a reserve basis in accordance with accepted actuarial principles." Underlying legal and constitutional aspects made a distinct division between the taxes collected and the benefits paid seem desirable. In actual practice, however, this language was interpreted to mean that the appropriations should be the estimated net proceeds of the taxes, after deduction for the estimated administrative expenses (which procedurally were paid out of the General Fund of the Treasury but, of course, in practice came from the gross Social Security tax receipts).

After the program was declared to be clearly constitutional in 1937, this indirect procedure was no longer necessary. As a result, the 1939 Act provided for the current automatic-appropriation basis.

The investments of the trust funds can be either in special issues or in any other securities of the Federal Government. Some regular issues have actually been bought, both on the open market and when they were offered to the general public. Special legislation has provided that certain semigovernment issues—such as those of the Government National Mortgage Association—can be purchased the trust funds, even though they are not guaranteed for both principal and interest by the Government.

Most of the investments, however, have been in special issues. As of June 30, 1981, about 92 percent of the assets of the four trust funds were in special issues (see Attachment A).

Before 1940, it was provided that the special issues should bear an interest rate of 3 percent. From then until the 1956 Act, they carried an interest rate slightly below the average coupon rate on all interest-bearing obligations of the United States outstanding at the end of the month preceding the issue of the special issues.

The 1956 Act changed the interest basis for special issues so that it was determined from the average coupon rate on all long-term Government obligations (issued initially for 5 or more years), rounded to the nearest ⅛ percent. The 1960 Act revised this interest basis, so that the interest rate is now determined from the average market yield rate on Government obligations that are not due or callable for at least 4 years from the date of determination. The actual experience over the years as to the interest rates applicable to special issues and the durations until their maturity is described in Attachment B.

ALTERNATIVE POSSIBLE INVESTMENT AREAS

Although there has, at times, been considerable opposition to investing the excess income of the system in Government bonds, no positive support has been offered for any other form of investment. All other possibilities have seemed to be objectionable for overwhelming reasons.

One possible investment practice would be to purchase securities of private concerns, either bonds or stocks. There are several objections to this approach. First, with the large amount of money available, the Government would control a considerable portion of the private industrial economy, which would, in effect, result in "socialism by the backdoor method." Another practical disadvantage would be the need for a far-reaching and deep-searching investment policy that would permit the trust funds to obtain an adequate rate of interest with reasonable security of principal. Under such a policy the Government would, in effect be setting itself up as a rating organization, because the investment procedures would naturally have to be open to full public view. If no preference were shown for different types of securities, but rather investments were made widely and indiscriminately, there would be a serious danger of loss of principal and diminution of investment income.

Another possible procedure would be to invest the funds in social and economic activities such as the construction of housing, dams, hospitals, and the like (as is done in some countries). This method would be open to some objection on the grounds mentioned previously—Government entry into private fields of activity. Even more serious is the argument that any use of public funds for such purposes should be under the control of the elected representatives of the people (Congress), rather than the indirect and less visible approach of having a social insurance organization making decisions as to what is best for the country.

Accordingly, it may properly be concluded that investment of the assets of the Social Security trust funds can feasibly be invested only in securities of the Federal Government.

CRITICISMS OF TRUST-FUND INVESTMENT RESULTS

In the light of current high interest rates, there has been criticism of the investment results of the Social Security trust funds. For example, it has been pointed out that, during the 12-month period ending June 30, 1980, the effective annual rate of interest earned by the combined OASI and DI Trust Funds was only 8.4 percent, whereas private money-market managers currently earn about 13 percent.

This is not a valid comparison, because it contrasts the investment return of a portfolio of securities purchased over a long period of years with the current, relatively high new-issues rate. The securities bought by the trust funds in the past bore interest rates which were proper and equitable at the time of purchase.

On the other hand, the high interest rates quoted for private money managers are those obtained for securities purchased currently. Any private investment organization which has built up a portfolio over the years (and has done so in a prudent manner) would currently have a much lower average rate of investment return for its total portfolio than it would for securities bought currently.

Thus, in comparing current investment managers, one should not simply measure the average rate of return on their total portfolios, which may have been acquired with much different timing, but rather one should take into account other factors—e.g., how they were doing on their current investments. In that regard, the Social Security trust funds have been obtaining relatively high interest rates on their current investments For example, the interest rate on special issues acquired in June was 13 percent. and it was at this rate that some $20 billion of new issues were acquired on June 30, with maturities of up to 15 years.

Moreover, as old securities mature, and as new higher-interest securities are purchased, the average effective rate of return for the assets of the trust funds will rise. Thus, as compared with the rate of 8.4 percent for the year ended June 30, 1980, the rate for the year ended June 30, 1981 was 8.8 percent. Attachment C shows these effective rates of returns for various years in the past for each of the trust funds. It is significant to note that, despite each of the funds receiving exactly the same rate on special issues purchased at the same time, the average effective rates for various years differ significantly. This is, of course, due to the different times of purchases of the various securities.

Also, it is of significance to note in considering the investment rate of return of the OASDI Trust Funds in the 12-month periods ending June 30, 1980 and June 30, 1981—namely, 8.4 percent and 8.8 percent, respectively, or an average of 8.6 percent—that the net rate of investment income (before Federal income taxes) of all United States life insurance companies in calendar year 1980 was 8.0 percent (source: "1981 Life Insurance Fact Book", American Council of Life Insurance, page 61). Thus, the trust funds had an investment experience closely comparable with that of life insurance companies in the aggregate.

A life insurance company which was formed in 1980 would, of course, have had a much higher rate of return, because it would be holding only new investments, at a relatively high rate. This, however, would not "prove" that it was such a sagacious investor, or on the contrary that the older, well-established companies were stupid investors.

CRITICISM OF DURATION OF INVESTMENTS

Finally, the criticism has, at times, been levied that the Social Security trust funds should be invested in short-term Government obligations, rather than long-term ones. It would have been feasible for the investments of the Social Security trust funds to have been in short-term obligations which would be rolled over every year (or even every month) instead of in long-term obligations, generally having a maturity length of 15 years. Thus, at present, this would have the advantage of the high current short-term interest rates. In hindsight—just as with other investment experience—this might have proven to be more advantageous.

Certainly, the general experience in the past has been that long-term interest rates are somewhat higher than short-term ones, even though this is not so at the moment. Accordingly, over the long run, the long-term-interest-rate procedure would seem preferable. Attachment D compares the average market-yield rate of all obligations of the U.S. Government with the corresponding long-term rate that the trust funds receive on new special issues. For 1967–81, the interest-rate basis used for Social Security trust-fund investments was higher than the all-obligations rate in 9 years (with 1 year being the same). The average excess was .35 percentage points.

Furthermore, the current high interest rates of, say, 15 percent are unlikely to last for much longer. With interest rates lower in years ahead, a change now to short-term securities would not be nearly as advantageous as continuing the present procedure and having the very large amount of long-term investments that are now "locked in" at 13-percent interest, as compared with much lower rates that might be obtained in the future.

Another investment strategy which is recommended occasionally is for the Social Security trust funds to roll over their assets into those securities with the highest current yield, but only if such yield exceeds that of current holdings. Such a strategy would be very advantageous to Social Security, but very disadvantageous—and, in fact, inequitable—to the General Treasury, which would have to pay the higher amounts of interest due from general revenues. Thus, while the Social Security trust funds would do better with such a strategy, the additional interest earnings would ultimately be reflected in higher Federal income taxes or a larger Federal deficit. in other words, it would be an indirect form of general-revenue financing for Social Security. And then too, private investors are not given this "best of both worlds" possibility.

SUMMARY AND CONCLUSIONS

The present investment policies and procedures for the Social Security trust funds is proper and equitable to both these funds and to the General Fund of the Treasury. Likewise, both the insured persons under Social Security and the general taxpayers—who are, by and large, the same persons—are treated in a fair, equitable, and consistent manner.

The rates of return obtained by the trust funds currently are reasonable in light of the past investment experience. The appropriate investment procedure is to choose one investment policy and remain with it, rather than attempting to do better by speculating through jumping back and forth among investment strategies.

[Attachment A]

DISTRIBUTION OF ASSETS OF SOCIAL SECURITY TRUST FUNDS, BY TYPE, JUNE 30, 1981

[In millions of dollars]

Category	OASI	DI	HI	SMI	Total
Special issues	23,393	3,569	17,659	3,791	48,412
Marketable securities [1]	1,996	295			2,291
Participation certificates	555		50		605
Undisbursed balances	1,203	19	−110	9	1,121
Total assets	27,147	3,884	17,599	3,800	52,430

[1] U.S. Treasury securities only (participation certificates of the Government National Mortgage Association are also marketable, but are not included here).

[Attachment B]

INTEREST RATES AND DURATIONS UNTIL MATURITY OF SPECIAL ISSUES OF INVESTMENTS OF SOCIAL SECURITY TRUST FUNDS

In 1940–43, the new special issues were for durations of four or five years. Beginning in 1944, some new special issues were for durations of one year (or less); beginning in 1945, all new special issues were of this duration. Accordingly, beginning in 1947, the entire investment portfolio was reinvested each year (on June 30). This procedure was followed until 1957, when a transition was begun toward spreading the investment portfolio of each of the trust funds over the following 10 years. Investments during a fiscal year were made in certificates that mature at the end of such year—June 30. At that time, the funds from the maturities were reinvested in long-term notes (up to seven years until maturity) or bonds (of seven years or more).

Then, in 1959, the permanent portfolio of special issues was spread more or less equally over the next 15 years, and this principle was followed until the late 1960s. In order to be equitable to the trust funds as interest rates rose above 4¼ percent, then, this principle was suspended, and new special issues were given a maturity of seven years, because other provisions of law prohibited a higher rate than 4¼ percent for longer-term securities. Such prohibition was removed insofar as the trust funds are concerned in mid-1974. Then blocks of special issues at an interest rate of 7⅝ percent were purchased with the funds then available for investment, in equal amounts maturing in each year of 1981–89. Since then the "equal spreading over 15 years" principle has been followed.

The special-issue interest rate was initially 1½ percent (in 1940), but as large volumes of long-term government bonds were floated to finance the war effort, the rate gradually decreased and reached a low of 1⅞ percent in the period from May 1943 to July 1946. Thereafter, there was a gradual rise to 2⅝ percent for the period from July 1958 to September 1960, which was the last month before the new basis provided by the 1960 Act went into effect.

When the interest basis was changed by the 1956 Act (effective for October 1956), there was no change in the rate actually made available to the trust funds. As it happened, under the conditions prevailing at that time, the new method of basing the rate on long-term obligations (rather than on all obligations) produced a slightly lower unrounded rate, but the change in the rounding procedure produced a final result that was exactly the same as the previous basis.

The new basis under the 1960 Act produced a sharp increase in the special-issue interest rate, yielding rates of 3⅞ to 4 percent for issues purchased in the last three months of 1960, or appreciably in excess of the 2¾ percent rate that would have been in effect then under the old basis. During 1961–65, this interest rate was generally between 3¾ and 4¼ percent, but thereafter it rose significantly, reaching a high of 7⅞ percent in February 1970. Then the rate fell somwhat and was about 6 percent during 1971-72, but rose to about 6¾ percent during 1973. Then it increased further in 1974, reaching a peak of 8⅛ percent in September, but fell off to about 7 to 7½ percent thereafter through 1977. In 1978, the rate increased to as much as 8⅞ percent and was a high as 10½ percent in late 1979. It then increased sharply in early 1980, peaking at 12⅝ percent in March, then fell to 9¾ percent in June, and thereafter rose to 12⅛ percent in December. Then, in 1981, the rate had a rising trend and was 13 percent in June, 13¼ percent in July, 14 percent in August, and 14⅞ percent in September.

[Attachment C]

EFFECTIVE RATES OF RETURN FOR SOCIAL SECURITY TRUST FUNDS IN VARIOUS YEARS

[Amounts in percent]

	OASI	DI	OASI–DI	HI	SMI
12 mo. period ending on June 30					
1961	2.7	2.7	2.7	[1]	[1]
1962	2.8	2.9	2.8	[1]	[1]
1963	2.9	3.0	2.9	[1]	[1]
1964	3.0	3.1	3.0	[1]	[1]
1965	3.1	3.2	3.2	[1]	[1]
1966	3.3	3.6	3.3	[1]	[1]
1967	3.6	3.9	3.6	4.6	4.6
1968	3.9	4.2	3.9	4.9	4.8
1969	4.1	4.8	4.2	5.3	5.2
1970	4.7	5.6	4.8	6.0	5.9
1971	5.2	6.1	5.3	6.5	6.4
1972	5.3	6.1	5.4	6.7	6.2
1973	5.5	6.1	5.6	6.4	6.1
1974	5.9	6.4	6.1	6.7	6.8
1975	6.5	6.8	6.5	7.2	7.1
1976	6.8	6.8	6.8	7.2	7.2
1977	6.9	7.0	6.9	6.3	7.4
1978	7.2	7.4	7.2	7.4	7.4
1979	7.4	7.9	7.4	7.7	8.2
1980	8.3	8.8	8.4	8.2	8.3
1981	[2]	[2]	8.8	8.9	8.7

[1] Trust fund began operation in 1966.
[2] Rate not computed because of distortion caused by reallocation of OASDI tax rate between OASI and DI during year.

[Attachment D]

AVERAGE MARKET-YIELD RATE ON MARKETABLE INTEREST-BEARING OBLIGATIONS OF THE UNITED STATES, AS OF THE BEGINNING OF JUNE OF VARIOUS YEARS

[Amounts in percent]

Year	All obligations	Trust-funds special-issue rate for June[1]	Difference
1981	14⅞	13	1⅞
1980	8⅞	9¾	−⅞
1979	9½	8¾	¾
1978	7¾	8¼	−½
1977	6	7⅛	−1⅛
1976	6⅝	7½	−⅞
1975	6¼	7⅜	−1⅛
1974	8⅜	7⅝	¾
1973	6⅞	6⅝	¼
1972	4⅝	5¾	−⅞
1971	5¼	6⅛	−⅞
1970	5½	7⅝	−2⅛
1969	6½	6½	....
1968	5¾	5⅝	⅛
1967	4⅛	4¾	−⅝

[1] Average market-yield rate of U.S. marketable obligations with 4 or more years until maturity.

Chairman PICKLE. Thank you, Mr. Myers. I am going to assume you will stay with us?

Mr. MYERS. Yes, Mr. Chairman.

Chairman PICKLE. Now we will be glad to hear from Mr. Mark Stalnecker, the Deputy Assistant Secretary of the Treasury.

STATEMENT OF MARK E. STALNECKER, DEPUTY ASSISTANT SECRETARY OF THE TREASURY (FEDERAL FINANCE), DEPARTMENT OF THE TREASURY

Mr. STALNECKER. Thank you, Mr. Chairman.

Chairman PICKLE. We will be pleased to hear from you.

Mr. STALNECKER. Mr. Chairman, members of the subcommittee, I am pleased to present the views of the Treasury Department on the subject of policies governing the investment of social security trust fund assets.

My comments will be directed only at the investment policies of the trust funds and will not address the more fundamental questions of funding and benefit levels.

The social security trust funds consist of four separate funds—the Old-Age and Survivors Insurance Trust Fund, the Disability Insurance Trust Fund, the Hospital Insurance Trust Fund, and the Supplementary Medical Insurance Trust Fund.

The invested assets of the funds were $48.6 billion as of September 30, 1981. The investment of the funds is by law the responsibility of the Secretary of the Treasury.

In your letter to Secretary Regan of October 6, 1981, you stated that the subcommittee is interested in learning Treasury's views regarding the continued appropriateness of all current policies and practices concerning the investment of trust fund assets.

Specifically, you requested our views on the following:

(1) the appropriateness of the current statutory interest rate formula in light of both current high interest rates on short-term investments and the fact that many trust fund securities are now held for only short periods before redemption;

(2) the advisability of increasing trust fund purchases of marketable U.S. Government securities in the open market; and

(3) the appropriateness of Treasury's policy of establishing maturities for new special issues given the fact that long-term special issues are often redeemed before maturity when trust fund outgo exceeds income, as is the case with the OASI and the DI trust funds today.

You also expressed your interest in learning whether any changes in policies governing the investment of trust fund assets are advisable given both today's short-term interest rate yields and the financial crisis facing the social security system.

We believe that the long-range investment policies governing the social security trust funds, and other trust funds, should not be dictated by the happenstance of current relationships between short-term and long-term interest rates.

At the time the present law governing the investment of the social security trust funds was enacted in 1960, long-term market rates were higher than short-term rates. For example, 3-month Treasury bill yields were about 2.9 percent on a coupon equivalent basis and yields on 10-year treasuries were about 4.1 percent.

Thus, the statutory requirement that the interest rate on fund investments be based on market yields on Treasury securities with 4 or more years to maturity resulted in a higher return to the funds than would have been realized from a formula based on short-term rates.

Since 1960, long-term rates have generally been higher than short-term rates, but the relationship has fluctuated substantially with changing market conditions, and in recent years there have been prolonged periods when short-term rates were higher than long-term rates.

This relationship has changed dramatically in recent months, as short-term rates declined relative to long-term rates.

The 3-month bill rate is currently about 13.9 percent and the 10-year rate is about 14.9 percent, but in May 1981 the 3-month bill rate was as high as 18 percent, while the 10-year rate was 14.7 percent.

Thus, the earnings of the funds will not necessarily be maximized by requiring that future investments be tied to either short-term or long-term rates.

Nor should the long-range investment policies be dictated by the current status of the much broader problem of social security funding, that is the problem of assuring adequate social security taxes or other sources of funds to meet future benefit payments. The funding problem obviously cannot be resolved by changes in investment policy.

The investment earnings of the funds would of course be increased if the Treasury were to pay a higher interest rate on fund investments than the Treasury is required to pay on comparable maturity borrowings in the market.

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However, this would result in a completely arbitrary subsidy to the funds at the expense of the general taxpayer, and the subsidy thus provided would not be subject to the congressional control and scrutiny inherent in the normal appropriations process

To assure that Treasury issues to the trust funds are at interest rates consistent with the Treasury's current cost of borrowing in the market the interest rates should be related to the maturities of the issues; that is, a 1-year issue to the trust funds would carry a rate equal to the estimated rate Treasury would pay at that time on a 1-year issue in the market, the rate on a 5-year issue would be based on Treasury's 5-year market rate, and so on.

As to the appropriate maturities of issues to the trust funds, we believe that the selection of maturities should be based on the expected cash needs of the funds. A statutory requirement that the funds be invested in short-term issues and rolled over as they mature would result in excessive dependence on short-term interest rates, which are generally lower than long-term rates, and considerable volatility in fund earnings, because short-term market rates fluctuate much more than long-term rates.

As to the advisability of increasing trust fund purchases of marketable Treasury securities in the open market, we see no advantage to the trust funds from such purchases. So long as Treasury issues of nonmarketable securities to the funds bear interest rates that are tied to market rates, the funds will be assured of current market rates

Moreover, the maturities and timing of special issues can be tailored more effectively to the needs of the funds, compared to open market purchases.

Given the investment principles suggested above, I would now like to turn to the present specific statutory requirement for the investment of the social security funds in special nommarketable issues. Existing law provides:

> Such obligations issued for purchase by the trust funds shall have maturities fixed with due regard for the needs of the trust funds and shall bear interest at a rate equal to the average market yield (computed by the Managing Trustee on the basis of market quotations as of the end of the calendar month next preceding the date of such issue) on all marketable interest bearing obligations of the United States then forming a part of the public debt which are not due or callable until after the expiration of four years from the end of such calendar month

There are three apparent deficiencies in this statutory formula.

First, as discussed above, the requirement that the interest rate be based on yields on Treasury marketable issues with 4 or more years to maturity prevents the Treasury from providing interest rates related to the specific maturities of the issues to the trust funds.

Thus, when short-term rates are higher than long-term rates, as has generally been the case this year, the trust funds receive a lower rate of return than they would receive if the statute permitted Treasury to pay interest rates related to the yields on Treasury marketable issues of comparable maturities

Second, the requirement that the obligations issued to the funds bear interest at a rate equal to the average market yield at the end of the month preceding the date of issue subjects the earnings of the funds to erratic fluctuations which may occur on any one day in the market, because of market reactions to short-term economic or financial developments or other unsettling news events.

A better approach would be to base the interest rate on an average over a period, which would provide a more equitable rate of return and would help assure more stability in the earnings of the funds

Third, the requirement that the obligations issued to the funds bear interest rates equal to market yields on all marketable interest bearing obligations of the United States of the prescribed maturities results in a somewhat lower rate of return to the funds than Treasury would be required to pay on new issues in the market; that is, under this statutory formula, Treasury must include in its rate computation the yields on many outstanding issues which were issued many years ago at market rates considerably below current yield levels.

Since such issues are thus traded at deep discounts in the current market, they are especially attractive to purchasers who benefit from the capital gains tax advantage of deep discount issues, as well as to purchasers who gain special tax advantages from the so-called flower bonds which are redeemable at par for the payment of estate taxes.

Consequently, such issues are traded at relatively higher prices, and thus lower nominal yields, than would be required on Treasury new issues.

This inequity to the trust funds could be remedied by permitting the Secretary of the Treasury greater discretion to base his rate determinations on current market yields on selected outstanding issues which are reasonably reflective of Treasury's current borrowing costs

Also, this administration is currently conducting a comprehensive review of the longstanding statutory requirements and administrative policies and practices governing investments of the social security funds and other trust funds, particularly those funds which are invested under similar statutory formulas.

This review will have to consider the overall levels of trust fund benefits in the future. Upon completion of this review, the Treasury Department will consider appropriate recommendations to Congress to assure an equitable rate of return to the trust funds under changing market conditions.

We look forward to working closely with your subcommittee on this important matter.

Mr. PICKLE. Thank you, Mr. Stalnecker

As an overall question, I would like to ask you both, if you think that the current manner in which you are investing the trust fund moneys is the best approach?

Are you satisfied with it? Are we getting the best return? Should we invest the trust funds differently?

Mr MYERS. Mr Chairman, answering first, I would say that the present method is, in general, the best possible method if it is carried on for a long period of time

If you jump in and out of investment strategies, it is not the best at the moment

I think that it is fair and equitable to everybody that the present general method be continued

Mr. Stalnecker has pointed out one or two technical elements, such as the possible exclusion of bonds like the "flower bonds" or bonds with deep discounts, that might refine the present method I think that the general structure of the present method is a fair and equitable one to the Social Security System as a whole and to the General Treasury as well.

Mr. STALNECKER I would agree with that. I think what has happened over the past 20 years or so since the 1960 amendments were passed has been a financial environment that was totally unanticipated under the statute.

Also, I would point out the long-term nature of these funds, which was anticipated throughout the history of the funds, has meant that the social security funds have been invested in longer term securities over the past 20 years.

As rates have risen, as Mr. Myers mentioned in his testimony, the fact that these longer term rates still exist on the books of the funds has made the comparison to the currently available interest rates look bad relatively speaking.

If you look at the performance of other longer term investment portfolios in the marketplace, which would be analogous to the long-term investment of the social scurity trust funds, the rates of return are very comparable to those earned by the social security trust funds

I think the problem hasn't been the investment policies of the fund which have been consistently applied regardless of market conditions, but in the general financial conditions which have resulted in ever-increasing interest rates since 1960.

Mr. PICKLE. The assertion by some that we have lost $1 billion in added revenue because of the present policy is a serious one We have to consider whether there is some way we can actually make much more in the investment of the trust funds, and whether or not that is an appropriate way to go?

Mr Stalnecker, you indicated there were three different approaches. You listed the one, two, three approaches in your testimony. One you did not mention would be the redeeming of the highest interest special issues before all the lower ones were redeemed.

That is another alternative, another option.

Mr. Myers, it seems to me you stated the policy question pretty well that we all face. You said, starting on page 10:

> Another strategy is for the Social Security trust funds to roll over their assets into those securities with the highest current yield, but only if such yield exceeded that of current holdings

Then you say·

> Such a strategy would be very advantageous to Social Security, but very disadvantageous to the General Treasury, which would have to pay the higher amounts of interest due from general revenues

It seems to me that this is the key to the issue We could redeem the lower interest-bearing bonds and take the higher interest rate now, but if we did it, it would cost the Treasury.

I raise the question, are you trying to protect the trust funds, social security trust funds, or are you trying to protect the General Treasury? It does come down to that

Whose interests are you looking after?

What is the proper course to take?

Either of you may comment on that

Mr. MYERS. Mr Chairman, my guiding principle on this—and it has been over the years—is that both parties should be treated equitably

It is not like a competition in the private sector where the investor and the person seeking a loan are competitive. Here, these are two branches of the Federal Government, and it is essential that there should be equitable treatment between them

In other words, I do not think that the general fund of the Treasury should take advantage of the trust funds, nor do I think that the trust funds should take advantage of the general fund

It could happen—which it has not—that the Treasury could take advantage of the trust funds, if the Treasury sold the trust funds, say, high interest bonds and made them very short duration and then when interest rates were low the Treasury put all of the money into long durations. That would be unfair to the trust funds

In the same way, I do not think that the trust funds should have the best of all worlds by redeeming only the lowest interest securities but rather there should be a mechanical way of making redemptions.

Mr. PICKLE. Could Treasury redeem the lower interest-bearing bonds?

Mr. MYERS. I think that, under the law, this could be done, because the law does not prescribe anything but the interest rate.

Mr PICKLE. Could it not be done without penalty?

Mr. MYERS Yes, it could

Mr. PICKLE If we did, wouldn't we gain more revenue for the trust funds?

Mr MYERS. Yes That would be true I do not think that it would be a fair and actuarially equitable thing to do.

Mr PICKLE. I recognize there is a flip side to it because, as you help the trust fund, it indirectly affects the General Treasury Yet the funds are money that the Treasury can also use, particularly in long-range bonded indebtedness of the national debt

It is a source of money that the Treasury must have. So the question is, who helps who? We are looking at it, as you undestand, Mr. Myers—at least I am—from the perspective of the social security trust fund

We do have the option of redeeming these lower interest bonds You can do it without penalty If we did, though the General Treasury would indirectly be affected, it would help our trust fund perhaps as much as $1 billion dollars a year. The question is whether or not we do that?

If we did increase investment income to the trust funds, would that increase the deficit?

Mr. MYERS. I think that the effect of that would be to increase the deficit because the Treasury would have to pay more money, as interest, in the budget It would probably be a wash item. Just as I think that it would not be fair for the Secretary of the Treasury, when he was redeeming bonds under the law, he could take the highest interest ones and redeem them first

I do not think that would be right. Rather, there ought to be an established procedure, so that mechanically a certain result happens whether interest rates are low or high.

Mr. STALNECKER. Could I comment on this, Mr. Chairman?

Mr. PICKLE. Before you do, specifically my question was, if we did redeem the lowest interest-bearing bonds and that can be done without penalty, would that increase the deficit?

I am trying to find out, will it actually increase the deficit? You said it would. I am led to believe it would not.

How do you answer that?

Mr. MYERS. Mr. Chairman, if the trust funds obtained this higher interest return in the manner that you describe, this would, of course, make the system sounder.

In other words, it would decrease the long-range actuarial deficit of the program by a small amount.

Mr. PICKLE. In effect, it would be a wash, would it not?

Mr. MYERS. As far as the general budget of the Government is concerned, yes.

Mr. PICKLE. Mr. Stalnecker, did you wish to comment?

Mr. STALNECKER. Yes. I wanted to comment on this general question of the discretion to redeem these special securities.

Historically and throughout the legislative history of the social security program, the presumption has always been as the policies have been laid down and enunciated, that the trust fund maturities and the redemptions would be based on the cash needs of the funds; and as a result there has been no discretion left to the managing trustee to manage the funds on the basis of market movements.

The issue of par value specials, for instance, might have to be reconsidered if redemption of the funds for noncash needs is anticipated, because to the extent that redemptions would be allowed in response to market movements, the question of subsidy to the social security fund at the expense of the general taxpayer would have to be addressed.

I would like to point out that, to the extent some securities have had to be redeemed prior to maturity, the fact they could be redeemed at par without any market loss has favored the funds.

The Treasury's view is that the less discretion in terms of the managing trustee's role to play the market and make market decisions, the better.

That is the way the fund has been managed. It has been managed consistently on that basis for the last 20 years at least.

We feel that as long as there is a consistent policy that is adhered to, these potential conflicts of interest are eliminated and both the general taxpayer's welfare and the trust funds' welfare can be looked after.

Mr. PICKLE. I want to ask you the same question I asked Mr. Myers:

If we did redeem these low interest bearing bonds, and the money was reinvested in higher yielding bonds, would that actually increase the Federal deficit from the budget standpoint?

Mr. STALNECKER. My understanding——

Mr. PICKLE. Mr. Myers says yes.

Mr. STALNECKER. My understanding is if the redemptions of lower coupon securities, lower interest securities were made and the proceeds reinvested in higher rate securities, interest on the public debt would rise which would increase the Federal funds deficit.

Because there would be a larger surplus in the trust funds, the effect on the unified budget deficit would be zero. There would be a wash.

Mr. PICKLE. As far as the unified budget, there would be no net effect—a wash. That is what I am trying to establish. I appreciate your views.

I have a lot of other questions, but I want to recognize next Mr. Jacobs.

Mr. JACOBS. Mr. Chairman, I think we have come up with a miracle here.

As a matter of fact, I think we can wipe out the whole deficit of the U.S. Government this morning if we use our wits well enough.

For example, if the Government goes into the market next year or in this fiscal year and borrows $80 billion, and then it spends it on something, that is something that becomes an asset in a sense, doesn't it? Even if it is education? That is an investment in the country.

By the same logic that I have heard just now, that would be a wash too.

You would have an asset to show for it.

Mr. STALNECKER. No, because what you are talking about is the issuance of a security in receipt of cash. In other words, the trust funds would be——

Mr. JACOBS. Yes. The security is an asset. A better educated nation is an asset.

Go out and buy a tank, God knows, that is an asset, a military tank. So we don't have deficits any more according to this logic, do we? Every time you borrow something, you buy something with it, and that is a wash. Whitewash maybe.

Mr. STALNECKER. It is because of the special accounting treatment in the unified budget for the social security fund deficits and surpluses.

That is not the case for operating budgets of the different agencies. They do have to raise the money and expend the cash which is counted in the Federal funds.

Mr. JACOBS. Let me just remind you of that Lincoln story about the lawsuit over whether the railroad right-of-way was flooding the farm. They had a very, very bright lawyer who brought in engineers and brought in statistical evidence, average rainfall and so on.

The country lawyer in his closing argument said that:

> You have proved beyond the peradventure of a doubt absolutely, conclusively that that railroad right-of-way couldn't possibly have flooded my client's land. I just have one question: Have you ever been down on that farm when it was raining?

What I hear you say is that we can get a billion dollars more for the social security trust fund without increasing Federal income taxes and without creating a deficit. That is wonderful.

I think we ought to get at it and apply it to the entire Government if all you need to do is that. Does that make sense to you?

It comes from somewhere, doesn't it? If you pay a billion dollars more from the Treasury to the social security fund, apart from whether you push the pencil or what kind of figures you put down on paper, you got to get that somewhere, don't you?

Mr STALNECKER Well——

Mr JACOBS Where would you get it?

Mr STALNECKER The Federal funds deficit would be increased as we mentioned

The Treasury would have to—to a certain extent this is an accounting problem The Federal funds deficit would increase As we mentioned

Mr. JACOBS. Let's say we build a new Bugtussle Building or Albert Building down the street, a new House office building. Let's say it costs $800 million, eight-tenths of a billion dollars

You fellows have to go out and borrow the $800 million to put that building up That is a wash too, isn't it? We have this $800 million building, an asset? Wouldn't that be a wash?

Mr STALNECKER. No, it would not be.

Mr JACOBS Wouldn't it? Why is that? The building isn't worth $800 million.

Mr STALNECKER. No. It is included, the accounting treatment, as an expenditure for a goods or service on the part of the Federal Government as opposed to the unified budget concept which treats the social security trust fund surplus as a contra-entry, so to speak, to the actual Federal funds deficit

If the social security system were a separate accounting entry and not unified with the Federal funds deficit, then what you are suggesting would, in fact, result in an increase in the Federal deficit.

Mr JACOBS But in real life if you borrow $800,000 and buy an $800,000 house and it is worth $800,000, is that a wash?

Mr. STALNECKER No

Mr. JACOBS. Just if you use Government accounting it becomes a wash?

Mr STALNECKER No. It just becomes a wash when the two Government accounts that are being considered as one are——

Mr. JACOBS I believe you have not quite answered my question, the other question.

If the social security trust fund gets a billion dollars more, where does it come from? Do you borrow it?

Do you have to raise taxes to get it? How would that be right now?

Mr MYERS Mr Jacobs, I might try an answer to that question I think what would happen is that the national debt would increase by $1 billion in that year, and then in subsequent years it would increase by the interest on that $1 billion

Mr. JACOBS Yes That is the answer to the question, in fact, isn't it? You would either have to raise general revenues by taxation, more oil income, or something, or you would have to borrow it, wouldn't you?

Wouldn't you have to borrow that billion dollars if you are already in a deficit? Isn't that a reasonable thing to assume?

Mr STALNECKER Yes In terms of the ultimate financing of the Federal Government, the outlay would require additional cash, yes

Mr. JACOBS. Either that or some big word like monetizing where you just print the money and turn it over to the social security system, isn't that right?

Mr. STALNECKER Yes

Mr. JACOBS Thank you, Mr. Chairman

Mr. PICKLE Mr. Archer?

Mr. ARCHER Thank you, Mr Chairman

I would like to follow up, if I could, for a minute on Mr Jacobs' comments and questioning.

Obviously what you have said is technically correct as far as the budget is concerned, but where it is flawed is the implication that we had a static situation as to what other action we would take otherwise with respect to the social security fund

You will be creating an extra billion dollars of money to spend on social security benefits which, if it was not available, would be raised in some other fashion and therefore would have an ultimate effect on the total budget

That is the difference between what you and Mr Jacobs are saying Both of you are correct, but it is not static and we would do something else. Therefore it is only a dialectical exercise of some type or other to talk about the fact that this has no effect on the budget

It does have an effect on the budget in the long term

That should be very clear. That is why Mr Jacobs is completely right.

I agree with both of you in that this should be constructed to the greatest degree to be neutral. The investment policy relative to the trust fund should be neutral between the Treasury and Social Security.

The greater discretion we give, it seems to me, the greatest potential abuse of discretion is put into the law

After all, the Government does not set interest rates The private sector sets interest rates The Government pays interest rates at whatever level it takes to get the money to fund its debt It does not go out into the marketplace and say: We are going to put a certain interest rate on these bonds and if they don't sell, well, that is tough luck; we are going to stick there on that interest rate because we are not going to pay over 10-percent interest or 12 percent or whatever it might be

So ultimately the buying public determines the interest rate, but for some strange reason when we deal with Social Security, we don't treat it like the buying public. The buying public, also having bought that bond, is subject to the vagaries of the continuing interest rates which affects what they can sell that bond for in the marketplace at any day and time

The relationship between those two items has got to be brought before the attention of this committee That is, you can say let's just roll over the interest rate bonds at par, that is not what the public can do, and that is not a neutral situation between the Treasury and Social Security

When the public buys a low-interest bond and the interest rates go up, then the public, if it wants to sell that, has got to discount it severely in order to match the current yields

It seems to me that we ought to have the same kind of relationship to the greatest degree possible between Social Security and the Treasury as we have between the public and the Treasury.

Only in that way are we going to be able to safeguard the fact that Social Security and the Treasury are being treated equally.

Now, do we need to change the formula in any way in order—I see both of you nodding. I assume you agree mostly with what I have been saying.

Having said that, do we need to make any changes in the law that would bring about a greater degree of neutrality that can be understood by the American public, instead of a bit of show trying to convey how we can make extra money with mirrors some way or other for Social Security?

I am completely in accord with Mr. Jacobs in that regard.

Mr. STALNECKER. If I were talking about making the social security trust investment a more arm's-length transaction relative to the Government than it is now, two things could be done, as I suggest in my testimony. One is the tying of the interest rate to the actual maturity in the marketplace that is identical to the maturity of the trust fund investment, rather than putting the same interest rate on all trust fund investment regardless of maturity.

Another change that could be done would be to issue market-based special securities to the trust fund which would, in addition to placing a market rate on the trust fund investment identical to the rate on the maturity in the marketplace, it would subject the trust fund investment to the same vagaries of market price that a marketable security would.

That would be an arm's-length transaction and give the social security trust funds the same rate they would earn in the market but also subject them to the same market value fluctuations.

In the event of a redemption, an emergency redemption for cash, it would subject the trust fund to the same kinds of potential for loss as you have already pointed out.

Mr. ARCHER. Do you agree with those suggestions, Mr. Myers?

Mr. MYERS. I think that they are excellent suggestions.

I suppose that I am a status quoer. I think that what we are doing now can be very clearly explained. I fear that, if the durations are matched up with the interest rates, there might be more questions then as to whether the Secretary of the Treasury is wearing two hats.

What is causing our problems at the moment is that, as you so well know, the trust fund balances are decreasing, and Treasury is having to sell many securities.

If the trust funds were to gradually increase over the years, this problem of selling special issues would not be such an important one.

Mr. ARCHER. I would like to take this opportunity, Mr. Chairman, to digress slightly on the subject matter, and place into the record, while we have Mr. Myers here particularly, some factual information relative to the social security trust funds which is not understood properly by the American people.

I would like to pose a couple of questions. No. 1, has money ever been let out of the trust fund for purposes other than social security benefits during the life of social security?

Mr. MYERS. The answer to that question is very simple. No, it has not. All the money that has gone into the system has been properly accounted for and invested.

Mr. ARCHER. The money has not been used for any other general purposes?

Mr. MYERS. No, it has not. When you put money into the bank, the bank may spend that money, but it is not really spending your money, but it is spending—loaning out—its own money.

Mr. ARCHER. Do you have any idea of what has caused these rumors? People seem to think the social security trust fund would be in great shape if we had not bled money from it.

Mr. MYERS. It baffles me where these rumors come from. Over the past 6 months I have had many inquiries about that, ranging from the Marshall plan and the Korean war, to the atomic bomb. People ask, was not money taken out of social security and used for that purpose?

The answer is, "No". The money in the trust fund was accounted for and was invested in special issues and elsewhere. It cannot be said what money went for what purpose, because it was, in essence, back in the general fund of the Treasury.

Mr. ARCHER. When money was borrowed from the fund during World War II, it was borrowed virtually in the same way it is being borrowed now, but it has always been paid back with interest. Is that a fair statement?

Mr. MYERS. That is a correct statement, Mr. Archer.

Mr. ARCHER. I would also like to ask both of you, how would the returns on social security trust fund investments compare with returns on long-term bonds in the private market managed by private investment managers?

Mr. MYERS. My best answer to that would be the comparison which I gave in my testimony, where I pointed out that the average rate of investment return on the trust funds in calendar year 1980 was about the same as—in fact, was slightly higher than—the average rate of investment return of all U.S. life insurance companies.

Mr. STALNECKER. I have seen some numbers on some mutual funds, on those invested in long-term bonds, in addition to Government bonds. Some of these funds are invested in corporate bonds as well. They are managed by the best the private sector has to offer. When you take into account the market value depreciation on them, their holdings have not done very well.

Using the Forbes magazine mutual fund ratings, as a group they averaged a negative return, because the market value depreciation that occurred on their longer term holdings more than offset the interest income that was being earned, so that as a group the funds came out with minus 1 percent return.

It does show the difficulty that all long-term investors have had to face in the last few years, given the market environment.

Mr. ARCHER. Do you believe that the Social Security Board of Trustees should be given the flexibility to invest in higher yielding federally sponsored agency securities that carry the credit of the United States as a guarantee behind those securities?

Mr. STALNECKER. I do not believe that the social security trust fund should be invested in those agency securities, basically for the reason they would have to be purchased in the market and could, therefore, disrupt the market when the purchases and sales were executed, but more fundamentally, such investment in other than a general Treasury obligation would raise questions of program support and subsidization of certain agency programs that I do not believe is appropriately in the purview of the managing trustee.

To the extent the investment in general Treasury obligations is socially neutral as well as financially neutral, that policy should be adhered to.

In response to your question, that policy should not be allowed.

Mr. ARCHER. What is the rationale for not having private representation on the board of trustees, including an outside investment counsel?

Mr. MYERS. As to that proposal, the administration has no position. However, as to that question, so far the proposals have generally been made only with regard to investment procedures. I would hope, however, if something like that were done, that the additional members would not have a great responsibility with regard to the actuarial cost estimates.

The chief actuarial officers of the Social Security Administration and the Health Care Financing Administration signed statements in the trustees reports that the actuarial methodology is proper, and the assumptions seem reasonable. These assumptions are developed by consultation with the staffs of the other trustees, the Secretary of the Treasury, and the Secretary of Labor. This has proved very useful over the years. It does perhaps slow up somewhat getting the report in on time, unfortunately. However, I would not like to see four more trustees trying to influence or make the determinations of the actuarial assumptions and methodology.

Mr. STALNECKER. Could I respond, especially to your comment about an outside investment manager being added?

It is our view that these are public funds, and the inclusion of private sector managers of the fund assets would result in an unnecessary politicization of the fund's management, and we do not believe the addition of an investment manager would necessarily enhance the fund's returns.

There is no evidence that private managers have been able to outperform the market, and I point to some of the figures I just mentioned that indicate the fund's performance in long-term investments. We believe a consistent policy of maturity selection in U.S. Treasury securities over the full interest rate cycle without making any judgments as to interest rates is the best policy to pursue. Therefore, adding a trust fund manager with market expertise would only open up the fund to second guessing, and could in fact result in bad market moves that would not benefit the fund.

We do not believe there should be a managing of the trust fund assets on the basis of the interest rate.

It has been based on the cash needs of the fund, which is the appropriate way to choose the maturities, and any fine tuning of the investment policies is not beneficial.

Mr. ARCHER. The yields on the par value special securities are the same whether they be, say, a 2-year security or a 15-year security?

Mr. STALNECKER. Yes, they are.

Mr. ARCHER. Why should it not be higher for the long term investments?

Mr. STALNECKER. The current statute specifies that all special obligations issued by the Treasury to the trust funds must bear an interest rate that is the average rate on all outstanding marketable obligations with 4 years or more to maturity, so that there is no discretion in setting the rate under the current statute. All securities bear the rate of the 4-year-and-longer average market yield.

Mr. ARCHER. I would think that provision does tend to warp the returns in contrast to what the public is dealing with, so that you don't have neutrality in a sense compared to public return on Government securities.

Mr. STALNECKER. I would agree with that. In the legislative history the reason the 4-year-and-over maturity was selected as the base for the interest rate was that it was expected that the funds would be long term in nature, and to reflect the long-term character of the fund investments the long-term rate was selected.

In addition, under most circumstances there is a positive slope to what is called the yield curve, which means longer term securities bear higher rates than short-term securities, and if that is the case the trust funds would earn a slightly higher return over time.

I agree with you, that is an arbitrary distinction to a certain extent, and that is why in my testimony I suggested that one possible change that might be considered is the tying of the interest rate to the maturity of the trust fund investment, not just the setting at the same rate regardless of maturity.

Mr. ARCHER. Mr. Chairman, I want to thank you for indulging me for the extra time, and thank both of the witnesses for putting some very cogent facts into the record. I hope the American public is listening as these facts get spread across the board here.

Mr. PICKLE. Mr. Myers, you stated that our problem is caused by the fact that we now have to sell our securities and bonds, because our reserves are being depleted.

We have to redeem obligations in order to pay benefits and we have to choose which obligations we will sell in order to have the cash on hand and to be able to pay the next month's benefit. What we are trying to discuss today is what is the best policy, what is the best approach on investing the social security trust funds.

Now, I would say first to Mr. Stalnecker, you concluded your statement by saying that the goal we ought to have would be, as I believe your phrase was, to have equitable rate of return to the trust funds.

We all agree that that ought to be the goal, but I also take from your testimony the fact that you are looking at the goal from the viewpoint of the Treasury rather than the viewpoint of our trust funds.

If you disagree with that, I want you to state it, but it seems to me that you are looking at it just as much from the Treasury standpoint as you are from our trust fund.

You are the one that actually is supposed to be investing our funds in a wise manner, as a "prudent investor" would. Would not the prudent investor, if that is the test, and that is what we are charged to follow, would he not go short when short-term rates are high and extend the maturity dates in his portfolio as the rates begin to decline, so that high, long-term rates would be locked in? Wouldn't the prudent investor normally do that?

Mr. STALNECKER. With hindsight the prudent investor would like to get the longest maturity securities in his portfolio at the absolute peak in interest rates.

The difficulty in analyzing what they should do at any point in time is that the future is nothing more than a hazy, abstract concept, and prospectively it is very difficult to know when interest rates are at their peak and when they are at their trough.

Some people felt a few years when long-term Treasury notes were at 9 or 10 percent they were as high as they were ever going to go, and subsequent events have shown that those levels were low.

In hindsight you can always come up with strategies that would maximize the return on the funds.

At any point there is no knowledge about what the future course of interest rates is going to be, and our view is that an investment policy that acknowledges that fact and tries to get a maturity distribution in the funds that is diversified subject to the cash needs of the funds is the fairest way to guarantee that the trust funds earn an equitable market-based return, and as I pointed out, other investors that purchased Treasury securities over the past 20 years were purchasing at the same rates as the social security trust funds and are carrying these securities on their books now at substantial discounts to their purchase price, so I do not believe the social security trust funds have been treated inequitably in their investments.

Mr. PICKLE. I am not implying that you have not handled the funds reasonably well, or that a poor investment policy has been followed.

The question is, Can we do better, can we get a better yield than we are getting now? And you keep referring, in hindsight we might have made more money.

I am trying to have a little of that hindsight now and say can we get more money, can we do better now? We ought to understand that, and you keep making a reference to this hindsight.

I am asking, whether or not, as a prudent investor, you would normally sell off all your lower yielding bonds if you were a prudent investor? Would not a prudent investor redeem the lowest yielding securities in his portfolio before selling the higher yielding securities? Would not any normal investor do that?

Is that a good policy?

Mr. STALNECKER. Most investors would have to realize substantial losses by the sale of their lower yielding securities. So I think to a certain extent, in terms of maximizing your cash income, yes, selling a low-coupon security and reinvesting the proceeds in a

higher rate could increase your cash flow, but the social security trust funds have been issued these special obligations that are redeemable at par.

Mr. PICKLE. Without penalty?

Mr. STALNECKER. Without penalty. That is correct, but the special obligations are issued partly because of the understanding that they will be redeemed only in emergency situations. The par-value securities were not issued so that the social security trust funds could continually redeem them and subsequently be subsidized by the general taxpayer.

Mr. PICKLE. Let me back up, because you are losing me with all these "yes but" answers.

Would not anybody normally handling the portfolio of a fund that needed cash which had to be derived by redeeming a portion of the portfolio sell his lowest yielding bonds at that point. Is this the Treasury policy?

Mr. STALNECKER. You cannot generalize as to what the prudent investor would do. I am saying one would have to look at the prudent investor's total portfolio. He might have some shorter term securities that would be more advantageous to liquidate, look at the shape of the yield curve and see which securities——

Mr. PICKLE. You have answered me, and you would not redeem the lowest yielding securities?

Mr. STALNECKER. It would depend on the overall portfolio structure that was being considered.

Mr. PICKLE. I am trying to establish that.

In that connection I would also ask you, because you made reference to the administration not reviewing the policies and practices governing the investment of these trust funds, and that you will, I presume, make some recommendation to the Congress.

In 1975, the Treasury responded to a GAO analysis of both social security and other Federal trust fund investments by stating:

> There are undoubtedly improvements that could be made in the procedures that have been developing for investing the trust funds. We will continue to look at the changes and make recommendations.

What changes or proposals has the Treasury made since this statement, and what can the Congress expect so far as your current proposal? You say you are reviewing it and the studies are under way. How long has this study been going on. Was it started by the previous administration? Are you at the point where you are going to make some proposals?

Mr. STALNECKER. The review that I referred to is not something that any previous administration initiated. It is something that has just been initiated with the new administration.

Mr. PICKLE. I had understood we had had this under investigation from 1975 on.

We are constantly reviewing our investment practices. Is this another way of saying you have an ongoing study?

Mr. STALNECKER. I believe these policies have been reviewed from time to time in the past. We are implementing a new review that will build on past studies that have occurred, and surely when we complete the review we will have recommendations.

The investment policies cannot be considered in isolation from the overall funding and benefit policies of the social security system, and——

Mr. PICKLE. The law stipulates that the trust funds shall be invested in special issues "except where to do otherwise would be in the public interest."

Now, should that be the law? Should that be the policy? Should the managing trustees be ordered always to invest in the interest of the beneficiaries, as would be in the case in any pension fund?

Mr. STALNECKER. I believe as a general rule that the least amount of discretion that is given to the managing trustee in terms of making management decisions of the trust fund, the better, so that to the extent Congress could prescribe what the investment policies would be, that would be a welcome development.

Mr. PICKLE. I thought you said previously we ought to keep in mind the beneficiaries and the need for the payment of these benefits, but the overall policy should be how to help the beneficiaries of the trust fund.

Now you are saying to me that that is not the primary thing, that we ought to consider the whole portfolio, and give yourself a little discretion, and I am trying to maintain some kind of a consistency of policy that you state.

Mr. STALNECKER. I hope the one line that has been consistent is that we do not believe investment policy should be changed based on market conditions. There should be a policy that is adhered to regardless of market conditions. The maturity selection process probably must be tied to the prospective cash needs of the funds. To the extent Congress can lay down these policies in an unambiguous fashion so that the managing trustee does not have discretion to play the market and do things that could conflict with other roles——

Mr. PICKLE. No one is advocating that we play the market, as if we would go out and buy Chrysler or Ford, or Sears, Roebuck. Nobody is asking that.

We are limited now to Government securities, Government Federal obligations. Do not chase rabbits on us here, and nobody is advocating that.

The question is: When you have to redeem the bonds in order to have sufficient cash on hand, and as reserves are going down we must do that, how do you best handle it?

You are saying you want very little leeway here. You want to have a set policy and stay with it, be consistent and not try to redeem them so as to maximize yield. Then you would maintain the practice, if that is your policy now, of redeeming your higher bearing interest, at this point, short term, and leave the low-interest-bearing long range bonds in the portfolio?

Mr. STALNECKER. No; the current policy would be to look at the shortest maturity securities, and then redeem first the lowest yielding securities within that maturity, and then go to the next year, and again redeeming in every maturity range the lowest coupon securities first.

We do not have a practice of redeeming the highest interest rate securities first. We start with the shortest and the lowest yielding security, and then go outward in that fashion.

Mr. PICKLE. I will refer to the chart here in a minute, because it seems to me like we have an awful lot of our old low-interest bonds in the portfolio.

Mr. STALNECKER. The shortest term maturities that have been liquidated have been the highest yielding in some instances, because we have been investing very short term recently due to the cash needs of the funds.

The longer term securities that are out there would be redeemed before a higher yielding security in the same maturity range if the shorter term securities were not sufficient to meet the cash needs of the funds.

Mr. PICKLE. I go back to the needs of the trust fund and the beneficiaries and I ask the question, should there be in the law any general language concerning the obligation of the managing trustees to the beneficiaries, and you are saying there should not. Is that correct?

Mr. STALNECKER. I am saying that there should be statutory requirements as to what the investment policy is, so that there is no discretion, or that there is very little discretion left to the managing trustee as to what management procedure should be followed.

Historically, that is in fact what has happened, although the statute does give some leeway to the managing trustee; the investment policies that have been adhered to have been adhered to relatively religiously since 1960, and as a result, I think we have already tried to incorporate an automatic investment procedure, and these redemption rules are reflective of that. We do have a policy of redeeming the lowest coupon, shortest maturity first, and that is the kind of stricture that should be embodied in any investment policy in the statute.

Mr. PICKLE. We started off the hearing by asking the question this morning.

Mr. Myers?

Mr. MYERS. Could I add one thing?

On June 30 of this year, among the other investments that the Treasury made for the trust funds was a total of $2.7 billion of 13-percent bonds due in 1996. If the assets of the trust funds were being reduced, these would be the last ones that would be liquidated. You and I both hope that we never see the day when we absolutely liquidate all of the assets of the funds, but then the last obligations that would be liquidated would be that $2.7 billion of 13-percent bonds. Thus, there is at least one very high yield set of bonds which will not be liquidated, hopefully, in the foreseeable future.

Mr. PICKLE. Mr. Myers, I notice in the committee print, dated October 13, regarding the social security trust fund investment policies and practices, on page 11, there is a list of various assets along with their par value, and the date they are purchased. Under present policies I presume that, there is need of these funds, Treasury would redeem these certificates, whether they are certificates of indebtedness or marketable Treasury bonds or even the Ginnie Mae, and that the first one to be sold would be the certificate of indebtedness at 14.78. Is that correct?

Mr. MYERS. That is correct. They were purchased most recently.

Mr. PICKLE. You would keep then in your portfolio your 7 and 8 and so forth?

Mr. STALNECKER. If, however, rates right now were below the level of the longer term investments, those securities would still be disinvested because they are the shortest term securities on the books of the fund.

The reasons these redemptions happen to be the highest yielding on the portfolio books are because recently interest rates have been the highest in history and thus the most recent issues represent the highest yielding assets, but they are not redeemed because they are the highest yielding but because they are the shortest maturities.

Mr. MYERS. The certificates of indebtedness that have durations of less than a year can really be compared to the interest which people are getting on their checking accounts now.

The money is invested currently and, because of the flow of funds, each month interest is paid during the month of investment, and at the end of the month, some certificates must be cashed in to pay the next month's benefits. Such interest that is paid currently is really not any indication of investment experience. It is just a very welcome return on temporary cash balances.

Many years ago, before the Treasury could handle this matter on a daily basis like this, the investments were not made nearly as promptly. As I understand the situation now, the Treasury, in essence, invests all of the money every day, so that continuous interest is received by the trust funds.

Mr. STALNECKER. That is one thing I should mention. You ask what the Treasury has done recently in terms of recommendations. Although some of these improvements are very technical, we have undertaken some initiatives in the past few years that have improved the earnings of the trust funds, one of which is crediting the float of the disbursments that occur in the fund throughout the course of the month. We have gone to a daily redemption of securities for payment of benefits rather than redeeming prior to actual need, so that these funds earn interest until they are actually needed for benefit payments. We have also gone to a wire transfer system for some State deposits rather than going through more cumbersome and delayed methods of receiving payment, so these technological changes, if you will, while not spectacular, have added millions of dollars to the funds' investments. They have been initiatives that the Treasury has undertaken to try to enhance the earnings to the trust funds.

Mr. PICKLE. Mr. Jacobs.

Mr. JACOBS. You may have already said for the record, but all things being equal so far as legal requirements are concerned, if you had a long-term holding at 8 percent, and a short-term holding at 15 percent, or 14 percent, does the law require you still, you had your choice as far as the contractual relationship is concerned, would the law require you to sell the short term rather than the long term?

Mr. STALNECKER. The statute, I do not believe, directly addresses the question of redemptions.

Mr. JACOBS. What would you do if you had a billion-dollar bond that was long term, and you had a billion-dollar bond that was short term, and neither one was mature, but the latter had the high interest rate and the former had a low interest rate, which one would you liquidate?

Mr. STALNECKER. We would redeem the security that was the shortest maturity date, the closest to maturity.

Mr. JACOBS. What is the advantage in that policy, despite the interest rate consideration?

Mr. STALNECKER. These securities are par value specials, which means they can be redeemed at their issue price, and to the extent that an early redemption is required you would best reflect the current market rate by selling the shorter term security because shorter term securities, given the mathematics of bond prices, normally have less volatility.

By selling the shorter term rather than the longer term in a neutral fashion over time, you would be more likely to sell a security closer to its par value than a longer term security would give you.

Mr. JACOBS. There is a financial advantage to the trust funds to do that, sir?

Mr. STALNECKER. It relates to keeping the trust funds' investments as closely based as possible to the rate they would earn if they were a private fund investing in marketable securities.

Mr. JACOBS. I have a staff-prepared question which I shall read to you in its entirety.

I believe you have a copy of it in front of you.

Would you explain your proposal in more detail than you did in your testimony? Specifically:

One. How would maturity dates be determined?

Two. Would there be any change in Treasury's redemption practices?

Three. Would these securities be redeemable at par, as are special issues?

Four. Would you provide for the record a comparison of interest income actually received by the trust funds from 1960 to the present, and what income would have been if your proposal had been in effect during this period.

It seems that the key to your proposal is that interest rates should be more closely related to maturity dates.

Which of those two, the interest rate or the maturity date, will be the determining factor when making the investment? Will the managing trustee seek to maximize yield and invest in those securities, or will he pay more attention, he or she, pay more attention to determining what maturities to purchase without regard to yield?

I believe you have that language in front of you. Could you respond in your best manner?

Mr. STALNECKER. The maturity dates of the investments would be determined the way they currently are, that is, the maturities would be based on the projected cash needs of the funds.

In terms of the redemption procedures, I would not anticipate any change of the current practice of redeeming lowest coupons, shortest maturity first, and working your way up and working your way out along the maturity spectrum.

Would they be redeemable at par? My proposal does not change the nature of the special issues and the par value redemption feature. It just changes the interest rate calculation. My suggestion would set the interest rate based on the market value, the market rate on the same security.

The key to my proposal really is, as you state, that the interest rate should be more closely related to the maturity date, but the controlling element in the investment policy would still be the cash needs of the funds, and the maturity date would, therefore, be based on the cash needs of the funds rather than the shape of the yield curve and the rates available on any given maturity.

Mr. JACOBS. One question, Mr. Myers, maybe you have been asked this question, and I am really not sure; namely, that I request you furnish the subcommittee with the report of the SSA actuaries as to what the short- and long-term effects of this Treasury proposal are likely to be. Can you supply that to us?

Mr. MYERS. I will be glad to do so. I have not seen the question or have done any work on it, but I would think just offhand that the proposed change would have no effect on the long-range costs, because I think the effects would balance out.

Mr. JACOBS. I guess the request by the staff was if your actuaries get around to it, they might make some analysis of the Treasury proposal from their point of view.

Mr. MYERS. Mr. Jacobs, I will have our actuaries consider that proposal and put something in the record.

Mr. JACOBS. Thank you, very much.

Mr. PICKLE. Well, thank you.

Mr. STALNECKER. We will be very happy to provide the figures you requested.

Mr. JACOBS. It is something like the college process, where they say the notes of the lecturer are transferred to the notes of the students without passing through either of their minds, but I think we are picking up a little bit right now.

Thank you very much.

[The information follows:]

MEMORANDUM

OCTOBER 30, 1981.

From: Harry C. Ballantyne.
Subject: Long-Range Effect of a Proposed Change in Trust-Fund Investment Policies.

A statement from the Department of the Treasury describes a possible change in the policies governing investments of the Social Security trust funds. The statement was presented by Mr. Mark E. Stalnecker, Deputy Assistant Secretary of the Treasury (Federal Finance), before the Subcommittee on Social Security of the House Committee on Ways and Means, on October 16, 1981.

Under the proposal, special issues purchased by the trust funds would bear interest at rates consistent with the Treasury's current cost of borrowing in the market and the interest rates would be related to the maturities of the special issues. A 1-year issue to the trust funds would carry a rate equal to the estimated rate Treasury would pay at that time on a 1-year issue in the market, the rate on a 5-year issue would be based on Treasury's 5-year market rate, and so on.

If the Treasury proposal were to become effective, we estimate that the long-range cost effect on the OASDI program, over the next 75 years, would be negligible.

HARRY C. BALLANTYNE,
Acting Chief Actuary.

Mr. PICKLE. Mr. Stalnecker, in connection with these maturity dates, it seems to be the governing factor that you follow concerning redemptions. I want to ask you, why is it the current Treasury practice to redeem securities according to their interest rates starting with the lowest first within each year maturity rather than redeeming the lowest yielding special issue in the whole portfolio first? Why is it that is your practice?

Mr. STALNECKER. As I mentioned, the thinking is that because the securities are par value specials and can be redeemed at par and because of the desire to maintain the trust fund investment policy as close to a private-market-based fund as possible, the decision was made that investing the shorter maturities first would result in a redemption value that more closely approximated the actual market value of the security, had it been a marketable security. Over the interest rate cycle, you will have more variability in the price of longer term securities than you will in shorter term securities, and therefore the likelihood that a shorter term security will be closer to its par value than the longer term security. Therefore, the redemption of the shorter term security would more accurately reflect the performance of the trust fund in the private market.

Mr. PICKLE. Mr. Gephardt has joined us this morning, and I would be glad to recognize him at this time.

Mr. GEPHARDT. Thank you, Mr. Chairman.

Thank you for your testimony. I have been able to read it over quickly, and I want to ask if you have any idea, or if there is a way to come to a conclusion about what the status of the funds would be if we had adopted the strategy that Mr. Myers talks about in the end of your testimony, which is to roll over trust fund assets into those securities with the highest current yield. I guess I am giving you a scenario of doing it with Federal securities that are of the highest current yield, a more aggressive strategy, one that would help the social security funds. Tell me what the status of the funds would have been a year ago, 5 or 10 years ago if that would have been done. Do we have those figures or can we arrive at them?

Mr. MYERS. Mr. Gephardt, that is a very interesting question, as to what would have happened if the procedure had been otherwise—and always to the advantage of the trust funds.

To the best of my knowledge, the actuaries of the Social Security Administration have never made such a calculation. It is an exercise that they could do. If you like, I can ask them to do that, and insert it in the record, say just for the old age, survivors, and disability insurance trust funds, not the medicare funds. This procedure would put the trust funds in a much better position than they now are. This is without regard to whether this would have been proper, but at least from an academic standpoint such calculations can be made.

Mr. GEPHARDT. I would like to see that, and I understand what you are saying at the end, where you say it would be an indirect form of general revenue financing for social security, that while the social security trust funds would do better with such a strategy, the additional interest earnings would be reflected in higher income taxes or larger Federal deficit.

I really think we have got to think that proposition through and try to arrive at a decision on it. I am not convinced that that should not be our strategy, and that we should not make a very clear demarcation between the social security program and the rest of Government, and the reason I think that, although I am willing to be convinced otherwise, is that we have gotten tremendous public adherence to this program through the years because of the perception that it is an insurance program, that it is different than the Government, that it is being paid for by the users, and that it is very much like private insurance programs, and that the investment policy would be as much like those programs as is possible.

Therefore, I guess I want to really think through your conclusion. I do not know that I agree with it, and I think it is something we ought to really chew on. It is almost a conceptual decision that we need to make, as well as obviously a pragmatic decision, but I am not sure I am convinced that we should glom it in with the rest of Government and have people believe that it is part of the rest of Government.

Mr. MYERS. It has been my basic belief, over these many years, that the trust fund should be treated neutrally by the Treasury. It should neither be advantaged or disadvantaged, but there is room for different views on this, and certainly I will be glad to have such a calculation made for you.

Might I make it on the basis that this different investment procedure would have started in 1960, which was when the interest basis was last changed, and project what the trust fund would be now if we had started following that other procedure in 1960, rather than going back to 1937?

Mr. GEPHARDT. That would be fine. Thank you very much.

[The following was subsequently received:]

MEMORANDUM October 30, 1981,

FROM: Harry C. Ballantyne SRG

SUBJECT: Additional Interest Income to the OASI and DI Trust Funds Under a Revised Investment Policy

We have determined the amount of additional interest income that would have been received by the Old-Age and Survivors Insurance and Disability Insurance Trust Funds during 1960-80 if the policies and procedures governing the investments of the trust funds had been changed as described below.

Under the revised policies and procedures, the special issues held by the trust funds on June 30 of each year, that carry an interest rate which is lower than the interest rate for new issues in June, would be reinvested (or rolled over) in special issues carrying the new issue rate for June, but with no change in the maturity date. If this revised procedure had been in effect since June 30, 1960, the assets of the OASI and DI Trust Funds would have been increased by the amounts shown in the following table:

Assets as of--	Increase in Assets (in billions)		
	OASDI	OASI	DI
December 31, 1980	$12.9	11.5	1.4
June 30, 1981	13.5	12.1	1.5

Harry C. Ballantyne

Harry C. Ballantyne
Acting Chief Actuary

Additional interest that would have been acquired by the OASI and DI Trust Funds if a proposal to change the interest rates on obligations sold only to these funds had become effective on June 30, 1960

(In millions)

Calendar year	Actual interest on investments			Additional interest under Proposal			Total interest		
	OASI	DI	OASDI	OASI	DI	OASDI	OASI	DI	OASDI
1960	$546	$53	$569	$4	(1/)	$4	$520	$53	$573
1961	548	66	614	90	$11	101	638	77	715
1962	526	67	594	160	21	181	686	88	775
1963	521	66	587	157	20	177	678	86	764
1964	569	64	633	173	20	194	742	84	827
1965	593	59	651	170	18	188	763	76	839
1966	644	58	702	210	17	227	854	75	929
1967	818	78	896	261	20	281	1079	98	1177
1968	939	106	1045	348	30	378	1287	136	1423
1969	1165	177	1342	563	51	614	1728	228	1956
1970	1515	277	1791	812	82	894	2327	359	2686
1971	1667	361	2027	906	103	1009	2572	464	3037
1972	1794	414	2208	868	104	971	2662	518	3179
1973	1928	458	2386	820	107	927	2748	565	3313
1974	2159	500	2660	815	120	935	2975	620	3595
1975	2364	502	2866	805	120	925	3169	622	3791
1976	2300	422	2722	732	109	841	3032	531	3563
1977	2227	304	2530	681	96	777	2908	399	3308
1978	2008	256	2264	793	98	891	2801	354	3155
1979	1797	358	2155	1026	129	1155	2823	487	3310
1980	1845	485	2330	1111	140	1251	2956	625	3581
1960-80	28444	5129	33573	11505	1416	12921	39950	6545	46495

1/ Less than $500,000

Note The actual interest on investments, and therefore the total interest, includes adjustments on reimbursed administrative expenses.

Social Security Administration
Office of the Actuary
October 30, 1981

Mr. PICKLE. Mr Myers and Mr. Stalnecker, I appreciate your testimony today.

This question, Mr. Gephardt, that you had asked was submitted to them earlier, and most of these gentlemen have testified that the present policy now is basically the best policy, and I want to be sure, if I understand it, that is what you are saying

I think it is well to establish that all of the investment is now limited to Government securities, we are not out investing in the market, and we are not asking for that privilege

Second, we are not using the funds, not for anything except for benefits They have never used the money to finance roads or bombers or food stamps or anything else

I think that that is good to know It is also good to know that the investments of our trust funds are in the special issue bonds almost entirely, 89 percent of them are in the special issue bonds, and we could go to the marketable Treasury bonds or the Ginnie Maes, but we invest primarily in this one field.

The question really boils down, can we do better, not that we have done poorly, but can we do better? What should be our policy?

The allegation has been made, particularly by Senator Proxmire, that we would have made at least $1 billion more this past year had we used a different investment policy, and whether that $1 billion is the sum, and whether you go back and make me a study of what-ifs for the last 5 or 10 years is beside the point.

We must recognize that somewhere in that neighborhood of another billion dollars could be made for the trust fund had we used a different policy of immediately buying, selling off our lowest interest bond and taking the low yielding rates

Do either of you disagree that approximately that much money could have been saved had we done that right, not whether it be right or wrong, but possibly we could have done that? Do you both agree that that is a reasonable sum or figure to accept?

Mr MYERS Mr Chairman, I think that it is true that with hindsight, operating under different procedures we could have had that much more income, but then there is also the possibility in the future if we had done that, we would have that much less.

I think that, to summarize, I think that the present basis in general has been right There could be some fine-tuning of it to improve things somewhat more as the Treasury has done in the past, and as Mr Stalnecker has said, the Treasury is thinking of doing now, but in general I think that the present procedure has been right and has treated the fund fairly.

Mr STALNECKER I would agree with that

I do not know whether the $1 billion figure is correct or not

Mr PICKLE Let us assume that the $1 billion figure is in the ball park, assuming that we could have made $1 billion more had we adopted the policy of investing in these high-yielding rates immediately, but that it has not been done because we are maintaining a long, consistent policy of a permanent sort of approach, and if we had done it, we would have taken money from the general Treasury in equal amounts You are saying you could have done it but you are recommending against it?

Mr STALNECKER Yes

Mr MYERS. Yes, Mr Chairman

Mr. PICKLE. So as to the public's standpoint, that much could have been saved, but you do not recommend it because it will cost the Treasury, together with the fact that there is a possibility you might not have made that and you could have lost some.

That is the question. What is the right policy?

I do not want to get into this never-never land again of whether or not this would increase the deficit. You both said it would not increase the deficit in a unified budget. It does not do that, but it does mean eventually the Treasury has got to come up with extra money from some source.

Mr. STALNECKER. Correct.

Mr. MYERS. Correct.

Mr. PICKLE. You both say we ought to consider our policies, and fine tune the investment policy.

I would like to have specific recommendations how you would want to fine tune it, and I would like to have the proposals that you are recommending, the study that you are making, and most of all I want to keep this record open by submitting to you, Mr. Myers, questions that the committee would want to ask about the investment policies. We will keep the record open, and we will be submitting you extra, additional questions.

Do we have any other questions by any members?

Mr. JACOBS. I would just ask the gentleman from Treasury what would you think about reversing the Johnson administration decision on the unified budget?

Mr. STALNECKER. I do not really have any comments on that right now.

Mr. JACOBS. That is what I suspected.

Mr. PICKLE. The chairman of the committee does not, either.

Mr. STALNECKER. With regard to your reference to our fine-tuning approach, it involves some technical matters insofar as setting the interest rate on the security. We are not recommending a fine-tuning approach to the extent it could be interpreted as meaning managing the maturities on the basis of market expectations. We are not recommending that the investment policies be fine-tuned based on current or prospective market developments. We are suggesting some technical changes that might be appropriate in setting the interest rates on the investments.

Mr. PICKLE. I guess we have come to the point that we could make some money for the trust funds but you would lose money to the Treasury, and therefore, what should our policy be? Are we trying to gain all the money we can for our social security trust funds, or do we want to also keep as an interest the concerns of the general Treasury?

We thank both of you gentlemen. We will be submitting additional questions to you in writing.

Thank you.

Mr. STALNECKER. Thank you.

[Whereupon, at 11:50 a.m., the hearing was adjourned.]

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