CATO INSTITUTE BRIEFING PAPERS

THE PERILS OF GOVERNMENT INVESTING

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No. 43 December 1, 1998

Executive Summary

The current Social Security system is unsustainable. As President Clinton has pointed out, the only alternative to tax increases or benefit cuts is to increase the rate of return to investment of Social Security funds. That means either allowing individuals to invest their own Social Security taxes or allowing the government to invest them. Supporters of government investing claim that it would allow the government to reap the benefits of the higher returns available in private capital markets, incur lower administrative costs than individual accounts, and allow the government to spread the risk of poor investment performance.

On the surface, that approach may have some appeal; in reality it is fraught with peril. It could potentially make the federal government the largest shareholder in American corporations, raising the possibility of government control of American business. In addition, there are serious questions about what types of investment the government would make. Political considerations and "social investing" are likely to influence the government's investment decisions, allowing the government to manipulate economic markets.

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Introduction

Speaking at a 1998 national forum on Social Security reform in Albuquerque, President Clinton suggested that the only way out of Social Security's looming financial crisis without devastating tax hikes or benefit cuts is to "take advantage of the higher return on investment" in private capital markets.[1] The president's remarks reflected a growing consensus that private investment is the key to any future Social Security reform. But what kind of private investment? And who should do the investing? Those questions will be at the heart of the upcoming debate over Social Security's future.[2]

On one side of the debate are those calling for individually owned, privately managed accounts that allow individual workers to divert their Social Security taxes into accounts similar to individual retirement accounts or 401(k) retirement plans. Workers would own their accounts and--within defined limits--control their investment choices. This would be a "defined-contribution" plan, under which workers' accumulated retirement benefits would depend on the amount of workers' contributions plus the return they earned on individual investments.

Others have proposed a continuation of the current Social Security system's "defined-benefit" approach: setting workers' retirement benefits by law without relation to individual contributions or investment. Under such a plan, however, a portion of the current Social Security surplus would be invested in private capital markets by the government itself, bringing a higher rate of return to the system as a whole.

Superficially, that approach offers some attraction. It promises the advantages of higher returns through private capital investment, while spreading individual risk and minimizing administrative costs. In reality, allowing the government to control such an enormous amount of private investment, in the words of Federal Reserve Chairman Alan

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Greenspan, "has very far reaching potential dangers for a free American economy and a free American society."[3]

The Current System

Social Security is currently running a surplus. In 1996, for example, Social Security taxes--both payroll taxes and income taxes on benefits--amounted to $385.7 billion. Benefit payments and administrative expenses totaled only $353.6 billion, resulting in a surplus of $70.8 billion.[4] Under current law, that money must be invested solely in U.S. government securities. The securities can be any of three types: government securities purchased on the open market; securities bought at issue, as part of a new offering to the public; or special-issue securities, not traded publicly. In actual practice, virtually all the securities purchased have been special-issue securities,[5] which earn an interest rate equal to the average market rate yield on all U.S. government securities with at least four years remaining until maturity, rounded to the nearest one-eighth percent--an average of approximately 2.3 percent above inflation.

By contrast, equities have earned an average 7.56 percent real rate of return over the past 60 years. Some have suggested that the government should be allowed to invest a portion of the Social Security surplus in equities rather than government securities, allowing the Social Security system to reap the benefits of the higher rate of return.[6]

Proposals for Government Investing

The idea of allowing the government to invest excess Social Security funds in private capital markets is not a new one. As early as the 1930s, fiscal conservatives warned that unless private securities were included in the government's portfolio, the trust fund would earn less than market returns. But they also realized that if the government invested in private securities, it would lead to large-scale government ownership of capital and interference in American business. Sen. Arthur Vandenberg (R-Mich.) warned that "it is scarcely conceivable that rational men should propose such an unmanageable accumulation of funds in one place in a democracy."[7] In the end, Congress rejected not only government investing but any system of full funding, establishing a pay-as-you-go program in which nearly all the taxes

paid by current workers are not saved or invested in any way but used to pay benefits to current retirees.

Two factors brought the concept of government investing back into public debate. First, following a series of Social Security reforms in 1983, the Social Security system began to run a modest surplus. Second, demographic trends made it clear that the program's pay-as-you-go structure was not sustainable.

Proposals for government investment first appeared in legislation in the early 1990s. The idea received widespread public attention when 6 of the 13 members of the 1994-96 Advisory Council on Social Security recommended the investment of up to 40 percent of the Social Security Trust Fund in private capital markets.[8] As Robert Ball, author of the proposal, put it, "Why should the trust fund earn one third as much as common stocks?"[9]

Proposals for government investment have now been endorsed by a handful of economists, including Henry Aaron of the Brookings Institution and Peter Diamond of the Massachusetts Institute of Technology. Government investing is reportedly the centerpiece of Social Security reform legislation being developed by Rep. Earl Pomeroy (D-N.D.). Proponents of government investing claim that it would allow the government to reap the benefits of the higher returns available in private capital markets but would incur lower administrative costs than individual accounts and would allow the government to spread the risk of poor investment performance.

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Corporate Governance

Allowing the government to invest directly in private capital markets raises serious questions of ownership and control. At its peak, the Social Security Trust Fund will contain approximately $2.9 trillion. The total value of all 2, 723 stocks currently traded on the New York Stock Exchange is about $12.8 trillion. It is obvious that allowing the federal government to purchase stocks would give it the ability to obtain a significant, if not a controlling, share of virtually every major company in America. Experience has shown that even a 2 or 3 percent block of shares can give an activist shareholder substantial influence over the policies of publicly traded companies.[10]

The result could be a government bureaucrat sitting on every corporate board, a prospect that has divided advocates of government investing. Some have claimed that the government would be a "passive" investor--that is, it would refuse to vote its shares or take positions on issues affecting corporate operations. Others, such as the AFL-CIO's Gerald Shea, have suggested that the government should exercise its new influence over the American economy, claiming that government involvement would "have a good effect on how corporate America operates."[11]

The experience of state employee pension funds suggests that governments may not be able to resist the temptation to meddle in corporate affairs. For example, in the late 1980s, state employee pension plans in California and New York actively attempted to influence the election of a new board chairman for General Motors.[12] According to a report by the U.S. House of Representatives, state employee pension plans are increasingly using their clout to influence "the corporate role in environmental improvement, humanitarian problems, and economic development."[13]

Supporters of government investment claim that the government would remain a passive investor, refusing to vote its shares. However, that would require an extraordinary degree of restraint by future presidents and congresses. Imagine the pressure faced by a congress if the government were to own a significant interest in a company that was threatening to close its plants and move them overseas at the cost of thousands of jobs. Could politicians really remain passive in the face of such political pressure?

Even if the government remained passive, its very ownership of large blocks of stock would, in effect, create a situation favoring certain stockholders and corporate managers. As the General Accounting Office has pointed out, if the government did not exercise its voting rights, other stockholders would find their own voting power enhanced and could take advantage of government passivity.[14]

The GAO also warns that regardless of what stock voting rules are adopted when the program begins, Congress can always change the rules in the future.[15]

Social Investing

Even if the government avoids directly using its equity ownership to influence corporate governance, there is likely to be an enormous temptation to allow political consider-

ations to influence the type of investments that the government makes. In short, should the government invest solely to earn the highest possible return on investments, or should the government consider larger political and societal questions?

The theory behind social investing was perhaps best explained in a 1989 report by a task force established by then Governor Mario Cuomo to consider how New York public employee pension funds were being invested. The task force concluded that state employee pension funds should not be operated solely for the benefit of state employees and retirees. In the opinion of the task force, those employees and retirees were only one among several groups of "stakeholders" in state employee pension programs, others being "the plan sponsor; corporations seeking investment capital from the pension fund; taxpayers who support the compensation of public employees, including contributions to the pension fund; and the public, whose well being may be affected by the investment choice of fund managers" (emphasis added).[16] Using that criterion, the task force rejected the idea that investments should be made solely on the basis of maximizing the immediate return to the pension trust. Instead, pensions should be invested in a way that maximizes "both direct and indirect returns" to all stakeholders, including "the larger society and economy." Therefore, the task force concluded, state employee pension funds should be guided into economic development projects beneficial to the state of New York.

Most state employee pension funds are subject to such social investing. Alaska may have been the first state to require social investing, with a requirement in the early 1970s that a portion of state pension funds be used to finance home mortgages in the state.[17] The Alaska example also illustrates the dangers of social investing. A downturn in the local real estate market cost the fund millions of dollars that had to be made up through other revenue sources.

Throughout the 1970s and 1980s, social investment increasingly came to be a part of state pension programs.[18] It became a subject of widespread public debate in the mid-1980s with the question of South African divestment. Eventually, 30 states prohibited the investment of pension funds in companies that did business in South Africa. Today, approximately 42 percent of state, county, and municipal pension systems have restrictions targeting some portion of investment to projects designed to stimulate the local economy or create jobs. This includes investment in local

infrastructure and public works projects as well as investment in in-state businesses and local real estate development.[19] In addition, 23 percent of the pension systems have prohibitions against investment in specific types of companies, including restrictions on investment in companies that fail to meet the "MacBride Principles" for doing business in Northern Ireland, companies doing business in Libya and other Arab countries; companies that are accused of pollution, unfair labor practices, or failing to meet equal opportunity guidelines; the alcohol, tobacco, and defense industries; and even companies that market infant formula to Third World countries.[20]

A nearly infinite list of current political controversies would be ripe for such restrictions if the federal government began investing Social Security funds. Both liberals and conservatives would have their own investment agendas. Should Social Security invest in nonunion companies? Companies that make nuclear weapons? Companies that pay high corporate salaries or do not offer health benefits? Companies that do business in Burma or Cuba? Companies that extend benefits to the partners of gay employees? Companies that pollute? Companies that donate to Planned Parenthood? Investment in companies ranging from Microsoft to Nike, from Texaco to Walt Disney, would be sure to engender controversy.

Supporters of government investment suggest two ways to avoid the problem of social investing. First, they propose the creation of an independent board to manage the system's investment, a board that would operate free of any political interference. However, Alan Greenspan, who should be in a position to know about board independence, has said that he believes it would be impossible to insulate such a board from politics. Testifying before Congress on proposals for government investment, Greenspan warned:

> I don't know of any way that you can essentially insulate government decisionmakers from having access to what will amount to very large investments in American private industry. . . . I know there are those who believe it can be insulated from the political process, they go a long way to try to do that. I have been around long enough to realize that that is just not credible and not possible. Somewhere along the line, that breach will be broken.[21]

Indeed, the difficulty of shielding investment decisions from political considerations was illustrated, unin-

tentionally, by one of the supporters of government investment, Jonathan Cohn, writing in the New Republic. "It would be easy to prohibit manipulation of the market for political reasons," Cohn wrote. "All you would have to do is assign responsibility for the investments to a quasi-independent body, then carefully limit how it can make investment decisions."[22] In other words, the new agency would be independent except that Congress would set restrictions on its investment decisions.

Supporters of government investment suggest a second means of avoiding social investment: the investment would be made only in index funds, eliminating the choice of individual stocks. However, that does not eliminate social investment questions, since there would remain the issue of what stocks should be included in the index, whether an existing index or a new one created just for Social Security.

The Federal Thrift Savings Program: An Imperfect Analogy

Supporters of government investing often cite the federal thrift savings program as an example to show that government pension funds can avoid politicization. It is true that, so far, the TSP has avoided social investment and interference with corporate governance. However, there are several important differences between the TSP and a government-invested Social Security program.

Perhaps most important, the TSP is a defined-contribution program with individually owned accounts. Workers do have a property right in their account, which is not true of Social Security. In the case of Fleming v. Nestor (1960), the U.S. Supreme Court held that individuals have no property right in Social Security. Allowing the government to invest a portion of Social Security revenues in capital markets would do nothing to alter that.

Therefore, a government-invested Social Security program would be far more akin to defined-benefit state employee pension plans. A 1990 congressional report concluded that while workers acquire an interest in pension funds once they are vested, they have no legal ownership rights. The report went on to note that it would be equally incorrect to say that government "owned" the funds because the government's discretion in spending or disposing of the funds is limited under state trust law and the Internal Revenue Code.[23] The report concludes that there is no exclusive ownership by either party,[24] and that ownership, in any case, may be unimportant because "public defined benefit

pensions are entitlements granted by governments that can be modified or taken away."[25]

Because workers have no ownership right to their pension funds, the government has no fiduciary duty to the workers. The situation may be even worse for a government-invested Social Security system. For all the social investment practices discussed above, state employee pension funds have been somewhat restrained by the "exclusive benefit rule," an Internal Revenue Service ruling that requires tax-exempt trusts to operate solely for the benefit of the trustees.[26] The applicability of that rule to government pension funds is extremely limited, however, since the tax exemption status of the trust is irrelevant. The employer--being the government--is already tax exempt. Therefore, the only potential enforcement mechanism is for the IRS to disqualify the plan, meaning that workers would be taxed on the employer's contribution. Because such a penalty would fall on innocent third parties, the threat is seldom invoked. It is even more unlikely to be invoked in the case of a government-invested Social Security system. It would certainly be unfair to do so--to impose a huge new tax on every American worker because the government mismanages the investment of its funds. Of course, that assumes an IRS independent enough to take action against the federal government's own investment decisions. As a result, unlike the TSP, there appears to be no legal barrier to social investing under a government-invested Social Security program.

Second, as a defined-contribution program, the TSP is transparent. Benefits are dependent on the return to their investment, not on an arbitrary benefit formula. Therefore, the workers have a direct interest in ensuring that investments are made solely to maximize their returns. Workers can see exactly how an investment decision impacts their retirement benefits. Under a government-invested Social Security program, benefits would be defined by law and would be only indirectly affected by individual investment decisions. Therefore, workers would have little incentive to resist social investing. They would have no direct interest in whether investments are made solely to maximize returns or for other purposes.

Finally, the TSP is a voluntary program. If workers are dissatisfied with investment practices under the program, they can refuse to participate. Therefore, fund managers have an incentive to maximize returns. Failure to do so will result in a loss of business. In contrast, a government-invested Social Security system would be mandatory. Workers would be forced to continue contributing 12.4

percent of their income to the system, no matter how dissatisfied they were.

Clearly, then, there are both legal and market restraints on the TSP that would not exist under a government-invested Social Security system. Indeed, the TSP model would seem to argue for exactly the opposite, a system of individually owned, privately invested accounts. Only such a system would replicate the TSP's safeguards--property rights, a fiduciary responsibility, transparency, and an ability to remove funds from a nonperforming investor.

Conclusion

The only way to reform Social Security without raising taxes or cutting benefits is to change the program from pay-as-you-go financing to a system based on saving and investment in real capital assets. However, allowing the government to do the investing would raise serious questions of corporate governance and social investing, potentially threatening the American economy. It would be far better to allow individual workers to invest for their own retirement.

Notes

1. Remarks by President William Jefferson Clinton at town hall meeting, Albuquerque, New Mexico, July 20, 1998.

2. For a longer and more detailed treatment of this issue, see Krzystof Ostaszewski, "Privatizing the Social Security Trust Fund? Don't Let the Government Invest," Cato Institute Social Security Paper no. 6, January 14, 1997.

3. Testimony of Alan Greenspan before the Senate Committee on Banking, July 21, 1998.

4. 1998 Report of the Board of Trustees of the Federal Old-Age Survivors and Disability Insurance Program (Washington: Government Printing Office, 1998).

5. Robert Myers, Social Security (Philadelphia: University of Pennsylvania Press, 1993), p. 142.

6. Supporters of government investing may actually be understating the difference in returns. Under the current system, the interest attributed to the government securities does not actually represent a cash transfer but is attributed to the Social Security Trust Fund, which makes the inter-

est more notional than real. When the time comes that payments must be made from the trust fund, the federal government will have to appropriate the attributed interest from general revenues. Thus, like the government securities themselves, the interest payments do not represent real current wealth, merely a promise by the government to tax future generations of workers. In contrast, if the government invested in equities or other assets outside the government, any return would result in a real increase in the system's assets.

7. Congressional Record, Vol. 81, Part 2, 75th Congress (March 17, 1937), p. 2324.

8. Report of the 1994-1996 Advisory Council on Social Security, Volume I: Findings and Recommendations (Washington: Government Printing Office, 1997), pp. 25-28.

9. Peter Passell, "Can Retirees' Safety Net be Saved?" New York Times, February 18, 1997.

10. Theodore Angelis, "Investing Public Money in Private Markets: What Are the Right Questions?" Presentation to a conference on "Framing the Social Security Debate: Values, Politics, and Economics," National Academy of Social Insurance, Washington, D.C., January 29, 1998.

11. Quoted in Michael Eisenscher and Peter Donohue, "The Fate of Social Security," Z Magazine, March 1997.

12. U.S. House of Representatives, Committee on Education and Labor, Subcommittee on Labor-Management Relations, "Public Pension Plans: The Issues Raised over Control of Plan Assets," Committee Print, June 25, 1990; U.S. House of Representatives, Committee on Education and Labor, Public Pension Plans: The Issues Raised over Control of Plan Assets, p. 49.

13. Ibid.

14. General Accounting Office, "Social Security Financing: Implications of Government Stock Investing for the Trust Fund, the Federal Budget, and the Economy," Report to the U.S. Senate Special Committee on Aging, April 1998, p. 62.

15. Ibid.

16. Our Money's Worth: Report of the Governor's Task Force

on Pension Fund Investment (Albany: New York State Industrial Cooperation Council, June 1989), p. 20.

17. Jennifer Harris, "From Broad to Specific: The Evolution of Public Pension Investment Restrictions," Public Retirement Institute, Arlington, Va., July 1998.

18. For a thorough discussion of state employee pension systems and their investment policies, see Carolyn Peterson, State Employee Retirement Systems: A Decade of Change (Washington: American Legislative Exchange Council, 1987).

19. James Packard Love, Economically Targeted Investing: A Reference for Public Pension Funds (Sacramento: Institute for Fiduciary Education, 1989).

20. Love, Economically Targeted Investing; Peterson, State Employee Retirement Systems.

21. Testimony of Alan Greenspan.

22. Jonathan Cohn, "Profit Motives," New Republic, July 13, 1998.

23. U.S. House of Representatives, Committee on Education and Labor, Public Pension Plans: The Issues Raised over Control of Plan Assets, pp. 44-46.

24. Ibid., p. 52.

25. Ibid., p. 50.

26. Internal Revenue Manual, Examination Guidelines Handbook, Sec. 711.1.

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