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WHY GOVERNMENT-CONTROLLED INVESTMENT WOULD UNDERMINE RETIREMENT SECURITY

DANIEL J. MITCHELL

As part of his recently unveiled plan to bail out Social Security, President Bill Clinton proposes that the government receive unprecedented power to invest more than $650 billion in the stock market over the next 15 years. The good news is that the White House recognizes private investment as a necessary component of long-term entitlement reform. The bad news is that giving this power to politicians is a recipe for disaster.

The Chairman of the Federal Reserve Board, Alan Greenspan, recently testified before Congress that government-controlled investment "would arguably put at risk the efficiency of our capital markets and thus, our economy." There are four broad concerns about government-controlled investment:

Concern #1: Government-controlled investment would mean the partial nationalization of major businesses, which would allow politicians to have direct involvement in the economy and influence over the decisions of individual corporations.

Concern #2: Government-controlled investment invites crony capitalism—industrial policy that allows politicians to control the economy indirectly by attempting to pick winners and losers.

Concern #3: Government-controlled investment opens the door to corruption by allowing politicians to steer funds toward well-connected interest groups or corporate contributors.

Concern #4: Government-controlled investment invites "politically correct" decisions at the expense of retirees because politicians could forgo sound investments in unpopular industries (such as tobacco) to steer money toward feel-good causes that are likely to lose money.

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To ascertain the risks of allowing government-controlled investment in a reformed Social Security system, analysts have compared the performance of politically influenced investments made by state government pension funds with that of traditional investments. John R. Nofsinger of

Marquette University, for example, finds that such policies reduce average annual returns by more than 1.5 percent. Others have determined that these investments have returns between 1.0 percent and 2.5 percent below those of funds that operate in the best interest of workers.

As former Clinton Administration Treasury Department official Alicia Munnell warns, a lower return on pension fund investments eventually will require either increased contributions or lower benefit payments to workers. Consider these notable government employee pension fund miscues:

- The Texas State Board of Education recently dumped 1.2 million shares of Disney to protest the content of films made by a subsidiary.
- The Missouri State Employees' Retirement System venture capital fund for new businesses was shut down after three years following poor returns and two lawsuits.
- Pennsylvania school teachers and state employees saw $70 million of their fund invested in a new plant for Volkswagen. The investment has lost more than half its value.
- Illinois transferred $21 million of workers' money to the state's general budget.
- The Kansas Public Employees' Retirement System lost $65 million by investing in a state-based Home Savings Association and $14 million by investing in Tallgrass Technologies, and it squandered nearly $8 million in a steel plant. Total losses of workers' money from these economically targeted investments will be between $138 million and $236 million.
- New York State and City pension funds were pressured in 1975 into buying bonds to avert New York City's bankruptcy, and, in 1976, into buying bonds to bail out four state agencies.
- The Connecticut State Trust Fund poured $25 million of workers' money into Colt Manufacturing, a local company that went bankrupt three years later.
- A California state pension system offered $1.6 billion of workers' money to help to balance the state's budget in 1991.
- The state of Minnesota lost $2 million of workers' money by dumping tobacco stocks.
- An independent study estimates that non-economic investing by government-controlled pension funds resulted in more than $28 billion in losses between 1985 and 1989.

Over the next 75 years, the Social Security program will face a shortfall of more than $20 trillion (in 1998 dollars). If no changes are made in the program's design, bringing Social Security into balance will require a 54-percent increase in payroll tax rates, a 33-percent reduction in benefits, a big hike in the retirement age, or a combination of the three. Yet tax increases and benefit reductions would serve only to exacerbate Social Security's other crisis—its poor rate of return—and make it an even worse deal for American workers. Forcing them to pay more to receive even less hardly represents fair and compassionate public policy.

Because the Social Security system is actuarially bankrupt and will not be able to meet its future obligations, policymakers are considering harnessing the power of private investment and compound interest to build retirement security for Americans. Giving this power to politicians, however, is a risky and dangerous experiment.

The safest way to protect the money of American workers for their future retirement is to allow them to have a portion of their Social Security payroll taxes invested by professionals from the financial services industry. Not only do these professionals have the knowledge and the incentive to invest the money wisely, they also are legally obligated to act in the best interests of the workers in their fund.

—Daniel J. Mitchell is McKenna Senior Fellow in Political Economy for The Thomas A. Roe Institute for Economic Policy Studies at The Heritage Foundation. This paper is revised and updated from Heritage Backgrounder *No. 1240, "Why the Government Should Not Invest Americans' Social Security Money," December 23, 1998.*

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DANIEL J. MITCHELL[1]

As part of his recently unveiled Social Security bailout, President Bill Clinton has proposed that the federal government receive unprecedented power to invest more than $650 billion in the stock market over the next 15 years. The good news is that the White House recognizes private investment as a necessary component of long-term entitlement reform. The bad news is that giving this power to politicians is a recipe for disaster.

Under the Clinton plan, the U.S. government would become the largest single shareholder in the U.S. economy. But giving the federal government that power and control would create immense risks for the economy and for the retirement security of today's workers. For example, evidence at the state and local levels with public employee pension funds demonstrates that politicians and their appointees often are tempted to steer the government-controlled pot of money toward special interests, political allies, or corporate contributors.

In addition, even well-intentioned policymakers are not qualified to invest funds and manage money. Simply stated, they do not face the bottom-line pressures that force private businesses and investors to allocate resources wisely. Yet, poor investment decisions have serious consequences. Most important, workers would earn lower returns on their money, and even small differences in rates of return translate into less retirement income. It certainly would be difficult for workers to wind up with less than they are promised currently from Social Security. Nonetheless, it would be a mistake to enact a policy—such as government-controlled investment—that offers less in return and risks more. The Chairman of the Federal Reserve Board, Alan Greenspan, recently testified before Congress that such approaches "would arguably put at risk the efficiency of our capital

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markets and thus, our economy."[2]

THE RISKS OF POLITICALLY DRIVEN INVESTMENT CHOICES

The Social Security system is actuarially bankrupt and will not be able to meet its future obligations. Over the next 75 years, the Social Security program will face a cash shortfall of more than $20 trillion.[3] If no changes are made in the program's design, bringing Social Security into balance will require a monumental policy change: a 54-percent increase in payroll tax rates, a 33-percent reduction in benefits, a big hike in the retirement age, or a combination of these three possibilities.

These choices are economically risky and politically unpopular. Moreover, tax increases and benefit reductions would serve only to exacerbate Social Security's other crisis—its poor rate of return—and make it an even worse deal for American workers. Many younger workers today already face negative returns from the taxes they pay into the Social Security system, after adjusting for inflation. Forcing them to pay more to receive even less hardly represents fair and compassionate public policy.[4] On the other hand, policies that would increase the current system's rate of return, such as reductions in the tax rate and increases in benefits, would drive the system into bankruptcy even sooner.

Faced with this *Catch–22* dilemma, many policymakers in Washington, D.C., are considering a shift from the current "pay-as-you-go" program to a pre-funded system. For example, all 13 members of the 1994–1996 Advisory Council on Social Security endorsed some form of investment in private assets as a way to address the program's long-term unfunded liability.[5]

An important debate is occurring, however, over how best to tap the benefits of private investment. Opponents of reform argue against personal accounts and assert that the current Old-Age and Survivors Insurance program can be salvaged by allowing politicians and their appointees to invest excess Social Security payroll tax revenues. This is the option the Clinton Administration has decided to pursue.

There are, however, four broad concerns about such government-controlled investment proposals.

Concern #1: Government-controlled investment would mean the partial nationalization of major businesses, which would allow politicians direct involvement in the economy.

Under a system of government-controlled investment, the government would be able to purchase a significant percentage of publicly traded companies. Once it had become a dominant shareholder, the government could use its power to insist, for example, that a company place politicians on its board of directors.[6] Even if politicians were not placed in positions of direct power, they could use their voting power to impose control.[7] And when

2. Alan Greenspan, Testimony before the Committee on the Budget, U.S. Senate, 106th Cong., 1st Sess., January 29, 1999.
3. In 1998 dollars. Based on Social Security Administration and Heritage calculations. For a full explanation of these calculations, see Daniel J. Mitchell, "Social Security's $20 Trillion Shortfall: Why Reform Is Needed," Heritage Foundation *Backgrounder* No. 1194, June 22, 1998. See also Social Security Administration's *1998 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds.*
4. William W. Beach and Gareth G. Davis, "Social Security's Rate of Return," Heritage Foundation *Center for Data Analysis Report* No. CDA98–01, January 15, 1998.
5. Advisory Council on Social Security, "Findings and Recommendations," *Report of the 1994–1996 Advisory Council on Social Security,* Vol. I (January 1997).
6. Theodore J. Angelis, "Investing Public Money in Private Markets: What Are the Right Questions?" *Framing the Social Security Debate: Values, Politics, and Economics*, National Academy of Social Insurance Conference, January 29–30, 1998.
7. Carolyn L. Weaver, "How Not to Reform Social Security," American Enterprise Institute *On the Issues,* August 1998.

A Glossary of Terms in the Social Security Reform Debate

Growing support in Washington for investment-based reform of Social Security reflects the deepening uneasiness with the pay-as-you-go system. Common terms in the debate include:

- **Compound interest.** Compounding occurs when annual income is reinvested. Take, for example, a bank account (or an investment account of stocks, bonds, or other income-producing assets) of $100 that earns 5 percent interest. After one year, the account will have the original $100 plus $5 in interest income. If the interest income remains in the account, the new balance of $105 will generate $5.25 of interest income the following year. Over a long period, the annual sums—if left untouched—would grow substantially.
- **Defined benefit.** In a defined-benefit system, a formula or agreement predetermines retirement income. Workers receive their benefits based on the formula, not on fund performance. A defined-benefit system can be funded (like old-fashioned company/industry pension plans) or pay-as-you-go (like the current Social Security system). Personal accounts do not exist and workers face systemic risk: company/industry pension plans may go bankrupt or be underfunded; politicians can change the eligibility rules of Social Security.
- **Defined contribution.** In a defined-contribution system, retirement income depends on how much a worker puts into an account and how well that money is invested (usually by a professional funds manager). A defined-contribution system is always pre-funded. The account belongs to the worker; the worker incurs all the risk and receives all the benefits.
- **Pay-as-you-go.** A pay-as-you-go retirement system finances each year's benefits by transferring money from workers to retirees. It also is called a tax-and-transfer system.
- **Pre-funding.** A pre-funded (or, more simply, funded) retirement system finances expected future benefits by selling stocks, bonds, and other financial assets that workers accumulate over a lifetime of work. It also is referred to as a savings- or investment-based system.
- **Rate of return.** The rate of return is the actual or implicit increase in the value of an investment. Because of the power of compound interest, even relatively small differences in returns on an investment have significant implications for the accumulation of wealth. Consider what happens to each $1,000 invested with either a 3-percent or 5-percent return. After 10 years, the $1,000 invested at 5 percent would grow to about $1,550, or about $250 more than it would generate at 3 percent. After 50 years, the $1,000 would grow to more than $4,256 with a 3-percent return, but nearly $11,000 at 5 percent. Increasing the rate of return on each $1,000 investment by just 2 percent would generate more than $6,665 of additional wealth over 50 years. After 40 to 50 years in the workforce, the rate of return workers receive on money they set aside for retirement will determine how comfortable and secure they will be in their retirement years.
- **Unfunded liability.** The unfunded liability of the Social Security system is the gap between the expected revenues and the projected expenditures over the same period. An unfunded liability can be measured in current dollars, in inflation-adjusted dollars, or in terms of present value (the amount of money needed to invest today to offset the future shortfall).

politicians control business decisions, political incentives become more important than economic ones. Invariably, this leads to less prosperity.

Consider the experience of other countries. Much of Western Europe suffers from stagnation and high rates of unemployment. High tax rates and excessive welfare benefits certainly deserve part of the blame, but the

widespread direct and indirect control of business has had severe consequences, too. Countries in the former Soviet Bloc suffered decades of deprivation and poverty under a system that allowed politicians, rather than the marketplace, to allocate resources. Without the guidance of competitive prices and lacking proper incentives, the centralized planning system created an economic catastrophe from which these countries will need years to recover.

Concern #2: Government-controlled investment invites crony capitalism—industrial policy that allows politicians to control the economy indirectly by attempting to pick winners and losers.

The managers of private pension funds have the legal obligation to make investments that are in the best interest of workers. In other words, they must try to get the highest possible return, adjusted for risk. Would such a standard apply under a system of government-controlled investment, and could it even be enforced? This is a significant concern because legislators sometimes believe that the marketplace is not producing the right results; they try to help or punish certain industries or companies through spending programs, tax breaks, and regulatory exemptions. They also can do this by providing special access to capital, another risk that would arise if politicians controlled how retirement funds were invested.[8]

The recent downturn in Asia illustrates the danger of this approach. Decades of industrial policy, or crony capitalism, left these countries with debt-laden banking systems, inefficient industries, and companies that cannot compete. Unlike the Europeans, the Asians largely avoided direct government ownership, but widespread political manipulation of lending decisions and investment choices produced the same result. Ironically, many of the Americans who praised Japan's industrial policies in the 1980s are the same people who argue in favor of government-controlled Social Security investment today.

Concern #3: Government-controlled investment opens the door to corruption by allowing politicians to steer funds toward well-connected interest groups or corporate contributors.

Politicians frequently use the levers of power to counteract markets by steering resources in certain directions. These same levers of power could be used for more narrow political purposes as politicians provide favors or steer resources to constituents and allies. A large pot of government-controlled money, such as would exist under Clinton plan or similar schemes, would create the opportunity to divert money for special interests.[9] This is what has happened in many countries in the less-developed world.[10]

Advocates of government-controlled investment argue that political institutions in the United States are too transparent to allow blatant corruption to exist. This is a fair response, but there is an ill-defined boundary between special-interest investing for purposes of industrial policy and special-interest investing that is done in exchange for campaign contributions and political support.

Concern #4: Government-controlled investment invites "politically correct" decisions at the expense of retirees because politicians could forgo sound investments in unpopular industries (such

8. Krzyztof M. Ostaszewski, "Privatizing the Social Security Trust Fund? Don't Let the Government Invest," Cato Institute Project on Social Security Privatization *SSP* No. 6, January 14, 1998.
9. U.S. General Accounting Office, "Implications of Government Stock Investing for the Trust Fund, the Federal Budget, and the Economy," GAO/AIMD/HEHS–98–74, April 1998.
10. World Bank, *Averting the Old-Age Crisis: Policies to Protect the Old and Promote Growth* (New York, NY: Oxford University Press, 1994).

Principles of a Privately Managed System of Personal Accounts

Supporters of personal retirement accounts in the United States generally do not favor an approach that allows politicians and appointees to invest the funds. They believe a privately managed system should be based on the following principles:

- **Workers divert some of their existing 12.4 percent payroll taxes into personal accounts.** All annual earnings (dividends, interest, capital gains, and so forth) would be their private property and reinvested in the account.
- **Financial services experts—not politicians—invest the money.** With the exception of establishing prudential restrictions (for example, preventing fund managers from "betting" a worker's entire balance on the movement of a single stock), politicians would not be able to interfere with investment choices.
- **Funds are used strictly for retirement.** Workers could not access the money in their account before retirement. After leaving the workforce, they would be required to purchase an annuity (a financial instrument guaranteeing a certain level of income for the rest of their life) or to make phased withdrawals.
- **A safety net ensures that everyone wins.** At retirement, workers who do not have enough money in their personal accounts to guarantee a comfortable retirement would have their income augmented by the government. Examples of this exist overseas in countries that have privatized their social security systems. In Australia, for example, workers are guaranteed to receive at least as much as they would under the old government entitlement program.

as tobacco) to steer money toward feel-good causes that are likely to lose money.

When operating private pre-funded systems, fund managers pick well-balanced portfolios designed to maximize long-term returns. This is a legal requirement,[11] largely because it is the best way to ensure that workers will have a comfortable and secure retirement. Fund managers may or may not approve of the goods and services produced by the companies in which they invest, but their fiduciary responsibility is clear: They must invest with the workers' interests in mind.

Unfortunately, it is not clear that managers in a system of government-controlled investment would have the same incentives. Politicians routinely go after certain industries and/or companies, and withdrawing investment funds would be one way to show their displeasure.[12] Conversely, some causes are politically popular. Allocating investments to these ventures, even if they are expected to lose money, could be advantageous for politicians.

HISTORY SHOWS THE GOVERNMENT SHOULD NOT PLAY STOCKBROKER

Although advocates of government-controlled investment may argue that the concerns outlined above are overstated, arguments against political control are supported by historical evidence. For example, pension funds for state and local government employees in the United States frequently are subjected to political manipulation. Moreover,

11. John R. Nofsinger, "The Affects of Restrictions and Targeting Policies on Public Pension Funds," at *http://www.busadm.mu.edu/~nofsinge/PENSION.html.*
12. Charles Kolb, "Pitfalls of Social Security Reform," *The Washington Times,* October 22, 1998.

Different Rules, Different Results

Why do state and local government employee pension plans choose economically targeted investments? Political manipulation and considerations of social benefits are only part of the explanation.[1] Notably, these plans do not have an exclusive fiduciary obligation to the workers; instead, each government employee pension fund has its own organizational structure and is subject to particular state and/or local laws. These varying arrangements permit fund trustees to make investments that earn a lower return.

Private pension funds, by contrast, are free of political control. They are subject to a universal legal requirement to operate in the best interest of workers.[2] More specifically, they are regulated by the 1974 Employee Retirement Income Security Act. This law states that trustees must act "in the best interest" and "for the exclusive benefit" of plan participants.[3] This fiduciary responsibility does not mean that every investment will make money, but it does mean that every investment is made with the intention of maximizing income for retirees. And even small differences in annual returns translate into big differences in retirement plans.

1. Roberta Romano, "Public Pension Fund Activism in Corporate Governance Reconsidered," *Columbia Law Review,* Vol. 93 (1993), pp. 795–853.
2. Krzyztof M. Ostaszewski, "Privatizing the Social Security Trust Fund? Don't Let the Government Invest," Cato Institute Project on Social Security Privatization *SSP* No. 6, January 14, 1998.
3. John R. Nofsinger, "The Affects of Restrictions and Targeting Policies on Public Pension Funds," at *http://www.busadm.mu.edu/~nofsinge/PENSION.html.*

other countries that set up social security systems using government-controlled investment have had lackluster or even negative results.

State and Local Government Pension Funds

Pension funds for state and local government employees in the United States are beholden, to varying degrees, to politicians.[13] And compared with the performance of private pension funds, government pension plans under-perform.[14] In terms of overall fund performance, the gap between government-controlled and private pension funds is not huge. But there is a big performance gap in the fund assets that government pension plans dedicate to economically targeted investments (ETIs), which, despite their title, are based on political criteria.

Supporters of ETIs argue that fund managers should be permitted—or perhaps even forced—to take into account the broader social benefits of their investments. For example, ETI proponents have favored increased investment in low-income housing, small business, and local development[15] as well as in-state investing and alternative energy.[16] And they usually promote a vague catch-all provision that the investments promote the

13. Research does show that the level of political control has an effect on the performance of state and local pension funds. Not surprisingly, if the trustees have considerable independence, they are less likely to make politically motivated investment choices. For more information, see Angelis, "Investing Public Money in Private Markets: What Are the Right Questions?"
14. Kevin J. Murphy and Karen Van Nuys, "Governance, Behavior, and Performance of State and Corporate Pension Funds," Simon School of Business *Working Paper,* September 1994. See also Abby Schultz and Kara Fitzsimmons, "Public Pension Funds Are on a Hot Seat," *The Wall Street Journal,* March 5, 1996.
15. "Economically Targeted Investments by State-Wide Pension Funds," Center for Policy Alternatives, 1993; available at *http://www.cfpa.org/publications/ci/ci-etiby.html.*
16. Ostaszewski, "Privatizing the Social Security Trust Fund?"

"general welfare of the state."[17] Ohio even includes racial preferences as a goal of its pension fund.[18] The fact that the alleged social benefits do not accrue to the benefit of the workers in the plan is apparently of little concern to the advocates of this type of investment approach.

In addition to requiring investment in projects that are likely to be less profitable, government-controlled investment often would prohibit investments that otherwise would generate a good return for workers. More than 30 states at one time, for example, barred investment in companies that did business with South Africa. Another 11 placed restrictions on investment in businesses operating in Northern Ireland.[19] Some pension funds face restrictions on investments in the tobacco, alcohol, and defense industries.[20]

This list would be likely to expand if the federal government got into the game. Depending on the latest political fad, it might mean restricting investments in companies charged with excessive pollution,[21] antitrust violations,[22] and "unfair" labor policies.[23] A 1989 report prepared for then Governor of New York Mario Cuomo even suggests that pension funds side with incumbent management in takeover disputes.[24] Protectionists would be likely to argue that investments should be limited to U.S. companies.[25] Another disturbing possibility is that the money would be used for infrastructure spending, using the rationale that the government would recoup the money through higher tax collections.[26]

To ascertain the risk of government-controlled investment in a reformed Social Security system, analysts compared the performance of ETIs with that of traditional investments. John R. Nofsinger of Marquette University found that ETIs reduced average returns by more than 1.5 percent annually.[27] Perhaps not surprisingly, he also discovered that restrictions on investments in South Africa and Northern Ireland were associated with lower returns.[28] Other scholars found that ETIs had returns that averaged between 1.0 percent and 2.5 percent below those of funds that operated in the best interest of workers.[29]

Alicia Munnell, a former Clinton Administration official at the Department of the Treasury, found that investments designed to promote home ownership would result in a reduction of between 1.9 percent and 2.4 percent in annual returns. According to Munnell, a "lower return on pension fund investments will eventually require either

17. Roberta Romano, "Public Pension Fund Activism in Corporate Governance Reconsidered," *Columbia Law Review,* Vol. 93 (1993), pp. 795–853.

18. *Ibid.*

19. Ostaszewski, "Privatizing the Social Security Trust Fund?"

20. *Ibid.*

21. Weaver, "How Not to Reform Social Security."

22. Gene Steuerle, "Investing Social Security Surpluses in the Stock Market," *Tax Notes,* April 3, 1995.

23. Lawrence J. White, "Investing the Assets of the Social Security Trust Funds in Equity Securities: An Analysis," *Investment Company Institute Perspective,* Vol. 2, No. 4 (May 1996).

24. *Ibid.*

25. Steuerle, "Investing Social Security Surpluses in the Stock Market."

26. Angelis, "Investing Public Money in Private Markets: What Are the Right Questions?"

27. *Ibid.*

28. *Ibid.*

29. M. Wayne Marr, Jr., John R. Nofsinger, and John L. Trimble, *Economically Targeted and Social Investments: Investment Management and Pension Fund Performance,* Research Foundation of the Institute of Chartered Financial Analysts, Charlottesville, VA, November 1995.

increased contributions or lower benefit payments to plan members."[30] Numerous other scholars confirmed these findings.[31]

ETIs produce poor results in part because of the inevitable pressure to make investments for political, rather than economic, reasons. Among the more notable miscues committed by government employee pension funds:

- The Texas State Board of Education recently dumped 1.2 million shares of Disney to protest the content of films made by a subsidiary.[32]
- The Missouri State Employees' Retirement System established a venture capital fund for new businesses in the state. It was shut down three years later following poor returns and two lawsuits.[33]
- Pennsylvania school teachers and state employees saw $70 million of their fund invested in a new plant for Volkswagen. The investment since then has lost more than half its value.[34]
- Illinois transferred $21 million of workers' money to the state's general budget.[35]
- The Kansas Public Employees' Retirement System lost $65 million by investing in a Kansas-based Home Savings Association. The fund also lost $14 million by investing in Tallgrass Technologies and squandered nearly $8 million in a steel plant. Total losses of workers' money from ETIs will be between $138 million and $236 million.[36]
- New York State and City pension funds in 1975 were pressured into buying bonds to avert New York City's bankruptcy.[37] The following year, they were strong-armed into buying bonds to bail out four state agencies.[38]
- The Connecticut State Trust Fund poured $25 million of workers' money into Colt Manufacturing, a local company that went bankrupt three years later.[39]
- A state pension system in California offered $1.6 billion of workers' money to help to balance the state's budget in 1991.[40]
- The state of Minnesota lost $2 million of workers' money in 1998 by dumping tobacco stocks.[41]
- A U.S. General Accounting Office (GAO) study finds that affordable housing investments by government employee pension funds are both illiquid and less profitable.[42]

30. Joint Economic Committee House Staff Report, "The Economics of ETIs: Sacrificing Returns for Political Goals," September 1995.
31. See, for example, Olivia S. Mitchell and Hsin Ping-Lung, "Public Sector Pension Governance and Performance," NBER *Working Paper* No. 4632, January 1994, and Romano, "Public Pension Fund Activism in Corporate Governance Reconsidered."
32. Greg Ip, "Can Social Security Funds Be Invested Free of Politics?" *The Wall Street Journal,* January 22, 1999.
33. Marr et al., *Economically Targeted and Social Investments.*
34. Joint Economic Committee Briefing, "Economically Targeted Investments," June 7, 1995.
35. Angelis, "Investing Public Money in Private Markets: What Are the Right Questions?"
36. Joint Economic Committee Briefing, "Economically Targeted Investments."
37. Marr et al., *Economically Targeted and Social Investments.*
38. Romano, "Public Pension Fund Activism in Corporate Governance Reconsidered."
39. Joint Economic Committee Briefing, "Economically Targeted Investments."
40. Marr et al., *Economically Targeted and Social Investments.*
41. Bill Wareham, "Minnesota OKs Tobacco Divestiture Plan," Associated Press, September 3, 1998.
42. Romano, "Public Pension Fund Activism in Corporate Governance Reconsidered."

- One independent study estimates that non-economic investing by government-controlled pension funds resulted in more than $28 billion in losses between 1985 and 1989.[43]

Such bad investment choices are important for two reasons. The first is that the taxpayers will have to make up the losses, in particular because the vast majority of the government pensions are defined-benefit plans (workers receive a pension based on formula, not fund performance). And because these plans reportedly are underfunded to the tune of $125 billion, this is not a trivial concern.[44]

The second reason bad investment decisions are important is that they illustrate the risks in allowing the government to control investments in a reformed Social Security system. Supporters of government-controlled investment claim that the risk can be avoided by limiting the decision-making authority of the trustees overseeing the plan. But Chairman Greenspan doubts "if it would be feasible to insulate, over the long run, the trust funds from political pressures."[45]

Government-Managed Pension Funds Abroad

Several other countries already have government-managed pension funds. Some, such as Singapore and Malaysia, have private systems in every sense except that the government controls the investments. Others have defined-benefit programs that are run completely by the government, including the investment of excess revenue.

Regardless of their form, government-controlled systems of investment fail to offer workers a decent rate of return. In fact, as Chart 1 shows, most of these countries have experienced negative returns in the 1980s. The Singapore and Malaysia systems have performed the best, although more recent data—particularly following the region's recent financial crisis—would show that average annual real returns in these countries are falling as well—approaching zero.[46]

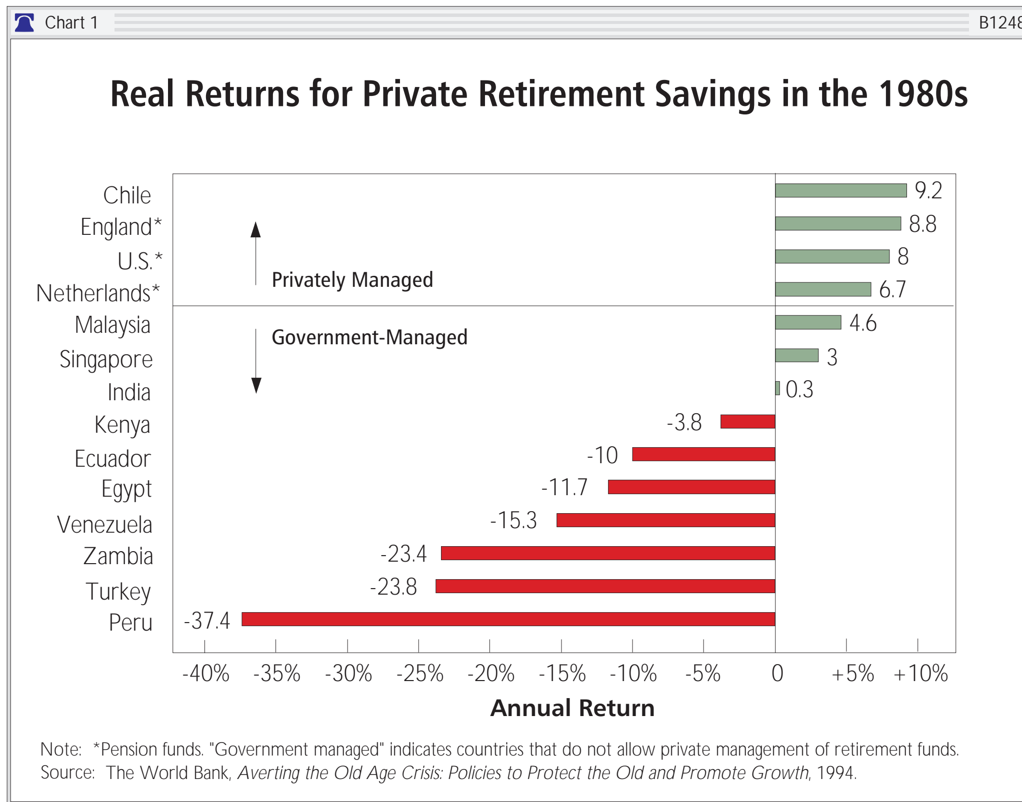
In many of these countries, enormous amounts of money have been lost because of blatant corruption. Other poor performances are the result of industrial policy. As Chart 1 shows, private-sector professionals did a much better job of improving retirement income than their government counterparts did. The World Bank refers to this gap as a "hidden tax" on workers, noting that government-controlled funds must either "charge higher contribution rates or pay lower benefits."[47]

The poor results of government-controlled investment have implications for a country's economy. As the World Bank notes, "Central planning has not been the most efficient way to allocate a country's capital stock," and the "net impact on growth may be negative, rather than positive, if public fund managers allocate this large share of national savings to low-productivity uses."[48]

GOVERNMENT INVESTMENT WILL NOT SOLVE SOCIAL SECURITY'S FINANCIAL PROBLEMS

Government-controlled investment does not give workers a better return for their money. Instead, the primary objective is to bolster the government's finances and eliminate the Social Security system's huge unfunded liability. Even on this basis, the Clinton plan would fail.[49] The GAO

43. *Ibid.*
44. Leslie Scism, "Public Pension Plans Are So Underfunded That Trouble Is Likely," *The Wall Street Journal,* April 6, 1994.
45. Greenspan, Testimony to the Senate Committee on the Budget.
46. Mukul G. Asher, "Investment Policies and Performance of Provident and Pension Funds in Southeast Asia," unpublished manuscript, National University of Singapore.
47. World Bank, *Averting the Old-Age Crisis.*
48. *Ibid.*



estimates that putting the Social Security surplus into stocks (assuming a real return of 7 percent) would extend the life of the Trust Fund by only three years,[50] and the Congressional Research Service recently reached the same conclusion.[51] Moreover, the GAO notes that "government stock investing would have no appreciable effect on future economic growth."[52]

True privatization, by contrast, will increase the incentives to work and boost savings nationally. According to Harvard Professor Martin Feldstein, shifting to a system of personal accounts would elevate gross domestic product by about 5 percent —permanently.[53]

THE ADVANTAGES OF PRE-FUNDING RETIREMENT BENEFITS

Although there is a strong argument against allowing politicians to invest retirement funds, this does not mean it would be a bad idea to shift Social Security to a system based on savings and investment. So long as professionals from the financial services industry directed the investments, workers would reap huge benefits. A major

49. The Clinton Administration plan would extend the life of the Trust Fund by more than 20 years, but this is almost completely the result of a separate proposal to add more IOUs to the ones already in the Trust Fund.

50. U.S. General Accounting Office, "Implications of Government Stock Investing for the Trust Fund."

51. Congressional Research Service, "Social Security Reform: Projected Contributions and Benefits Under Three Proposals (S. 1792, S 2313/H.R. 4256 in the 105th Congress, and a Plan by Robert M. Ball)," CRS *Report* No. 98–961 EPW, December 3, 1998. See also David C. John, "CRS Report Says Government Investment Won't Save Social Security," Heritage Foundation *Executive Memorandum* No. 565, December 21, 1998.

52. U.S. General Accounting Office, "Implications of Government Stock Investing for the Trust Fund."

53. Martin Feldstein, "The Missing Piece in Policy Analysis: Social Security Reform," *American Economic Review*, Vol. 86, No. 2 (May 1996).

attraction of pre-funding retirement benefits with private investment is that a balanced portfolio of stocks, bonds, and other assets will produce much higher returns than a traditional entitlement program offers. This is especially true when the income generated by that portfolio (including dividends and interest) is reinvested in the account, thereby capturing the benefits of compound interest. In effect, pre-funding would generate additional retirement income without having workers pay more into the system.

Another advantage of pre-funding is that the accumulation of real assets would mean far less pressure to raise taxes in the future. Under current law, workers will face a big tax increase beginning around 2013 when the Baby Boomers begin to retire.[54] Because Social Security's unfunded liability is so large, payroll tax rates could climb above 18 percent. Although some argue that the assets in the Social Security trust fund can be used to delay tax increases, those IOUs can be redeemed only by collecting more money from the taxpayers.[55] Either way, tomorrow's workers will have to pick up the tab. Pre-funding future retirement benefits, by contrast, would lower Social Security's long-term deficit and help to keep the tax burden under control.

The Alternative Proposals

Although there is broad support for pre-funding Social Security retirement benefits, the growing consensus does not extend to such key issues as who controls the investment and who reaps the benefits of higher returns. The various proposals for pre-funding retirement benefits address these concerns in very different ways:

- **Personal accounts with individual control of investment.** These plans would allow workers to divert a portion of their payroll taxes into an account patterned after today's individual retirement accounts (IRAs). They would choose how the money is invested or select a fund manager. Additional income earned by the investments would accrue to the benefit of the worker.
- **Personal accounts with professional control of investments.** These plans would allow workers to divert a portion of their payroll taxes into a personal retirement account more closely resembling today's 401(k) accounts. Professional pension fund managers, probably chosen by employers, would exercise the most control over how the money was invested. The additional income earned by the investments would accrue to the benefit of the worker.
- **Personal accounts with government control of investment.** Under this plan, workers would divert a portion of their payroll taxes into an account, but politicians and/or political appointees would invest the money. Any additional income earned by the investments would accrue to the benefit of the worker. This approach is similar to the private social security system that exists in Singapore and several other countries.[56]
- **Collective system with government investment of annual surplus (the Clinton plan).** Under President Clinton's plan, the tax and benefit structure of Social Security would remain unchanged and workers would not get personal accounts under Social Security. Instead, politicians and/or political appointees would invest the program's surplus. None of the additional income earned by the investments would accrue to the benefit of the worker. This approach is associated most frequently with Robert Ball, a member of a

54. See Daniel J. Mitchell, "Creating a Better Social Security System for America," Heritage Foundation *Backgrounder* No. 1109, April 23, 1997.

55. White, "Investing the Assets of the Social Security Trust Funds in Equity Securities."

56. This approach is similar to the social security system in Singapore and a handful of other countries. Some other former British colonies, including Kenya, Malaysia, and India, also have this type of system, known as a Central Provident Fund. See World Bank, *Averting the Old-Age Crisis.*

faction of the 1994–1996 Social Security Advisory Council that favored government-controlled investment.[57]

As this list indicates, the only issue for those who favor private control of Social Security investment is the degree to which individuals would be allowed to self-direct the investment of the money in their personal accounts. Proponents of government-controlled investment, by contrast, are deeply divided on the issues of whether workers would get personal accounts and who would get the additional income earned by the investment. Supporters of the Singapore approach favor a version of privatization[58] in which individuals would be allowed to have accounts. Bureaucrats would invest the money, but workers would receive the benefits of the higher returns. Advocates of the Clinton plan support the opposite approach, one in which workers would not be allowed to have personal accounts and would not receive any benefit if the bureaucrats made wise investment choices. Instead, all additional earnings would be used to prop up the current system.

CONCLUSION

The Social Security system is actuarially bankrupt and will not be able to meet its future obligations. This looming crisis is leading policymakers to consider harnessing the power of private investment and compound interest. Although this is the correct approach, it is important to ensure that a pre-funded system is not hijacked by the political process so that politicians or their appointees take control and are able to steer investments to politically favorable businesses, their cronies, or their campaign contributors. President Clinton's plan fails this important test.

The safest way to protect the money of workers for their future retirement is to have a portion of their Social Security payroll taxes invested by professionals from the financial services industry. Not only do these professionals have the knowledge and the incentive to invest the money wisely, they also are legally obligated to act in the best interests of the workers in their fund. This type of genuine reform is the best way to ensure that future retirees will have a safe and comfortable retirement income while also protecting the economy and taxpayers.

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57. The Ball plan specifically called for investing 50 percent of the Trust Fund in the private sector by 2014. This means the federal government would control more than $1 trillion worth of stock, making it the country's largest shareholder. See Advisory Council on Social Security, *Report of the 1994–1996 Advisory Council on Social Security.*

58. To be more specific, privatization occurs when mandatory savings, in whole or in part, replace the government-run system. Requiring workers to save without a concomitant reduction in the payroll tax is not genuine reform. The key questions are: Would workers be able to use some of their payroll tax to fund their mandatory savings accounts? If so, how much of the current 12.4 percent payroll tax would go to the account? Or would the new accounts exist in addition to the current Social Security system?