

Background

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Government-Controlled Investment: The Wrong Answer to the Wrong Question

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Some argue that using personal retirement accounts to reform Social Security would be a mistake and that the government should instead set up its own investment fund to help finance future benefit payments. The good news is that this indicates a growing awareness that “pre-funding” (i.e., accumulating assets) is a necessary component of Social Security reform.

The bad news, however, is that government-controlled investment is the wrong answer to the wrong question. It assumes that policymakers should focus solely on balancing the program’s revenues and expenditures. This ignores the other Social Security crisis—the fact that the tax burden on today’s workers is extraordinarily high compared to the benefits received (often referred to as the rate-of-return crisis).

Even if balancing Social Security’s long-term finances were the only goal, government-controlled investment would be the wrong answer. This is because a government-controlled pension fund would not face the competitive pressure and legal obligation to make investments solely for the economic benefit of future retirees. As one expert has explained:

[U]nlike a private fund manager, who only wants to see the value of his investment rise and who will sell it if he loses confidence in the company or its managers, highly political public pension trustees are free to pursue political as well as economic objectives.¹

Talking Points

- A government-controlled pension fund would not face competitive pressure and would not have a legal obligation to make investments solely for the economic benefit of future retirees.
- Government-controlled investment ignores the other Social Security crisis—the fact that the tax burden on today’s workers is extraordinarily high compared to the benefits received.
- The Congressional Budget Office warns that “Government ownership of stocks could affect corporate decision making, interfere with the nation’s competitive market system, and impede the operation of financial markets—potentially limiting economic growth.”
- Federal Reserve Board Chairman Alan Greenspan has testified before Congress that such approaches “would arguably put at risk the efficiency of our capital markets and thus, our economy.”

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Giving the federal government that power and control would create large risks for the economy and for the retirement security of today's workers. The Congressional Budget Office has warned:

Government ownership of stocks could affect corporate decision making, interfere with the nation's competitive market system, and impede the operation of financial markets—potentially limiting economic growth.²

Evidence at the state and local levels with respect to public employee pension funds—as well as evidence from similar arrangements in other nations—demonstrates that politicians and their appointees are often tempted to steer the government-controlled pot of money toward special interests, political allies, and 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 would certainly be difficult for workers to wind up with less than they are currently promised 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. Federal Reserve Board Chairman Alan Greenspan has testified before Congress that such approaches “would arguably put at risk the efficiency of our capital markets and thus, our economy.”³

The Risks of Politically Driven Investment Politics

The Social Security system is actuarially bankrupt and will not be able to meet its future obligations. Over the next 75 years, the program will face a cash shortfall of \$27 trillion. If no changes are made in the program's design, bringing Social Security into balance will require a monumental policy change: a 50 percent-plus 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 only exacerbate Social Security's other crisis—its poor rate of return—making it an even worse deal for American workers. Many younger workers today already face negative returns (adjusted for inflation) from the taxes they pay into the Social Security system. 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 Washington policymakers 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 over how best to tap the benefits of private investment. Oppo-

1. Nicole Gelinas, “Corporate America's New Stealth Raiders,” *City Journal*, Vol. 15, No. 1 (Winter 2005), at www.city-journal.org/html/15_1_corporate_america.html (March 29, 2005).
2. Congressional Budget Office, “Acquiring Financial Assets to Fund Future Entitlements,” *Long-Range Fiscal Policy Brief* No. 8, June 16, 2003, at www.cbo.gov/showdoc.cfm?index=4324&sequence=0 (March 29, 2005).
3. Alan Greenspan, testimony before the Committee on the Budget, U.S. Senate, 106th Cong., 1st Sess., January 29, 1999.
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, at www.heritage.org/Research/SocialSecurity/CDA98-01.cfm.
5. Advisory Council on Social Security, “Findings and Recommendations,” *Report of the 1994–1996 Advisory Council on Social Security*, Vol. I, January 1997, at www.ssa.gov/history/reports/adccouncil/report/toc.htm (March 29, 2005).

nents 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 supported, for instance, by the AARP.⁶

Such government-controlled investment proposals, however, raise four broad concerns.

Concern #1: Government-controlled investment would mean the partial nationalization of major businesses, which in turn would allow politicians to interfere with major economic decisions.

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.⁷ Even if politicians were not placed in positions of direct power, they could use their voting power to impose control.⁸ When politicians control business decisions, political incentives become more important than economic ones. Invariably, the result is less prosperity.

This is demonstrated by the experiences of other countries. Much of Western Europe suffers from stagnation and high unemployment rates. High tax rates and excessive welfare benefits certainly deserve part of the blame, but the widespread direct and indirect state control of business has also had severe consequences. Former Soviet bloc countries 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 without 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 are legally obligated 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? If so, could it even be enforced?

This is a significant concern because legislators sometimes believe that the marketplace is not producing the right results, and they respond by trying 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.⁹

The downturn in Asia during the 1990s 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.

6. AARP, "Social Security: A Background Briefing," updated March 24, 2005, at assets.aarp.org/www.aarp.org/_articles/presscenter/pdf/SocialSecurityBackgroundBriefing.pdf (March 30, 2005).

7. Theodore J. Angelis, "Investing Public Money in Private Markets: What Are the Right Questions?" in R. Douglas Arnold, Michael Graetz, and Alicia H. Munnell, eds., *Framing the Social Security Debate: Values, Politics, and Economics* (Washington, D.C.: Brookings Institution Press, 1998).

8. Carolyn L. Weaver, "How Not to Reform Social Security," American Enterprise Institute *On the Issues*, August 1998.

9. 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.

Concern #3: Government-controlled investment opens the door to corruption by allowing politicians to steer funds toward well-connected interest groups and 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 to provide favors or steer resources to constituents and allies. A large pot of government-controlled money would create the opportunity to divert money to satisfy the demands of special interests,¹⁰ as has happened in many countries in the less-developed world.¹¹

Advocates of government-controlled investment argue that U.S. political institutions 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 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 that are designed to maximize long-term returns. This is a legal requirement,¹² 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.

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.¹³ Conversely, some causes are politically popular. Allocating investments to these ventures, even if they are expected to lose money, could be advantageous for politicians.

The Lesson of History: Government Should Not Play Stockbroker

Although advocates of government-controlled investment may argue that the foregoing concerns are overstated, the arguments against political control are supported by historical evidence. For example, pension funds for state and local government employees in the United States are frequently subjected to political manipulation. Moreover, 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, to varying degrees, beholden to politicians.¹⁴ Compared with the performance of private pension funds, government pension plans underperform.¹⁵ In terms of overall fund performance, the gap between government-controlled and private pension funds is not huge, but the impact grows over time because of compounding. Major studies find that govern-

10. 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. The GAO is now known as the U.S. Government Accountability Office.

11. World Bank, *Averting the Old-Age Crisis: Policies to Protect the Old and Promote Growth* (New York: Oxford University Press, 1994).

12. John R. Nofsinger, “The Affects of Restrictions and Targeting Policies on Public Pension Funds,” paper presented to the Midwest Finance Association, Kansas City, Missouri, March 1997.

13. Charles Kolb, “Pitfalls of Social Security Reform,” *The Washington Times*, October 22, 1998.

14. Research does show that the level of political control affects 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.”

ment-controlled pension funds have rates of return at least 1 percentage point below those of private fund managers.¹⁶

There is a particularly big performance gap between private pension funds and government-controlled pension plans dedicated to economically targeted investments (ETIs), which actually are based on political, not economic, 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,¹⁷ as well as in-state investing and alternative energy.¹⁸ They usually promote this with a vague catchall provision requiring that the investments promote the “general welfare of the state.”¹⁹ Ohio even includes racial preferences as a goal of its pension fund.²⁰ 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 ETI advocates.

In addition to requiring investment in projects that are likely to be less profitable, government-controlled investment would often prohibit invest-

ments that otherwise would generate a good return for workers. For example, at one time, more than 30 states barred investment in companies that did business with South Africa. Another 11 placed restrictions on investments in businesses operating in Northern Ireland.²¹ Some pension funds face restrictions on investments in the tobacco, alcohol, and defense industries.²²

This list would likely 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,²³ anti-trust violations,²⁴ and allegedly unfair labor policies.²⁵ A 1989 report prepared for then-New York Governor Mario Cuomo even suggests that pension funds side with incumbent management in takeover disputes.²⁶ Protectionists would be likely to argue that investments should be limited to U.S. companies.²⁷ Another disturbing possibility is that the money could be used for infrastructure spending, based on the rationale that the government would recoup the money through higher tax collections.²⁸

To ascertain the risk of government-controlled investment in a reformed Social Security system, analysts compared the performance of ETIs with that of

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15. 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.
 16. Gelinas, “Corporate America’s New Stealth Raiders.”
 17. Richard Ferlauto and Jeffrey Clabourn, “Economically Targeted Investments by State-Wide Pension Funds,” Center for Policy Alternatives, 1993.
 18. Ostaszewski, “Privatizing the Social Security Trust Fund?”
 19. Roberta Romano, “Public Pension Fund Activism in Corporate Governance Reconsidered,” *Columbia Law Review*, Vol. 93, No. 4 (May 1993), pp. 795–853.
 20. *Ibid.*
 21. Ostaszewski, “Privatizing the Social Security Trust Fund?”
 22. *Ibid.*
 23. Weaver, “How Not to Reform Social Security.”
 24. Gene Steuerle, “Investing Social Security Surpluses in the Stock Market,” *Tax Notes*, April 3, 1995.
 25. 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).
 26. *Ibid.*
 27. Steuerle, “Investing Social Security Surpluses in the Stock Market.”
 28. Angelis, “Investing Public Money in Private Markets: What Are the Right Questions?”

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 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 lower returns.

Private pension funds, by contrast, are free of political control. They are subject to a universal

legal requirement that they operate in the best interest of workers.² More specifically, they are regulated by the 1974 Employee Retirement Income Security Act, which 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 necessarily make money, but it does mean that every investment is made with the intention of maximizing income for retirees. 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, No. 4 (May 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,” paper presented to the Midwest Finance Association, Kansas City, Missouri, March 1997.

traditional investments. John R. Nofsinger of Marquette University found that ETIs reduced average returns by more than 1.5 percent annually.²⁹ Perhaps not surprisingly, he also discovered that restrictions on investments in South Africa and Northern Ireland were associated with lower returns.³⁰ Other scholars found that returns from ETIs averaged between 1.0 percent and 2.5 percent below those of funds that operated in the best interest of workers.³¹

Alicia Munnell, a Department of the Treasury official during the Clinton Administration, 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 increased contributions or lower benefit payments to plan members.”³² Numerous other scholars have confirmed these findings.³³

ETIs produce poor results in part because of the inevitable pressure to make investments for political rather than economic reasons. The following are

29. *Ibid.*

30. *Ibid.*

31. 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, Virginia, November 1995.

32. Joint Economic Committee, *The Economics of ETIs: Sacrificing Returns for Political Goals*, House staff report, September 1995.

33. For example, see Olivia S. Mitchell and Hsin Ping-Lung, “Public Sector Pension Governance and Performance,” National Bureau of Economic Research *Working Paper* No. 4632, January 1994, and Romano, “Public Pension Fund Activism in Corporate Governance Reconsidered.”

among the more notable miscues committed by government employee pension funds.

- The Texas State Board of Education dumped 1.2 million shares of Disney to protest the content of films made by a Disney subsidiary.³⁴
- 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.³⁵
- A fund for Pennsylvania school teachers and state employees invested \$70 million in a new Volkswagen plant. The investment lost more than half its value.³⁶
- Illinois transferred \$21 million of workers' money to the state's general budget.³⁷
- 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 on a steel plant. Total losses of workers' money from ETIs were projected to be between \$138 million and \$236 million.³⁸
- New York State and New York City pension funds in 1975 were pressured into buying bonds to avert New York City's bankruptcy.³⁹ The following year, they were strong-armed into buying bonds to bail out four state agencies.⁴⁰
- The Connecticut State Trust Fund poured \$25 million of workers' money into Colt Manufacturing, a local company that went bankrupt three years later.⁴¹
- A California pension system offered \$1.6 billion of workers' money to help balance the state's budget in 1991.⁴²
- The State of Minnesota lost \$2 million of workers' money in 1998 by dumping tobacco stocks.⁴³
- A U.S. General Accounting Office study found that affordable housing investments by government employee pension funds are both illiquid and less profitable.⁴⁴
- One independent study estimates that non-economic investing by government-controlled pension funds resulted in more than \$28 billion in losses between 1985 and 1989.⁴⁵

Such bad investment choices are important for two reasons.

First, the taxpayers will have to make up the losses, particularly because the vast majority of government pensions are defined-benefit plans (workers receive a pension based on formula, not fund performance). Because these plans are reportedly underfunded to the tune of \$125 billion, this is not a trivial concern.⁴⁶

Second, the bad investment decisions illustrate the risks in allowing the government to control

34. Greg Ip, "Can Social Security Funds Be Invested Free of Politics?" *The Wall Street Journal*, January 22, 1999.

35. Marr *et al.*, *Economically Targeted and Social Investments*.

36. Joint Economic Committee, "Economically Targeted Investments," briefing, June 7, 1995.

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

38. Joint Economic Committee, "Economically Targeted Investments."

39. Marr *et al.*, *Economically Targeted and Social Investments*.

40. Romano, "Public Pension Fund Activism in Corporate Governance Reconsidered."

41. Joint Economic Committee, "Economically Targeted Investments."

42. Marr *et al.*, *Economically Targeted and Social Investments*.

43. Bill Wareham, "Minnesota OKs Tobacco Divestiture Plan," Associated Press, September 3, 1998.

44. Romano, "Public Pension Fund Activism in Corporate Governance Reconsidered."

45. *Ibid.*

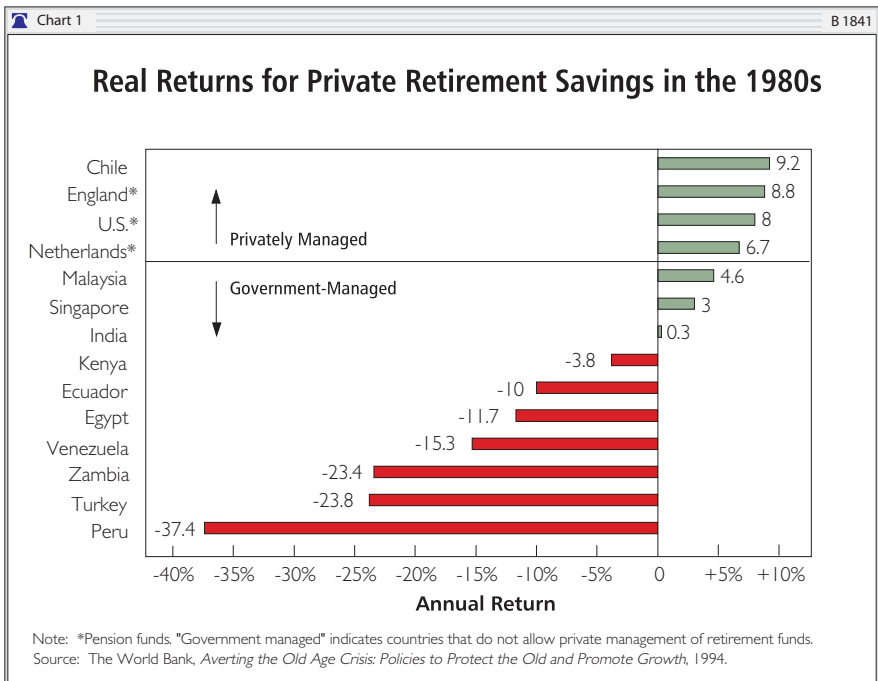
46. Leslie Scism, "Public Pension Plans Are So Underfunded That Trouble Is Likely," *The Wall Street Journal*, April 6, 1994.

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. However, Chairman Greenspan doubts that “it would be feasible to insulate, over the long run, the trust funds from political pressures.”⁴⁷

Government-Managed Pension Funds Abroad. Several other countries already have government-managed pension funds. Some, such as Singapore and Malaysia, have systems that are private 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 investment systems fail to offer workers a decent rate of return. As Chart 1 shows, most of these countries experienced negative returns in the 1980s. The Singapore and Malaysia systems have performed the best, although more recent data that included the region’s recent financial crisis would show that average annual real returns in these countries are also falling—approaching zero.⁴⁸

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.”⁴⁹

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.”⁵⁰

Conclusion

Some proponents of government-controlled investing assert that the Thrift Savings Plan for federal employees is a model for Social Security. This is true, but only if workers are given personal retirement accounts. As the Congressional Budget Office explains:

47. Greenspan, testimony before the Committee on the Budget.

48. Mukul G. Asher, “Investment Policies and Performance of Provident and Pension Funds in Southeast Asia,” unpublished manuscript, National University of Singapore.

49. World Bank, *Averting the Old-Age Crisis*.

50. *Ibid.*

A crucial feature of the TSP is that its assets are owned by federal workers, not the government. The board that oversees the program has a fiduciary responsibility to manage those assets for the sole benefit of the owners of the individual accounts.⁵¹

The AARP and other interests want the opposite: to have the government make private investments in order to increase government's control of

national economic output. This would be the wrong approach. It would not help workers to get a better deal from Social Security, but it would open the door for political mismanagement and intervention in America's capital markets.

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51. Congressional Budget Office, *Social Security: A Primer*, September 2001, p. 53, at www.cbo.gov/ftpdocs/32xx/doc3213/EntireReport.pdf (March 29, 2005).