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Should the Federal Government Invest Social Security Trust Funds?

In his State of the Union address, President Clinton proposed that "we commit 60 percent of the budget surplus for the next 15 years to Social Security, investing a small portion in the private sector just as any private or state government pension would do."

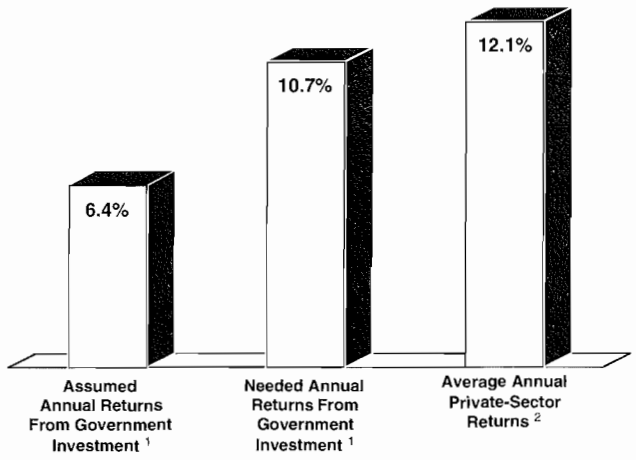
While it is true that state and local government pension funds usually invest in the market, it is also true that politicians have often tried to get their hands on that money to use for political purposes. Before we give Congress and President Clinton access to Social Security funds, we need to ask several questions.

Are public pension fund managers required to maximize returns? No. The difference between public pension funds and private pension funds is that private funds come under the Employee Retirement Income Security Act (1974), which requires a fiduciary managing a plan to "discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries . . ." This means that private pension fund managers have a legal obligation to maximize returns on investments, while public pension plan managers and elected officials often are not constrained by such restrictions — and there is little reason to think that members of Congress would recognize any restriction.

Would government investment in the stock market solve Social Security's financial problems? Not according to the Congressional Research Service (CRS). In December of 1998 the CRS released its study of a plan backed by Robert M. Ball, a former commissioner of the Social Security Administration. The plan calls for investing up to 50 percent of the Social Security trust fund in stocks. The CRS assumed that the trust fund would earn about 6.4 percent annually on its stock market investment, but it would need 10.7 percent to resolve Social Security's long-term funding crisis. So long as government investments are prudent and conservative, they won't earn as much as Social Security needs. By contrast, the Employee Benefit Research Institute estimates that private pension assets earned 12.1 percent per year between 1990 and 1995, about twice the expected return were the federal government to invest the money. [See Figure I.]

FIGURE I

Estimates on Social Security Investment Returns in the Stock Market



[1] Congressional Research Service. Assumes investing up to 50 percent of the trust fund in stocks.

[2] Employee Benefit Research Institute.

Would the government turn to economically targeted investments? Probably. Former Labor Secretary Robert Reich wanted private pension funds to make socially oriented investments in order to finance infrastructure or public works projects, to stimulate local economies and protect jobs in troubled companies or industries. Known as Economically Targeted Investments (ETIs), these investments would be "selected for their economic benefits apart from their investment return to the employee benefit plan," according to a bulletin from the Department of Labor.

Proponents contend that ETIs can earn market rates of return, but studies do not bear out this contention.

- A 1995 study by Clemson University economist M. Wayne Marr and Washington State University economist John R. Nofsinger found that pension funds that include ETIs underperform other pension funds by 1.18 to 2.10 percentage points, even after accounting for differences in governance structure and asset allocation.
- A 1983 study by Boston College economist Alicia H. Munnell, a member of the president's Council of Economic Advisors, found that ETIs result in a 2 percentage point reduction in investment returns.

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As Figure II shows, even a 2 percentage point loss can make a huge difference in retirement income.

Many state and local public employee pension funds invest in ETIs, generally designating between 1 percent and 5 percent of their workers' retirement savings for these programs. For example:

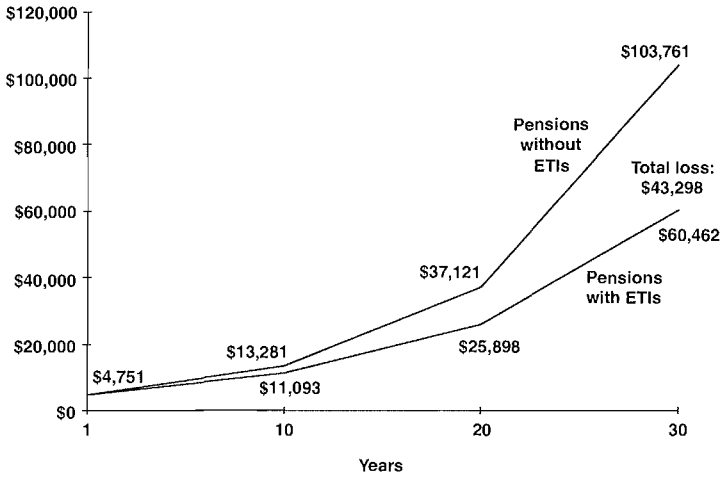
- A 1993 survey by the Institute of Fiduciary Education found that of the 119 public pension funds responding, 50 had at least one ETI.
- A 1995 study by the General Accounting Office found that public pension plans in 29 states were implementing ETIs.

Interestingly, Bill Clinton, while governor of Arkansas, promoted and signed such legislation, and Arkansas is one of the states diverting the largest share (5 percent) of its public employees' retirement funds into ETIs.

If public officials want to invest in local businesses or the infrastructure, they should appropriate funds directly for that purpose, rather than raiding public employees' pensions.

FIGURE II

What Difference Do ETIs Make?*



* A pension participant begins with a single contribution of $4,751. Average annual rate of return for pensions without ETIs is 12.1 percent, and 10.1 percent for pensions with ETIs.

Source: Dan Miller, Joe Engelhard and Lewis Weinger, "The Economics of ETIs: Sacrificing Returns for Political Goals," Joint Economic Committee House Staff Report, September 1995.

Would Congress use the funds to make political statements? Almost certainly. In July 1998 the Texas State Board of Education approved the sale of $46 million of Walt Disney Co. stock from the Permanent School Fund, which provides revenue for public schools. The board was sending a message to Disney that it disapproved of the "violence" and "explicitness" contained in the company's adult-oriented productions, distributed by Miramax Films.

Ironically, an analysis by the *Dallas Morning News* of the Permanent School Fund's stock holdings found other "holdings with companies involved in alcohol, gambling and adult entertainment."

Such political statements are widespread and growing — sometimes taking a conservative and other times a liberal political stand. According to a recent study by Jennifer D. Harris of the Public Retirement Institute, "public pension funds increasingly are becoming subject to specific prohibitions against investments in specific types of companies." As of 1997:

- Five public pension funds imposed restrictions on foreign investments.
- Three restricted investment in South Africa.
- Others restricted investment in tobacco companies, companies in Northern Ireland and companies involved in infant formula pricing in Third World countries.

Would investment fund managers attempt to curry favor with politicians? They already do. According to the liberal watchdog group Common Cause, about 500 securities and investment companies contributed some $10 million to campaigns during the 1995-96 election cycle. While state and local pension plans have over $2 trillion in assets, those are divided among about 180 different plans. The Clinton plan, as well as some similar proposals, would transfer between $650 billion and $1.2 trillion into stocks over the next 15 years, or about 4 percent of the U.S. market. Could that much money lure companies and lobbyists to cross the ethical line in attempting to influence politicians?

Conclusion. Too many problems and conflicts could arise if the federal government is investing Social Security funds. With that much money at politicians' discretion, it would be too tempting to use the funds to do what's good for political reasons, rather than do what's right for America's workers.

This Brief Analysis was prepared by NCPA Vice President of Domestic Policy Merrill Matthews Jr.