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February 26, 2001

THE GREENSPAN CONCERN OVER PUBLIC OWNERSHIP OF PRIVATE ASSETS: CAN THE SOCIAL SECURITY TRUST FUND SAFELY OWN SUCH ASSETS?

By Peter Orszag and Robert Greenstein

In testimony before the Senate Budget Committee on January 25, Federal Reserve Board chairman Alan Greenspan argued that allowing the government to hold private assets would risk "sub-optimal performance by our capital markets, diminished economic efficiency, and lower overall standards of living than would be achieved otherwise."[1] Chairman Greenspan expressed concern that public ownership of private assets would introduce dangerous political interference in our capital markets.

Chairman Greenspan also noted, however, that if the government were to hold private assets, it should do so through the Social Security trust fund, rather than through a generic government account. He stated: "Short of some privatization, it would be preferable in my judgment to allocate the required private assets to the social security trust funds, rather than to on-budget accounts. To be sure, such trust fund investments are subject to the same concerns about political pressures as on-budget investments would be. The expectation that the retirement of the baby-boom generation will eventually require a drawdown of these fund balances does, however, provide some mitigation of these concerns."

This paper explores whether allowing the Social Security trust fund to invest in private assets is feasible. Given Chairman Greenspan's recent testimony, the question has important implications for both Social Security and overall budget policy.

The currently projected budget surpluses are sufficiently large that, if they actually materialize, the publicly held debt would be eliminated within the coming decade. Once the debt is eliminated, policy-makers would have only two choices if they decided the Social Security trust fund could *not* own any private assets: they would either have to dissipate the projected surpluses in the form of higher spending or lower taxes, or they would have to divert Social Security funds into individual accounts. Otherwise, the government would end up accumulating private assets.

This means that if policy-makers are unable to find some safe mechanism for facilitating government ownership of private assets through the Social Security trust fund, and if current budget projections are realized, the country may be driven to adopt critical changes in the budget

[1] Alan Greenspan, "Outlook for the federal budget and implications for fiscal policy," Testimony before the Committee on the Budget, U.S. Senate, January 25, 2001.

or the Social Security system solely because of the "peril of zero debt"[2] rather than as a result of the substantive costs and benefits of these changes in the budget and Social Security themselves.

Do other governments have experience in private investments?

In evaluating whether the Social Security trust fund could invest in private assets without causing political interference in the capital markets — and economic inefficiency as a consequence — it is useful to examine the experiences of state and local pension funds, as well as foreign governments, in undertaking similar investments.

State and local governments in the United States, along with some foreign governments, have had success in investing their pension funds in private assets. In the United States, state and local public pension funds have long invested in private assets. At the end of the third quarter of 2000, state and local pension investments in private assets (including stocks and bonds) amounted to 28 percent of the U.S. Gross Domestic Product (GDP), and state and local pension investments in corporate equities amounted to almost $2 trillion, or 19.5 percent of GDP.[3] This scale is likely to be well beyond that which the federal government would undertake if a portion of the Social Security trust fund were invested in private markets. Yet this state and local pension fund investment has not endangered the efficiency of our private capital markets. This fact is significant, given that state and local funds generally lack the institutional protections that would almost certainly be part of any reasonable proposal for investing a portion of the Social Security trust funds. (These institutional protections are discussed below.)

Recent research suggests that state and local pension funds now perform relatively well. Alicia Munnell and Annika Sunden of Boston College recently concluded that, "the story that emerges at the state and local level is that while in the early 1980s some public plans sacrificed returns for social considerations, plan managers have become much more sophisticated. Today, public plans appear to be performing as well as private plans."[4] State and local pension funds now devote no more than 2.5 percent of their total holdings to "economically targeted investments," the ones that could reflect political interference. Munnell and Sunden also note

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[2] The "peril of zero debt" phrase is taken from Alice M. Rivlin, "Why Fight the Surplus?" *New York Times*, January 30, 2001, page A23. For further discussion of the peril of zero debt, see Peter R. Orszag, "The Peril of Zero Debt and the Long-Term Budgetary Outlook: Some Questions Regarding Chairman Greenspan's Recent Testimony," Center on Budget and Policy Priorities, February 22, 2001.

[3] Data from Table L.120 of the Flow of Funds Accounts, December 8, 2000, available at www.federalreserve.gov. At the end of the third quarter of 2000, state and local government employee retirement funds held a total of $3.034 trillion in financial assets, of which $208.9 billion was in U.S. Treasury securities and $1.7 billion was in municipal securities. Financial assets representing investments in the private sector amounted to $2.824 trillion, or 28 percent of GDP in the third quarter of 2000 ($10.039 trillion). Of this total, $1.95 trillion was held in the form of corporate equities. These data are the most current data available.

[4] Alicia Munnell and Annika Sunden, "Investment Practices of State and Local Pension Funds: Implications for Social Security Reform," Center for Retirement Research, Boston College, CRR WP 1999-01, April 1999, page 3.

that, "In our view, it is particularly remarkable that so little social investing has taken place at the state and local level given that many of these public plans lack the federal protections afforded corporate pension plans and those envisioned for possible Social Security equity investment."[5]

The experiences of foreign governments in managing private investment also is illuminating.[6] For example, Canada has recently changed the regulations governing its Canada Pension Plan to allow that system to invest a portion of its reserves in private assets.[7] It is still too early to know how well the Canadian approach will work. But other developed countries have shown they can successfully invest in private assets over extended periods of time.

In Denmark, for example, the ATP fund is a public pension fund whose assets amount to 25 percent of GDP. It invests largely in Denmark, including in stocks, corporate bonds, and mortgage securities. It has very low expenses. More important, there is no evidence of political interference in its decision-making. The fund is so successful that private pension funds in Denmark have began hiring it to administer their investments.[8]

In Norway, it is widely anticipated that the State Petroleum Fund, with assets of more than 15 percent of GDP, will be used to help pay for social security benefits in the future. The State Petroleum Fund invests largely in foreign bonds and has achieved a successful investment record.[9]

The Federal Thrift Savings Plan in the United States provides yet another example of successful private investments by a public entity. Francis Cavanaugh, the first executive director of the Federal Retirement Thrift Investment Board (which oversees the Thrift Savings Plan's

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[5] Munnell and Sunden, page 35.

[6] In many developing countries, the experience with trust fund investments has been poor: The investments have been politicized, and the trust funds have been mismanaged. See, for example, the discussion in the World Bank, *Averting the Old Age Crisis* (1994). It is not clear, however, that experiences in developing countries are relevant to the United States.

[7] The Canadian approach incorporates many of the protections against political interference discussed below: investments are governed by an independent investment board comprising 12 members, each of whom will serve a three-year term. The board is currently investing in stock funds that replicate the TSE 300 Index on the Toronto Stock Exchange, the S&P 500 Index for large public companies in the United States, and the EAFE Index of about 1,300 companies in Europe, Australasia and the Far East. (Last year, it invested roughly 80 cents of every new dollar in the TSE 300 fund and 10 cents each in the U.S. and foreign funds.) For more on the investment board in Canada, see http://www.cppib.ca.

[8] For more on the ATP fund in Denmark, see Tryggvi Thor Herbertsson, J. Michael Orszag, and Peter R. Orszag, *Retirement in the Nordic Countries: Prospects and Proposals for Reform,* prepared for the Nordic Council of Ministers, May 2000, available at http://www.sbgo.com, page 65.

[9] See International Monetary Fund, *Norway: Selected Issues*, February 1999, IMF Staff Country Report 99/11.

investments), noted in a 1999 interview that, "The question is not can it be done. The question that should be asked is whether the Congress, having protected three million Federal employees from political manipulation of their retirement funds, will be willing to extend that same protection to the 150 million beneficiaries of Social Security."[10]

In short, there are numerous examples in which the public sector has effectively managed investments in private assets without any significant politicization. The rest of this analysis explores the types of protections that would help to minimize any potential dangers associated with investment of Social Security trust fund assets in private markets.

Would the Federal government be investing in the market and controlling private companies?

Critics of allowing "government investment" in the market warn of investments being made on a political rather than an economic basis.

Virtually all parties to this debate concur that no Congressional or executive branch involvement should be allowed in investing Social Security reserves in equities. The details vary, but most proposals to allow a portion of Social Security reserves to be invested in private securities entail the establishment of an independent board tasked with choosing private investment managers.[11] (One could even create a new government-sponsored enterprise, with a government charter but a private ownership structure, as this intermediary to add another layer of private-sector protection against government interference in markets.)

Although it was not particularly well-received in Congress (in part because of Chairman Greenspan's opposition at that time), the proposal the Clinton administration made in 1999 for trust fund investments provides an example of how to structure such investments. The administration's proposal would have *removed* management of a portion of the trust-fund reserves from the executive branch and Congress and transferred it to an independent, non-political, professional management board structured so the board would be beyond Administration and Congressional control. This independent board, the members of which would have been expected to have substantial experience in pensions and investing, would in turn have contracted with private fund managers selected through competitive bidding. These managers — which could include entities such as Merrill Lynch, Vanguard, or State Street Bank — would have undertaken the investing of a modest portion of Social Security reserves in broad index funds in the equities markets. Investments in individual stocks, rather than in index funds, would not have been permitted.

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[10] "Social Security Investment Plan Raises a Debate," *New York Times*, January 24, 1999, page 16.

[11] See, for example, the discussion in Henry Aaron and Robert Reischauer, *Countdown to Reform: The Great Social Security Debate* (The Century Foundation, 1999).

A stock market index is a collection of a particular group of stocks. For example, the Standard and Poor's 500 index measures the average performance of the stock of the 500 largest publicly traded corporations. One of the broadest indexes is the Wilshire 5000, which measures the average performance of virtually all publicly traded stocks; more than 7,000 firms are represented in this index. The Clinton Administration's proposal envisioned use of a broad index such as the Wilshire 5000 rather than an index like the S&P 500 that covers only the largest companies.

Under what is know as passive index investing, as is done by the managers of the Federal Retirement Thrift Investment Board and as would have occurred under the Clinton Administration Social Security proposal, a fund manager purchases and holds the shares of all firms included in a particular index. The fund manager would be required to mimic the index and thus may not delete firms included in the index or invest in firms not reflected in the index. Since the fund manager would be required to mimic the overall index, he or she could not pick and choose among companies for political or other reasons. Restricting investments to index funds reduces the risk of political interference in the capital markets.

Furthermore, the actual investment would be undertaken by private-sector pension managers, not by the government. Then-Treasury Secretary Robert Rubin noted that "there [are] really two layers of protection" against political interference under such a proposal. He stated: "there'll be an independent body that will oversee the investment of the funds, and then the funds themselves will be invested by private sector money managers, not by the government. The government will be involved absolutely not at all in the investment."[12]

To ensure the independence of the professional management board that would select the private fund managers, the board would be structured like the Federal Reserve Board or the Federal Retirement Thrift Investment Board, the entity that oversees the investment of the funds that federal employees deposit through the Thrift Savings Plan. Federal Reserve governors serve staggered 14-year terms and cannot be removed for political reasons. The same type of approach would be used here. In addition, both the Fed and the Federal Retirement Thrift Investment Board are independent of Congress and the White House financially. They secure the revenues they need for operating expenses from very small charges on the investments they oversee; they are not dependent on actions of Congress or the President to secure their operating funds. That would be the case here as well.

With this structure, the Federal Reserve has successfully maintained its independence for decades in setting monetary policy; it, not Congress or the executive branch, establishes those policies. Since its creation in 1986, the Federal Retirement Thrift Investment Board has similarly maintained its independence and not been subject to political meddling. As Francis X. Cavanaugh, the Board's first executive director, has noted, Congress designed the board to be

[12] Interview with Secretary Robert Rubin on Good Morning America, January 21, 1999.

insulated from both political interference and corporate decision-making, and this design has worked.[13]

The Federal Retirement Thrift Investment Board also provides a model for how proposals to enable a portion of Social Security reserves to be invested in equities — such as the Clinton proposal or proposals advanced by Henry Aaron of the Brookings Institution and Robert Reischauer of the Urban Institute — would work in another way. Equity investment by the Thrift Investment Board is limited to a stock index fund; the Board does not pick and choose among companies or sectors of the economy. The same would be true under these proposals. Equity investment would be limited to passive investment in very broad index funds, with neither the independent board nor the private-fund managers having authority to add or delete companies from the indices.

The specter of a government behemoth or cadres of government bureaucrats wielding awesome market power for political purposes, making or breaking companies, and applying pressure to firms that are out-of-favor such as tobacco companies and businesses with which the government is engaged in legal disputes thus does not reflect the structure of the proposals for trust fund investments. The proposals would afford no opportunity for politicians to block investment in firms of which they disapprove.

Under this type of approach, the executive branch and Congress would be walled off from the investment process, just as they are walled off from Federal Reserve Board decisions on interest rates. Moreover, the independent board overseeing the investment of Social Security trust fund reserves would itself have relatively little discretion or authority. Its functions would be restricted by law to selecting the private fund managers through competitive bidding (and possibly selecting the broad indices that could be used).

Some critics of this type of approach have voiced concerns that the government might use the Social Security trust funds' ownership of stock to cast votes to influence corporate behavior. This, too, could be ruled out; the board could either be denied authority to vote the shares of companies the trust funds hold or be required to vote its shares in proportion to other shareholders' votes, which would effectively eliminate the effect of the board's votes. This issue is discussed below.

In fact, while the structure of an investment board would resemble that of the Federal Reserve in that the board would consist of members who were appointed to long, staggered terms and could not be removed for political reasons, the board's authority would be far more circumscribed than that of the Fed. The board would have only the rather mechanical function of selecting fund managers through competitive bidding.

The structure and authority of such a board would be essentially the same as that of the federal investment board established under partial privatization legislation that Senators Gregg

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[13] See "Social Security Investment Plan Raises a Debate," *New York Times*, January 24, 1999, p. 16.

and Breaux and Reps. Kolbe and Stenholm introduced in 1999 (the 21st Century Retirement Act). The individual accounts that their legislation would create would be administered centrally, with the funds in these accounts invested by a board or institution managed by federal appointees. The board would select private fund managers and possibly the index funds to be used. Its role and function would be virtually identical to those of a board that would invest on behalf of the Social Security system.

Still another safeguard could be erected by requiring the fund managers that invest the trust-fund reserves to pool the Social Security funds they are investing with other funds they are handling on behalf of private clients. This would provide another layer of insulation against political interference. Any alteration in investments for reasons other than maximizing rates of return would provoke the wrath of the private clients whose funds have been pooled with the Social Security funds. The Federal Thrift Investment Retirement Board employs this approach.

Finally, if desired, the board itself could be government-chartered but privately owned. Thus, a privately owned entity would be choosing private fund managers who were required to invest in broadly diversified market indexes and were prohibited from voting their shares.

This structure should place the investment of trust-fund reserves beyond political interference. In some ways, this proposal is best understood as a proposal to professionalize the management of Social Security reserves, diversifying the trust fund's investments. It also would address the "peril of zero debt" discussed above.

Legislation establishing these safeguards could, of course, be altered by a subsequent Congress. But so, for that matter, could the legislation establishing the independence of the Federal Reserve Board and the Federal Retirement Thrift Investment Board —and that has not occurred. If it is politically taboo for Congress to intrude upon the workings and decisions of the Fed, it would likely be even more taboo for Congress to interfere with the professional management of the Social Security pension reserves of nearly 150 million American workers and retirees.

Would trust-fund investment result in excessive trust fund ownership of companies?

If investment of a modest share of trust-fund reserves in equities were approved, the legislation authorizing this investment could establish a low percentage limit on the proportion of the overall equities market that the trust fund's investments would be allowed to constitute. As one benchmark for the limit, note that state and local public employee pension funds currently hold more than 10 percent of the overall stock market. This has not disrupted market operations. The Social Security system could be limited to holding no more than 10 percent of the overall market.

In addition, the board overseeing the federal investments would apportion the resources to be invested among the private fund managers it selects. It is likely that no single fund manager would handle trust-fund investments exceeding one percent of the market. By comparison, the funds that Fidelity invested in 1997 equaled four percent of the market, and the investments that the 10 largest private-sector fund managers handle all exceeded one percent of the market.[14]

The Voting of Shares

The legislation authorizing trust-fund investment could establish procedures to ensure the independent board had no ability to influence corporate decisions by exercising voting rights on shares the board holds. These voting rights could be "sterilized" so they have no effect on corporate decision-making.

This can be accomplished in any of several ways. The legislation could adopt the approach the Federal Retirement Trust Investment Board employs; that board assigns voting rights to the private fund managers it selects through competitive bidding and requires these managers to vote shares solely in the economic interests of the shareholders. No political criteria may enter into the voting decisions. Alternatively, the legislation authorizing trust-fund investment could assign voting rights on shares the Social Security trust fund holds to the private fund managers but require the shares of each company to be voted in the same proportions that all other shares of that company are voted, thereby nullifying or "sterilizing" the effect of the trust-fund voting rights. The legislation also could simply require that voting rights not be exercised.

The same issues regarding voting rights would be encountered under the partial-privatization legislation that Senators Gregg and Breaux and Reps. Kolbe and Stenholm introduced in 1999. As noted, their bill would establish an entity overseen by federal appointees and modeled on the Federal Retirement Thrift Investment Board to manage centrally the investment of hundreds of billions of dollars in individual accounts.

Conclusion

In his recent testimony, Chairman Greenspan discussed what he regards as potential dangers associated with public investment in private assets. He also noted, however, that such investments would be somewhat less problematic if undertaken through the Social Security system. With appropriate protections, allowing a portion of the Social Security trust fund to be invested in private assets through private managers should not result in any significant problems for our capital markets or overall economic performance.

Public investment of pension funds in private assets has been successfully accomplished by state and local governments and some foreign governments. Canada is currently investing some of its pension fund in stocks. Given these examples, it seems eminently feasible to invest a

[14] At the end of 1997, Fidelity held 3.95 percent of the U.S. equities market. See "America's Top 300 Money Managers," *Institutional Investor*, July 1998, p. 87.

portion of the Social Security trust fund in private assets while avoiding politicization of the securities markets. To protect against such dangers, an independent investment board should be created to choose private fund managers, who would then undertake the investments. The investments should be limited to broad market indexes to provide further protection.

Allowing the Social Security trust fund to invest in private assets would avoid the unappealing policy alternatives of consuming most or all of projected surpluses that may not fully materialize or diverting Social Security funds into individual accounts solely to avoid public investments in private assets.