

Institutional Factors to Consider With Respect to
Proposals to Invest Social Security Funds in Equity Securities

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In 1994 the Secretary of Health and Human Services appointed an advisory committee, the 1994-96 Advisory Council on Social Security, to consider issues relating to the long-term status of the Social Security Trust Funds. The Advisory Council submitted its report in January 1997.¹ In its work, the Advisory Council considered policy options relating to the investment of some portion of Social Security retirement funds in equity securities of private companies. Some of those policy options related to investments that would be managed centrally on behalf of the Social Security Trust Funds; other options related to individually directed investments held in individual accounts.

The Advisory Council commissioned an earlier version of this work to help consider some of the institutional issues that would need to be addressed in the implementation of any such policy options.² This paper looks at the feasibility of investing in the equity market; the desirability of such policy involves

¹ Report of the 1994-1996 Advisory Council on Social Security, two volumes, Washington, DC, January 1997.

² Reproduced in, Report of the 1994-1996 Advisory Council on Social Security, Volume II, pp. 415-430. The research was completed in October 1995.

consideration of factors that fall well beyond the scope of this analysis.

These larger issues are value-laden and controversial. Indeed, the Advisory Council itself split into three factions with respect to substantive policy recommendations about means of strengthening the long-term financial soundness of the social security system.³ Some members of the Advisory Council differed so strongly that they were unable even to agree upon the wording of the overview of the final report.⁴ The one issue that all factions did support was that there should be investment of Social Security funds in the equity market.

Briefly, one group of Council members favored maintenance of the present Social Security benefit and tax structure, with some changes to improve the financial strength of the trust funds. This group envisioned the possibility, after further study, of investing Trust Fund monies in the equity market to help bring the program into financial balance. A second group favored an adjustment in benefits combined with a mandatory contribution of 1.6 percent of the covered payroll that would be held by the

³ See, e.g., Spencer Rich, "Advisers Split on Plans to Keep System Solvent," The Washington Post, December 21, 1995, p. A21; and, Subcommittee on Social Security and Family Policy, Committee on Finance, United States Senate, Social Security Advisory Council Report, hearing, March 25, 1996.

⁴ Report of the 1994-1996 Advisory Council on Social Security, Volume I, e.g., at p. 14, fn 4.

government as defined-contribution individual accounts. A third group of members recommended a transition to a two-tier system consisting of a flat retirement benefit for full-career workers plus fully-funded defined-contribution retirement accounts that would be owned and managed by individuals, similar to the individual ownership and management of today's system of individual retirement accounts (IRAs).⁵

This paper discusses the elements of institutional design raised by these three approaches to investing Social Security monies in the equity market. It consists of four sections. The first section considers a fundamental issue relating to the design of an institutional framework: whether the funds are legally public or private. Many choices are affected by the threshold question whether the money in the trust funds belongs to the government or to the beneficiaries. This is seen in a review of the ownership, control and budget treatment of the Social Security Trust Funds, compared to the privately owned Thrift Savings Fund of the Federal Employees' Retirement System (FERS).

The second section analyzes factors relating to institutional capacity. This includes a review of possible attributes of the federal agency that would be responsible for the administration of the funds. This section also looks at

⁵ These options are summarized, Ibid., pp. 25-33.

issues relating to the magnitude of equity investments contemplated under the various options.

The third section explores (1) the need for a balance between the independence and the accountability of the agency and (2) the amount of discretion that the law should give to the agency to make investment decisions. The section draws upon lessons from the FERS model and the experience of state agencies that administer state public employee plans.

The fourth section returns to the issue of the ownership of the money that is invested and examines a range of options. The paper concludes by suggesting that it would be possible to design a structure to permit investment of some Social Security funds in equity securities. However, the budget scorekeeping for such investment is likely to raise a significant obstacle, at least under current rules.

I. Institutional Framework: Ownership and Control

Analysis of institutional factors begins with the basic questions of ownership and control of the monies that would be invested in equity securities. The Social Security (i.e. OASDI) Trust Funds are remarkable institutions. They consist of a Board

of Trustees and two funds containing some \$ 550 billion⁶ that, under law, are held to pay benefits to eligible beneficiaries.

In the words of the United States Supreme Court:

"The Social Security system may be accurately described as a form of social insurance...whereby persons gainfully employed, and those who employ them, are taxed to permit the payment of benefits to the retired and disabled and their dependents."

Flemming v. Nestor, 363 U.S. 603 at 609, 80 S.Ct. 1367 at 1372 (1960).

Social Security is designated a federal entitlement: under the law a claimant can sue to enforce his or her claim to be paid. However, the Social Security Trust Funds are not trust funds in the formal sense. As a legal form, a trust generally is created for the purpose of giving "to one or more persons the beneficial ownership of property while committing the management of the property to others..."⁷

⁶ Office of Management and Budget, Budget of the United States Government, Analytical Perspectives, Fiscal Year 1998, Table 17-3, p. 303. This figure is the trust fund balance as of September 30, 1996, i.e. the end of the federal fiscal year.

⁷ Austin Wakeman Scott and William Franklin Fratcher, The Law of Trusts, Fourth Edition, Volume 1 (Boston: Little, Brown & Company, 1987), p. 40.

The formal definition of a trust thus presumes that the ownership and the management of the property in the trust are in different hands. By contrast, money in the Social Security Trust Funds legally is owned and managed by the United States government until it is paid out.

This distinction is important in assessing alternative institutional forms for permitting investment of Social Security funds in equity securities. The implications of the distinction are seen in a comparison of the legal and institutional attributes of the OASDI Trust Funds with those of the Thrift Savings Fund of the Federal Employees' Retirement System (FERS).

The comparison is useful at this point to highlight issues of ownership and control. In contrast to central management of investments of the OASDI Trust Funds, the Thrift Savings Fund consists of individual accounts subject to some direction by the individual owner of each account. Figure 1, below, contrasts the basic institutional attributes of the OASDI Trust Funds with those of the Thrift Savings Fund.

Figure 1

Ownership, Control and Budget Treatment: Two Models

	OASDI Trust Funds	Thrift Savings Fund
Ownership	Government Owns the Money in the Trust Funds	Money is Held in Individual Accounts on Behalf of Private Participants
Control	Government Controls the Money in the Trust Funds	Government Administers the Accounts; Private Participants Choose Among Investment Options
Trusteeship	No Fiduciary Responsibility to Beneficiaries	Fiduciary Responsibility to Manage the Fund for Beneficiaries
Budget Treatment	Money is On-Budget for Purposes of Calculating the Federal Deficit	Trust Fund Money is Off-Budget Because it is Held for Private Owners

A. The Social Security (OASDI) Trust Funds: Government Owned and Controlled

Consider first the Social Security (OASDI) Trust Funds. The money in these funds is owned entirely by the United States government. In establishing the trust funds, the government did not create a contractual or other enforceable right of a beneficiary to receive predetermined amounts of money from the fund. The Congress expressly has reserved the right to alter, amend or repeal any provision of the Social Security Act. See, Flemming v. Nestor, 363 U.S. 603, 80 S.Ct. 1367 (1960).⁸

The money in the Social Security Trust Funds is controlled by the federal government. The Board of Trustees of the trust funds consists of the Commissioner of Social Security and the cabinet secretaries of the Departments of Treasury, Labor and Health and Human Services, all serving ex officio, plus two public members appointed by the President of the United States and confirmed by the Senate. The Deputy Commissioner of Social Security serves as the secretary of the board. Federal law expressly provides that a member of the Board of Trustees shall not be considered to be a fiduciary and shall not be personally

⁸ The federal government also owns the money that is held in other major federal trust funds. With respect to the Civil Service Retirement and Disability Fund, see, Stouper v. Jones, 284 F.2d 240 (D.C. Cir., 1960). ("It is well settled that a pension granted by the Government confers no right which cannot be revised, modified or recalled by subsequent legislation.")

liable for his or her actions with respect to the trust funds as a member of the board. 42 U.S.C. Sec. 401(c).

Neither the Board of Trustees nor the Secretary of the Treasury, acting as Managing Trustee, has discretion to invest money from the trust funds in anything other than interest-bearing obligations of the United States or obligations fully guaranteed by the United States. Consistent with the absence of investment discretion, the statute does not require that any member of the Board of Trustees should have experience, training or expertise in the management of financial investments.

Money in the Trust Funds is included in the budget of the United States government. Income to the Trust Funds from Social Security contributions is counted as federal revenues; investment income to the Trust Funds from interest on the Treasury securities that they hold is offset against the equivalent payments from the Treasury for that interest for a net zero impact on the federal budget. Outlays from the Trust Funds are counted as federal outlays.

In summary then, the money held in the OASDI Trust Funds is government-owned and government-controlled. This has implications for the institutional issues involved in possible investment of some of that money in equity securities of private companies.

B. The Thrift Savings Fund: Privately Owned and Government Administered for the Private Owners

The Thrift Savings Fund of the Federal Employees' Retirement System presents a quite different model of ownership and control. Money in the Thrift Savings Fund is held on behalf of the individual participants who contribute to the fund. The money is allocated to individual accounts. Each participant's contributions are credited to his or her account and are legally nonforfeitable; contributions by a federal agency on behalf of a participant are credited and nonforfeitable once the participant has been employed for a period of two or three years, according to his or her position, as specified in the law. 5 U.S.C. Sec. 8432 (g).

The participant may elect to invest some or all of his or her money in a fixed income fund or an indexed common stock fund administered by the Fund for the participants; absent such an election the Fund automatically invests a participant's money in a government securities fund. Participants who elect to invest in the fixed income or equity securities funds are legally required to sign an acknowledgement that they bear the financial risk from such investments and that they are not protected by the government against loss. 5 U.S.C. Sec. 8439 (d).

The money in the Thrift Savings Fund is controlled by a Federal Retirement Thrift Investment Board and an Executive Director appointed by the board. These are officials of the Executive Branch of government.

Members of the board and the Executive Director are fiduciaries under the law and must discharge their responsibilities with respect to the Fund solely in the interest of the participants and beneficiaries. Any fiduciary who breaches his or her responsibilities or obligations shall be personally liable for losses to the Fund resulting from such breach. 5 U.S.C. Sec. 8477. The statute expressly requires that members of the board and the Executive Director shall have "substantial experience, training and expertise in the management of financial investments and pension benefit plans." 5 U.S.C. Secs. 8472 (d) and 8474 (a)(2), respectively.

Because the money in the Thrift Savings Fund is held on behalf of the individual participants, the Thrift Savings Fund is not included in the budget of the federal government. Administrative expenses of the Federal Thrift Retirement Thrift Investment Board are financed from the Fund rather than from general revenues, thereby giving the Board independence from the federal budget process.

In summary, the Thrift Savings Fund is a trust fund in the traditional sense of being a segregated account that is administered by fiduciaries solely for the benefit of participants and beneficiaries. Investment of such private money in equity securities of private companies raises quite different issues from those relating to investment of government money.

C. Implications of the Distinction Between Public and Private Funds

The contrast between the Social Security (OASDI) Trust Funds and the Thrift Savings Fund highlights the basic distinction between public and private funds that are administered by public officials. When monies are public, the general public bears the direct costs and receives the direct benefits of governmental decisions; the beneficiaries are indirectly affected to the extent that more or less money may be available for allocation to them. By contrast, when monies are private, the risks and rewards go directly to the private participants.

A second distinction also is important. When monies are public, the government is free at any time to change the legal framework that governs administration and disposition of the funds; when monies are owned by private participants, the government is bound by its legal and contractual commitments to them.

The experiences of other governments help to illustrate these points. Take first the government of Japan.⁹ The two Japanese social security plans involve trust funds that are owned and controlled by the Japanese government. As in the United States, the Japanese government is legally free to adjust the terms of its social security commitment. Any benefit of increased returns from investing in the securities market accrues directly to the government. Indirect benefits may accrue to the beneficiary population as a result of the increased availability of money in the trust funds.

Japan has one of the most rapidly aging populations in the world, and changing demographics are projected to require substantial increases in payroll taxes. The government enacted legislation in 1986 to reduce the level of benefits paid by the Employees' Pension Insurance System, one of the two Japanese social security plans, and in 1994 enacted legislation to delay the eligible retirement age of beneficiaries.

Trust fund monies from the two social security plans are invested largely in government projects such as infrastructure development; interest on that money is pegged to a fixed interest rate and credited to the appropriate trust fund.

⁹ Virtually all information about Japan has been taken from Robert L. Clark, "Japanese Pension Plans in Transition," monograph, North Carolina State University, July 1995.

Since 1986, the Japanese government has permitted the Pension Welfare Service Public Corporation to invest roughly one sixth of the funds of the two social security plans in the securities markets. The corporation is a semigovernmental organization overseen by the Ministry of Health and Welfare. It borrows money from the Ministry of Finance and repays its loans at a stated rate of interest; the corporation transfers any net earnings to the Ministry of Health and Welfare for use in paying benefits.

The government of Chile provides a contrasting example that relies upon private accounts instead of governmental investment of funds in equity securities. In 1981, the government introduced a new fully funded social security system with individual accounts. The new system is a mandatory defined-contribution system with a guaranteed minimum benefit that the government funds from general revenues and adjusts from time to time. The minimum benefit is not indexed for inflation; its value may depend upon "the state of the government budget and the party in power."¹⁰

The older Chilean social insurance program was owned and administered by the government. It occasionally ran serious

¹⁰ Peter Diamond, "Privatization of Social Security: Lessons from Chile," monograph prepared for the Seventh Annual Conference of the National Academy of Social Insurance, January 26, 1995, p. 14.

deficits that required replenishment from general revenues. By contrast, the new system places most financial risks and rewards into the hands of the private participants. The participants select from among an array of approved fund managers and investments. The size of their pensions will depend largely upon the rate of return that they receive on their investments.

The structure of commission rates, both for fund managers and for annuity plans, and some variation in investment returns appear to have caused "regressive redistribution in favor of high income workers."¹¹ However, it should be noted that the old Chilean social security system also was regressively redistributive in its effects.¹²

II. Institutional Capacity

Investment of money from the Social Security Funds in equity securities will require new institutional capacity for the Board of Trustees. By law today, the Managing Trustee, i.e. the Secretary of the Treasury in this capacity, must invest OASDI

¹¹ Dimitri Vittas, "Swiss Chilanpore: The Way Forward for Pension Reform?" Policy Research Working Paper, the World Bank, February 1993, pp. 16-17.

¹² Robert J. Myers, "Chile's Social Security Reform, After Ten Years," Benefits Quarterly, Volume eight, Number three, Third Quarter 1992, pp. 41-55.

funds in Treasury securities with specified maturities and rates of return. 42 U.S.C. Sec. 401(d). No investment discretion is required, either of the trustees or of the beneficiaries of the funds. This means that the Board of Trustees, if it became responsible for investment of some social security money in equity securities, would need to develop new capacity within a statutory framework to support such capacity.

The Thrift Retirement Fund provides a useful institutional model. Under the Federal Employees' Retirement System Act, participants may elect to invest their money in a designated equity fund managed by a private company selected by the Executive Director under policies established by the Federal Thrift Investment Board. Such a passively managed stock fund limits the investment discretion of fund managers to a specific index. This differs from the actively managed funds that some state and local retirement and defined contribution plans offer to their participants.

A. Institutional Capacity: The Statutory Framework

If the government decides to permit or require investment of potentially large amounts of Social Security monies in equity securities, then it must assure that the responsible federal agency has the capacity to supervise those investments. Institutional capacity involves staffing with capable

individuals, adequate budget resources and flexible rules for agency activities such as procurement of goods and services.

Figure 2 presents some of these elements of institutional capacity. Figure 2 compares (1) the Treasury Department as the benchmark federal agency to (2) a mixed-ownership federal government corporation such as the Federal Deposit Insurance Corporation (FDIC) and (3) the Federal Retirement Thrift Investment Board. The design of a government enterprise involves careful consideration of the tradeoffs inherent in each

Figure 2

Design Elements Relating to Institutional Capacity

	US Treasury Department	Federal Deposit Insurance Corporation (FDIC)	Federal Retirement Thrift Investment Board
Budget Resources	Subject to annual federal appropriations	Funded from assessments on insured institutions (i.e. private money)	Funded from the Thrift Retirement Fund (i.e. private money)
Staff: Compensation Levels	Civil service levels apply	Compensation levels set about 30 percent above civil service levels	Civil service levels apply
Staff: Professional Requirements	Set by the Department	Set by the Agency	Set by law for Board Members and the Executive Director
Staff: Flexibility to Hire, Fire, Deploy	Civil service and classification laws apply	Free to hire, fire, deploy staff; adopts civil service classification	Executive Director is exempt; other employees are covered
Flexibility in Procurement	Subject to federal procurement laws	Follows spirit of procurement laws	Subject to federal procurement laws

institutional attribute that varies from those of the benchmark federal agency.

1. The Benchmark Federal Agency: The Treasury Department

The benchmark federal agency, here the Treasury Department, is largely funded from annual appropriations. It is staffed by federal civil servants who are hired, classified, promoted, compensated and fired according to the civil service and classification laws. The Treasury is subject to the panoply of other laws applicable to federal agencies, such as the procurement laws. Special units of the Treasury Department, such as the Office of the Comptroller of the Currency, may operate under special laws that vary some of these basic characteristics.

As an agency funded from appropriations, the Treasury Department is limited to year-to-year funding levels that are established by the Congress. This can preclude the making of investment decisions that involve large expenditures in one year as a means of gaining significant returns in later years. The Office of Management and Budget reviews and approves the budget requests of the agency and, through controls such as apportionment, supervises outlays and major expenditures.

The application of the civil service and classification laws means that a federal agency must select and deploy staff according to approved procedures and compensate them according to prescribed government-wide pay and benefit schedules. The Treasury Department is not bound by statutory requirements that specify professional qualifications for career or political officers or employees. The application of procurement and contracting and other such laws means that a federal agency must follow prescribed procedures for advertising and solicitation of competition, for selection of the successful vendors and for administration of the performance of the contracts that are awarded.

Over time many civil service requirements and federal acquisition rules appeared to impose considerable inflexibility or delay upon the performance of federal agencies. Recent statutory reforms seem to have helped in addressing some such problems.

Thus, the Federal Employees Pay Comparability Act of 1990, Public Law 101-509, modifies the rigid pay schedules of the federal civil service and, where a good case can be made, permits federal agencies to fix pay according to more flexible standards. One benefit of the act is the way that it can permit agencies to provide more appropriate compensation for employees in special

positions that require special skills and who otherwise could not be retained.

The Federal Acquisition Streamlining Act of 1994, Public Law 103-355, simplifies some procurement requirements and procedures for thorough competition. The law permits agencies to streamline some procurement processes and reduces the extent that competing vendors may use bid protests to delay a procurement.

2. The Mixed-Ownership Government Corporation: The FDIC

The Federal Deposit Insurance Corporation is a federal agency that operates two large funds, the Bank Insurance Fund and the Savings Association Insurance Fund, that are owned and controlled by the federal government. The FDIC is funded from assessments on the banks and thrift institutions whose deposits are FDIC-insured. The FDIC receives no federal appropriations.

Under the Government Corporation Control Act, 31 U.S.C. chapter 91, the FDIC is designated a "mixed-ownership" government corporation. This means that the FDIC is not subject to the regular OMB budget process. There are no limitations upon administrative expenses or capital expenses. OMB does not provide a line-item review and has no authority to require apportionment.

The corporate charter of the FDIC permits the agency to hire, fire, define the duties and fix the compensation of FDIC employees. The FDIC administratively follows many of the civil service laws that apply to other government agencies. One notable exception is the authority of the FDIC, in coordination with the other federal bank regulators, to pay its staff at levels above those otherwise permitted by the civil service laws. This preferential pay structure is necessary to assure that the government can retain its financially skilled examiners and other officials who otherwise might take their skills to higher-paying positions in the private sector. The agency sets its own standards for qualifications of the professionals that it employs.

The FDIC is not legally obligated to follow federal procurement rules. For example, the Federal Acquisition Regulations do not apply to the FDIC. However, the FDIC does follow the spirit of the procurement laws and their requirements for fair, open and effective competition.

3. Specially Designed Legislation: The Federal Retirement Thrift Investment Board

Administrative costs of the Federal Retirement Thrift Investment Board are funded from the Thrift Savings Fund. An express provision of law permits the Board to submit its budget

directly to the Congress at the same time that it sends its budget to the Office of Management and Budget. Because the funds of the Board are not appropriated, they are exempt from controls such as apportionment that otherwise might apply.

The Senate version of the Federal Employees' Retirement System Act, P.L. 99-335, had provided that the Executive Director of the Board would hire and set pay of personnel without regard to the federal civil service and classification laws.¹³ The legislation was enacted without this exemption. However, the Board does have authority to appoint the Executive Director (but not other staff) without regard to the requirements of the competitive civil service. As noted above, the law does set standards for professional experience and expertise that are required of board members and the Executive Director. Finally, the Board is subject to federal procurement laws. The Board follows the Federal Acquisition Regulations to the extent that they do not conflict with the agency's fiduciary responsibilities to participants.

The legal framework of the Federal Retirement Thrift Investment Board shows how policymakers may want to consider special statutory provisions to enhance the capacity of the

¹³ Senate Governmental Affairs Committee, Federal Employees' Retirement System Act of 1986, S. Rept. No. 99-166, October 30, 1985, p. 75, reprinted in U.S. Code Congressional and Administrative News, 99th Congress, Second Session, Volume 4 (1986), p. 1480.

institution to carry out its mission. Each departure from the benchmark federal agency model should be evaluated for its advantages and disadvantages and also with respect to the possibility that such a departure will set a precedent for other federal agencies.

B. Institutional Capacity and the Magnitude of the Social Security Investment in Equity Securities

Under some options, the Social Security Trust Funds would invest a potentially large amount of money in equity securities. This raises questions of institutional capacity, both for the responsible government agency and for the private firms that the government agency may employ to help manage the investments.

The parameters of investment of Social Security funds in equity securities were provided by the staff of the Advisory Council. Two scenarios would involve investment of increasing amounts of money in equity securities, starting at a few billion dollars in 1998 and growing rapidly through the year 2020, to \$ 3.7 trillion or \$ 4.9 trillion, respectively. This would mean that the equity investments of the Social Security Trust Funds would amount to over 30 percent of Gross Domestic Product (GDP). Two other scenarios would cap equity investments at 5.0 percent of GDP; in the year 2020, this would amount to \$ 1.4 trillion compared to projected GDP that year of \$ 27.7 trillion.

By contrast, at yearend 1994 the nation's total qualified pension funds, including public and private plans, held total plan assets of \$ 4.3 trillion,¹⁴ compared to 1994 GDP of \$ 6.7 trillion.¹⁵ These pension plan assets included a total investment of \$ 1.7 trillion in equity securities, or about 25 percent of GDP in 1994. The \$ 1.7 trillion of equity securities amounted to about 28 percent of the value of the total of \$ 6.0 trillion of corporate equities in 1994.¹⁶

Figure 3 attempts to capture some of these comparisons on a consistent basis. It adopts the assumptions of the Board of Trustees and assumes that Gross Domestic Product will increase from \$ 6.7 trillion in 1994 to \$ 27.7 trillion in the year 2020. To place all assumptions on common footing, the figure deflates the equity investments that the Advisory Council staff projected for 2020 under the various proposed options, and restates them in comparable terms for the year 1994.

¹⁴ Employee Benefit Research Institute, Quarterly Pension Investment Report: 1st Quarter 1995, Vol. 10, No. 1 (Washington, DC: July 1995).

¹⁵ Congressional Budget Office, The Economic and Budget Outlook: An Update, (Washington, DC: August 1995), Summary Table 2, p. xiv.

¹⁶ Board of Governors of the Federal Reserve System, Federal Reserve Bulletin, Vol. 81, No. 6 (Washington, DC: June 1995), "Summary of Financial Assets and Liabilities," p. A44, line 55.

Figure 3

Equity Investments of Social Security Funds Under Various Options

	1994 Dollar Value	Item as Percent of Total Corporate Equities
Total Value of Corporate Equity Securities	\$ 6.0 trillion	100 %
Option 1 (High % of OASDI funds in Equities)	\$ 1.2 trillion	20 %
Option 2 (Medium % of OASDI funds in Equities)	\$ 900 billion	15 %
Option 3 (Low: Cap Equity Investment at 5 % of GDP)	\$ 340 billion	6 %
Current (Public Plus Private) Plan Investment in Equities	\$ 1.7 trillion	28 %
Top Ten Money Managers: Total Assets	\$ 2.0 trillion	33 %
Top Ten Money Managers: Domestic Equity Securities	\$ 692 billion	11 %

These comparisons highlight several issues. The high investment option would involve investment of some \$ 4.9 trillion of social security funds in corporate equity securities by the year 2020. Deflated back to the GDP of the year 1994, this would be an investment of about \$ 1.2 trillion, or one-fifth of the current total value of the corporate equity market. The Social Security Trust Funds would manage a far greater value of corporate equity investments than any other entity in the United States.

As of 1994, total pensions in this country, public and private, invested some \$ 1.7 trillion in equities. Taken together with these existing investments, the high option would mean that about half of the corporate equity securities in the United States would be managed, either actively or passively, by pension fund managers. The low option for Social Security investment, by contrast would constitute only a modest addition to the value of equity securities managed by pension fund managers.

The bottom chart on Figure 3 gives some sense of the institutional capacity in the private market today. A 1995 survey by Institutional Investor magazine shows that the top ten fund managers that year managed a total of \$ 2.0 trillion of investment assets. The industry leaders are Fidelity Investments (\$ 315 billion), the Prudential Insurance Company (\$ 244 billion) and Mellon Bank Corporation (\$ 209 billion).

In terms of the dollar value of domestic equity investments, Figure 3 shows that the top ten managers hold \$ 692 billion of domestic equity securities. Institutional Investor ranks the industry leaders as Fidelity Investments (\$ 156 billion), Wells Fargo & Company (\$ 100 billion), and Bankers Trust Company (\$ 77 billion).¹⁷

With respect to institutional capacity, two points emerge from these statistics: first, given the transition period envisioned under each of the investment options for Social Security, private money managers would appear to have the capacity to help to manage the corporate equity investments for the Social Security trust funds. Indeed, the private sector would appear to have the capacity today to manage the portfolio of equity securities envisioned under the low investment option that is capped at five percent of GDP.

Management of a FERS-type set of investment options requires high quality customer service to literally millions of participants. Interviews with the Federal Retirement Thrift Investment Board and with plan managers in state governments and the private sector indicate that customer service through toll-free (800) numbers has become user-friendly and inexpensive. FERS serves some two million people today and permits participants to

¹⁷ "America's Top Money Managers," Institutional Investor, Vol 29, No. 7 (July 1995), pp. 73-108. The top ten institutions and top ten holders of domestic equities are ranked on p. 74.

transfer their money monthly between investment alternatives; other plans, state and private, permit daily transfers without requiring a fee from the customer.

Second, the federal agency that oversees the activities of these private fund managers must have the capacity to conduct a procurement to select some of these huge private institutional investors, evaluate their performance and assure their compliance with the needs of the federal program. It is a source of some reassurance in this regard that interviews with state officials and with respect to the Federal Employee Retirement System would seem to indicate that such procurement and supervision is possible.

Effective private performance appears to be promoted by a combination of (1) imposition upon the private fund managers of legal fiduciary responsibility, and (2) some of the aspects of increased governmental capacity discussed above (i.e. ability to deploy resources and hire and compensate staff without some of the constraints of the benchmark federal agency).

However, the first Executive Director of the Federal Retirement Thrift Investment Board, Francis X. Cavanaugh, has expressed concern that the magnitude of Social Security funds is so large as to threaten the ability of any federal agency properly to oversee a system of FERS-type accounts:

"With over 2 million participants, the Thrift Savings Plan is the largest defined contribution plan in the country and an enormous administrative challenge. Social Security, with more than 120 million covered employees, is administratively dependent upon many millions of employers, including the self-employed, the mom and pop stores, and the households employing part-time maids and nannies earning as little as \$ 1,000 a year -- not a seamless operation. If possible at all, it is highly unlikely [that an agency that administered FERS-type accounts for Social Security] could meet the high fiduciary standards expected of pension plan administrators today."¹⁸

Mr. Cavanaugh argues that the most effective, and perhaps the only feasible, way to permit investment of huge volumes of Social Security monies would be to permit the Treasury or an independent federal agency to invest in a broad stock index fund, such as the S&P 500 or Wilshire 5000 fund. The investment risk would remain with the group of beneficiaries rather than shifting to each individual. Administrative costs would be negligible and beneficiaries would be spared the potentially high costs of establishing separate investment accounts.

¹⁸ Francis X. Cavanaugh, The Truth About the National Debt: Five Myths and One Reality, (Boston, MA: Harvard Business School Press, 1996), p. 107.

III. Independence, Accountability and the Scope of Agency Investment Discretion

The proper balance of independence and accountability is very important for a government organization that is expected to oversee the investment of hundreds of billions or even trillions of dollars in equity securities of private companies. On the one hand, a federal agency must retain sufficient independence that it is protected from political pressure to prefer certain investments or vendors that might not be selected on purely financial grounds. On the other hand, a federal agency must remain accountable for its decisions and properly responsive both to the Congress and to its Social Security participants and beneficiaries. The statutory extent of the agency's permitted discretion to make investment decisions is also important.

Figure 4, below, summarizes some of the elements of independence and of accountability that can be found both in the Thrift Investment Fund and in some of the state agencies that administer public pension funds.

One important element is the imposition by law, 5 U.S.C. Sec. 8477, of a fiduciary responsibility upon officials of the

Figure 4

Independence and Accountability

Elements of Independence

An Independent Board of Directors Heads the Agency.

Law Designates Agency Officials and Private Investment Managers to be Fiduciaries With Responsibility to Act for Participants and Beneficiaries.*

The Agency Pays its Operating Expenses From Income and Submits a Business-Type Budget Directly to the Congress. It does not Receive Appropriated Funds to Pay for Operations.

Elements of Accountability

Congress Oversees the Agency and its Activities.

Congress Specifies in Law the Extent of Agency Investment Discretion; the Agency Must Make Investment Decisions Explicitly and Openly.

Law Designates Agency Officials and Private Investment Managers to be Fiduciaries With Responsibility to Act for Participants and Beneficiaries.*

Law Requires the Agency to Obtain Annual Independent Audits and Publish Financial Reports.

Law Requires the Agency to Conduct Open, Fair and Competitive Procurement of Fund Managers and Other Vendors.

* Note: Fiduciary responsibility is appropriate for trust funds that are held on behalf of private owners who are the program participants and beneficiaries; other forms of legal responsibility would need to be imposed if the money remains the property of the government.

Federal Thrift Retirement Investment Board and upon state public pension plans¹⁹ to act on behalf of the participants and beneficiaries whose money is at stake in their decisions. This assumes that the money is kept in a true trust fund; if instead the OASDI funds remain the property of the federal government then such a provision would not be appropriate. The Congress would need to fashion substitute statutory provisions instead.

A. Independence

Consider first the elements of independence. The Federal Employees' Retirement System and virtually all of the states create a board of trustees to administer the trust funds. These boards generally select an executive director who is responsible for day-to-day operations. Thus, the law requires that the Federal Retirement Thrift Investment Board shall establish policies for the investment and management of the Thrift Savings Fund, review the Fund's investment performance, and review and approve the agency's budget.

¹⁹ The National Council on Teacher Retirement has published two useful surveys of laws of the fifty states. They are: Cynthia L. Moore, Protecting Retirees' Money: Fiduciary and Other Laws Applicable to State Retirement Systems, Third Edition, (Arlington, VA: January 1995), and Cynthia L. Moore, Public Pension Plans: The State Regulatory Framework, Second Edition, (Arlington, VA: July 1993).

In addition to state law, the federal government requires that the trust for a pension, profit-sharing or stock bonus plan must be operated for the exclusive benefit of employees or their beneficiaries if it is to qualify for tax exemption under the Internal Revenue Code. 26 U.S.C. Sec. 401 (a)(2).

The Executive Director in turn is responsible for carrying out policies of the Board, for investing and managing the Fund in accordance with Board policies and otherwise for implementing the law. Except with respect to government securities invested according to law, the Board is expressly prohibited from directing the Executive Director to invest money from the fund in any specific asset or to dispose of any specific asset. 5 U.S.C. Sec. 8472 (g) (2).

Interviews with officials in several states indicate that a state board of trustees may be composed of a minority of state agency officials plus a majority of employee representatives and private individuals who tend to have special backgrounds in financial and investment matters. The trustees will decide matters of policy such as the number and type of investment options that shall be provided to plan participants. The executive director and staff then undertake the basic procurement process with respect to private investment managers for each type of fund. The final procurement decision may be made by the board of trustees or by an investment committee that consists of a majority of trustees plus a few investment experts.

Interviews with people inside and out of government confirm the importance of providing an independent board of trustees serving fixed terms and removable only for good cause. This can help to insulate the board from pressure to direct the selection

of vendors or the investment of funds according to nonfinancial criteria in ways that could undermine confidence in the system and its administration.

One important element of independence is the ability of a trust fund to pay for its operations out of its own funds. This leads to freedom from many of the budget controls that otherwise apply to agencies whose activities are funded from government appropriations. The law expressly permits the Federal Employees' Retirement Thrift Investment Board to submit its budget directly to the Congress at the same time that it sends a copy to the President for inclusion in the Budget of the United States government. Because its expenses are financed from the Thrift Savings Fund and not from appropriations, the Board also is free from the legislative budget process. Some state officials note the importance of such budget freedom so that an agency can be protected from pressures that otherwise might occur from time to time to depart from its fiduciary obligations.

Both the Federal Employees' Retirement System and virtually all state pension systems impose a fiduciary responsibility upon trustees and agency officials to act on behalf of the participants and beneficiaries. This fiduciary responsibility helps to reinforce the ability of the agencies to withstand pressures to select vendors on a preferential basis or to make

investments that may yield less than adequate returns.²⁰ By contrast, state deferred compensation plans manage funds that are considered to be the property of the state government until such time as they vest; fiduciary requirements thus do not apply to such funds.

B. Accountability

While independence is important, agencies must remain publicly accountable. Accountability for the Federal Employees' Retirement System is achieved through congressional oversight and through the requirements that the Congress may write into law. For FERS, these include (1) the specification in law of the passive nature of equity investments and the parameters of the common stock index that the agency should select, (2) the imposition of fiduciary responsibility upon officials of the agency and the requirement that investments be made solely in the interests of participants and beneficiaries, (3) application of laws that impose openness and accountability such as the procurement laws and Freedom of Information Act, and requirements to publish financial statements that are independently audited each year.

²⁰ This issue has been raised with respect to economically targeted investments. For instance, a state may have an interest in directing some fraction of its public pension funds to investments within the state. See, Ray Schmitt, "Pension Fund Investment in Economically Targeted Investments," Congressional Research Service (Washington, DC: Library of Congress), January 26, 1995.

Another aspect of accountability relates to the responsibility of the agency to the plan participants and beneficiaries. If the agency offers plan participants the opportunity to switch investments among alternative choices, then it must offer an array of information disclosures plus access to a toll free (800) telephone number and mail services.

The quality of fund management and disclosures can be promoted if the agency selects private fund managers that are subject to the 1940 Investment Company Act, 15 U.S.C. Sec. 80a, rather than trying to manage fund investments with an in-house staff. This is because of the requirements that the 1940 Act imposes with respect to activities and disclosures provided by such private fund managers.²¹ The 1940 Act applies to private firms even when they manage investments of funds that by law belong to a government rather than to private owners.²²

C. The Scope of Agency Investment Discretion

²¹ It should be noted that the Federal Employees' Retirement System Act, 5 U.S.C. Sec. 8438 (a)(7), sets standards for qualified professional asset managers, but does not require that they be subject to the 1940 Act.

²² A current example of such funds would be Section 457 public employee deferred compensation plans that technically do not vest to the individual employee for a number of years. Under these circumstances, the money technically belongs to the state or local government. See 26 U.S.C. Sec. 457.

The issue of accountability relates to the scope of the agency's authority with respect to investment decisions. Some practical issues also deserve mention here. Consider a FERS-type plan that permits individuals to choose among investment options. The design of such a plan must take account of the fact that many plan participants may not have a significant context for making financial decisions. Some participants may have difficulty understanding the implications of the investment choices or even in reading the available material. This has been an issue of concern to responsible state and local governments.²³

Problems of investor inexperience and the aversion to investment risk of many people, especially less affluent people, can be amplified if individuals are given broad investment discretion. This is seen in analyses of the Chilean pension system. That system seems to involve high promotional costs and a significant number of uninformed investment decisions.²⁴

²³ See, e.g., Sharon Kossak, "Deferred Compensation: Is Incomprehensibility Interfering with Retirement Futures?" Administration: 457 Independent Information Services, May/June 1990, pp. 13-18.

²⁴ Peter Diamond, "Pension Reform in a Transition Economy: Poland and Chile," in The Transition in Eastern Europe: Volume 2, Restructuring, Oliver Jean Blanchard, Kenneth A. Froot, and Jeffrey D. Sachs, eds., (Chicago, IL: University of Chicago Press, 1994), pp. 71-110. ("I think that it is natural to be very suspicious about the efficiency of the competitive market in this type of intertemporal transaction involving large numbers of inexperienced investors." p. 95).

The Congress addressed this issue with the Federal Employees Retirement System by starting with very few permitted investment options -- a government securities fund, a fixed-income fund and a single indexed equity fund. By law, 5 U.S.C. Sec. (b)(2), the agency must select a commonly recognized index comprised of common stocks that are reasonably representative of the United States equity markets.

The Congress invited the Federal Retirement Thrift Investment Board to gain experience with these funds first, and then to return for legislation expanding the options.²⁵ Noting the comparable practice in private retirement plans, the Senate report explicitly states that "The Committee finds limiting the choices as important as providing them."²⁶

²⁵ Legislation is pending that would permit the Thrift Investment Fund to offer several different equity funds as options for participants. The current fund is linked to the performance of the Standard & Poor's S&P 500 index. The pending legislation would permit the Thrift Investment Fund also to offer an international stock investment fund and a small capitalization stock investment fund to participants. See S. 1080, introduced by Senator Stevens (for himself and Senators Pryor and Roth), July 27, 1995.

²⁶ The Congress gave a number of persuasive reasons for its determination to start simply:

"As an alternative the committee considered permitting any qualified institution to offer to employees specific investment vehicles. However, the committee rejected that approach for a number of reasons. First, there are literally thousands of qualified institutions who would bombard employees with promotions for their services. The committee concluded that employees would not favor such an approach. Second, few, if any, private employers offer such an arrangement. Third, even qualified institutions go

The same approach would be important in the implementation of any proposals to invest Social Security funds in equity securities: it is wise to start with limited options before expanding. Such an approach of offering a limited number of indexed broad-based common stock funds would be especially beneficial if the invested funds belong to the government rather than to private participants and beneficiaries. The United States has a history of concern about the consequences of concentrations of economic power in a few hands.²⁷ Lawmakers are unlikely to welcome the prospect of creating a government agency with broad discretion to invest huge amounts of government money in individual companies or companies in particular economic sectors or locations.

This concern receives specific content in the application of the federal budget laws. Under the principles established by the

bankrupt occasionally and a substantial portion of an employee's retirement benefit could be wiped out. This is in contrast to the diversified fund approach which could easily survive a few bankruptcies. Fourth, it would be difficult to administer. Fifth, this 'retail' or 'voucher' approach would give up the economic advantage of this group's wholesale purchasing power derived from its large size, so that employees individually would get less for their money."

"Federal Employees' Retirement System Act of 1986," Report of the Committee on Governmental Affairs, United States Senate, Report No. 99-166, October 30, 1985 [to accompany S. 1527], p. 19. United States Code and Congressional Administrative News, 99th Congress, Second Session, p. 1424.

²⁷ See, e.g. Mark J. Roe, "A Political Theory of American Corporate Finance," Columbia Law Review, Vol. 91, No. 1, January 1991, pp. 10-67.

1967 President's Commission on Budget Concepts, it could be argued that all of the operations of a company must be shown on the federal budget unless the company is completely privately owned. This would seem to preclude the government from making equity investments in individual firms or types of firms. By contrast, the purchase of a broad-based indexed fund of common stocks (without voting rights) may permit budget scorekeepers to waive application of such a principle.²⁸

Another issue with respect to investment discretion relates to the financial risk that is inherent in equity investments. Barry Bosworth begins his discussion of a proposal for equity investments with reference to hard choices that demographics are forcing between increased contributions and reduced benefits.²⁹ In this context, the government may be tempted to set itself high targets for its financial returns. If the government were to permit active management of equity investments, then investment managers may come under some pressure to meet ambitious returns even if these involve some degree of financial risk.

²⁸ In this regard, see the discussion of "The Federal Government's Boundary Lines," at p. 25 of the Report of the President's Commission on Budget Concepts, (Washington, DC: GPO, October 1967).

²⁹ Barry Bosworth, "The Social Security Fund: How Big? How Managed?" Brookings Institution, January 1995.

While the federal government differs from Orange County, the lessons of that body are relevant in this regard.³⁰ The prescription of broad-based investment indices that are specified by law removes the discretion of investment managers to make such tradeoffs between risks and returns.

IV. Conclusion: Some Institutional Choices

This brief introduction to institutional issues shows some of the policy choices that policymakers must address as a part of any decision to invest funds of the Social Security System in equity securities. As a technical matter, it should be possible to design an institutional structure to implement a proposal to invest Social Security funds in equity securities. Policymakers are fortunate to have available a number of current models, including FERS and state and local pension and deferred compensation plans, to show the advantages and disadvantages of

³⁰ The former Treasurer of Orange County testified that "maximizing yield became the driving force behind his investment actions." California State Auditor, Bureau of State Audits, Orange County: Treasurer's Investment Strategy Was Excessively Risky and Violated the Public Trust, March 1995, p. 10.

Among a myriad of problems, it appears that county treasurers in the State of California lack an appropriate legal framework to limit their investment discretion and to assure transparency and accountability of their actions. California State Auditor, Bureau of State Audits, County Investments: Treasurers Should Avoid Risky Investment Strategies, June 1995.

various approaches. This concluding section returns to a fundamental question: whose money will be invested?

A. Ownership of the Invested Funds

Option 1: The Money Belongs to the Federal Government

This option would continue the current status of the Social Security Trust Funds as governmental funds that the government legally may increase or decrease by law at any time. Two possibilities then suggest themselves.

Option 1a: Invest in Treasury Securities That Pay Indexed Returns

Under this option, the Social Security Funds would continue to invest in Treasury obligations, as today. However, the returns from the Treasury securities would be indexed to pay a higher rate, possibly pegged to an equity index or to changes in Gross Domestic Product.

The advantage of this option is that it entails virtually no additional administrative costs and does not require changes in the structure, functions or responsibilities of today's Board of Trustees. The disadvantage of this option is its budgetary impact. Although the size of the federal deficit would not

change, the budget allocation for interest on the federal debt would increase because of the increased returns that the Treasury would pay to the Social Security Trust Funds. Also, other holders of Treasury obligations may seek to receive similarly indexed returns on their holdings.

Option 1b: Invest in an Indexed Portfolio of
Private Equity Securities

Under this option, the Board of Trustees would set aside an amount of money prescribed by law and invest that money in an indexed portfolio of private equity securities. To avoid problems of government voting of proxies in private companies, the government would invest only in indexed funds. The government might operate under a statutory provision such as applies to FERS, that precludes the agency from voting as a shareholder. The Federal Retirement Thrift Investment Board has adopted a policy of reviewing the proxy voting practices of its private fund managers but of refraining from influencing these policies with respect to shares held for the Thrift Retirement Fund.

Given the size of the government's investment, even under the low option (see figure 3, above), it is likely that the agency would select at least several private managers for its indexed portfolio.

The Board of Trustees would need to enhance its institutional capacity to select and oversee private fund managers. However, the agency would have few new responsibilities to the participants in Social Security. Because the money remains the property of the federal government, participants and beneficiaries will not seek disclosures with respect to the quality or value of the government's equity investments; they will concern themselves only with the terms of their own social security benefits, just as they do today.

The advantages of this approach relate to the increased returns that may accrue to the Social Security Trust Funds from investing in equity securities. There are also some disadvantages. First, current budget scorekeeping would require that funds used to purchase private equity securities be recorded as federal outlays, i.e. as adding to the deficit, at the time that the investments occur.³¹

Second, the government needs to concern itself about the risk and extent of its investments. The issue of risk relates to the chance that equity investments will not perform as well as the government expects. The issue of extent of government

³¹ Income from the equity investments would be recorded as revenues to the government at the time that it is received. This would probably be offset by the added costs incurred by the Treasury from the increased returns that it would need to offer to private investors who would purchase the obligations instead of the Social Security Trust Funds.

investment relates to arguments that might be made if the Social Security investments prove to be a financial success: if investment of some social security funds in private equities is good, then why not invest more of it? What magic is there in a particular cap, such as the cap at five percent of GDP that is suggested under one proposal?

Moreover, if the government can make money by arbitraging Treasury borrowings into the private equity market, why limit this investment to the Social Security Trust Funds? Other constituencies may use the success of Social Security investments as grounds to plead for investment of their preferred trust funds, revolving funds or other government agency money.

Some might go so far as to suggest that the Treasury could issue new obligations as a way to finance higher yielding returns from equity investments. The lessons of Orange County come to mind here as evidence that some policymakers may find such arguments and extensions to be attractive.

Option 2: The Money Belongs to Individual Participants

Here again, two options present themselves. One resembles the Federal Employees' Retirement System. Under that option, workers would invest specified amounts of their own money in one or more approved types of account offered by private investment

managers who are selected and supervised by a federal agency. The other option is a Chile-type model. Under this option, workers would be required to invest specified amounts of their own money in government-approved IRA-type accounts.

It can be seen that these two options in fact represent parts of a continuum. Given the problems of uninformed investors and high transactions costs of the Chilean model, it may be best to begin with a FERS-type arrangement. Then, as experience warrants, the array of investment options might be expanded to provide additional diversity in the direction of a Chile-type plan. Ultimately, however, issues of cost would seem to argue for some form of group investment decision. Peter Diamond points out:

"As a general proposition, group choice is considerably cheaper than individual choice. For example, in the U.S., measured relative to assets, mutual funds aimed at individuals are roughly three times as expensive (on average) as mutual funds handling large accounts (and so aimed at groups)."³²

From an institutional perspective, the FERS-type option is attractive. The Federal Retirement Thrift Investment Board appears to be a well run agency that operates under a well

³² Peter Diamond, "Privatization of Social Security: Lessons from Chile," January 1995, p. 8 (typed version).

designed statutory framework. Interviews with federal and state officials indicate that it is possible for government officials to conduct a fair open and competitive procurement and to supervise performance of large private fund managers who serve the participants efficiently and inexpensively.

FERS appears to be living up to the congressional mandate that the agency should be "small and efficient."³³ The all-in cost of fund administration appears to run between 0.1 and 0.15 percent of total investments (i.e. less than \$ 40 million to manage over \$ 27 billion of assets in three funds in 1994). The big question is whether a FERS-type option can be adapted to the substantially larger and more complex operations that would be required to serve Social Security beneficiaries.

There are a number of institutional advantages to private rather than government ownership of funds that are invested in equity securities. Private ownership involves a number of statutory characteristics that can help to foster an institutional culture that is very important in assuring good performance.

³³ "Federal Employees' Retirement System Act of 1986," Report of the Committee on Governmental Affairs, United States Senate, Report No. 99-166, October 30, 1985 [to accompany S. 1527], p. 20. United States Code and Congressional Administrative News, 99th Congress, Second Session, p. 1425.

Private ownership also involves some disadvantages. First, to the extent that Social Security revenues are used to fund private accounts, they are unavailable to serve as federal revenues. This means that creation of private accounts would be scored as an increase in the federal deficit, compared to allocation of such money to the government's Social Security Trust Funds.

Also, private ownership places the risk of poor fund returns (or even loss) squarely upon plan participants. Both FERS and the Chile system try to cushion this effect by combining the private plans with a government-run defined benefit plan. If workers are to be transformed into wise investors, they will require access to fairly extensive investment counseling and information. This has institutional implications to the extent that the government will need to assure the availability and supervise the quality of such counseling and information.

B. Conclusion: The Feasibility of Investing Social Security Funds in Equity Securities

This review of available institutional models concludes that it would be possible to design a structure to permit investment of some Social Security funds in equity securities. The statutory

framework could provide for the necessary capacity, independence and accountability of investment decisions.

That framework would be stronger if the funds were made legally private rather than if they remained the property of the federal government. Of particular value in this regard is the ability to impose fiduciary responsibility if the funds legally belong to the participants and beneficiaries rather than to the federal government. Also, it will be important to start simply and to build institutional capacity over a number of years.

All of these proposals involve major budget scorekeeping issues under today's budget rules. Allocation of money from today's Social Security Trust Funds, either to create private participant ownership or to purchase private equity securities, would involve outlays of the federal government and a consequent increase in the federal deficit. Use of anticipated Social Security payments for such purposes would involve a reduction in revenues and similar impact upon the deficit.

Proposals to invest in equity securities must be evaluated in terms of large policy issues such as the choice between defined benefits and defined contributions in the system of Social Security; this paper is intended to introduce policymakers to some of the technical issues that need to be addressed once the larger questions are answered.