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Benjamin A. Templin¹

I. INTRODUCTION

The future of Social Security is anything but secure. Actuaries and economists predict that incoming revenues will be insufficient to pay benefits by 2017 and that the Social Security Trust Fund reserves will be exhausted by 2041.² Yet Social Security remains the most important government program designed to prevent poverty among elderly citizens.³ If it were not for Social Security benefits, fifty percent of elderly beneficiaries would be living below the poverty line.⁴ Unfortunately, Social Security reform is stuck in a political gridlock.⁵ After five years of debate, President Bush's proposal for private accounts⁶ has been tabled in

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² THE BOARD OF TRUSTEES, FEDERAL OLD-AGE AND SURVIVORS INSURANCE AND DISABILITY INSURANCE TRUST FUNDS, 2005 ANNUAL REPORT OF THE BOARD OF TRUSTEES OF THE FEDERAL OLD-AGE AND SURVIVORS INSURANCE AND DISABILITY INSURANCE TRUST FUNDS, H.R. DOC. NO. 109-18, at 7-10 (2005). The trust holds \$1.7 trillion in government bonds. The value of annuities to current retirees is \$5 trillion. The value of accrued statutory benefits to current workers is \$11.2 trillion. Consequently, there is \$16 trillion in the promise of benefits and in accrued benefits. Not everyone agrees that Social Security is in jeopardy. See MICHAEL A. HILTZIK, *THE PLOT AGAINST SOCIAL SECURITY* (2005) (arguing that the Bush Administration has misused facts to make Social Security appear less viable); Paul Krugman, *Confusions about Social Security*, 2 *ECONOMISTS' VOICE* 3 (2005), available at <http://www.bepress.com/ev/vol2/iss1/art1> (claiming that the problem is with government spending in other sectors and that Social Security is actually relatively well-funded). For purposes of this article, I adopt the generally accepted actuarial projections of the Social Security Administration stated here.

³ Kathryn L. Moore, *The Privatization Process: Redistribution Under a Partially Privatized Social Security System*, 64 *BROOK. L. REV.* 969, 988-89 (1998) (arguing that the private account proposals will change the historic balance the Social Security maintains between equity and adequacy).

⁴ *Id.* at 990. These claims are not free from debate. SYLVESTER J. SCHIEBER & JOHN B. SHOVEN, *REAL DEAL: THE HISTORY AND FUTURE OF SOCIAL SECURITY* 208 (1999). Schieber and Shoven contend that the Social Security Administration actually under-represents the income received by the elderly from other sources, such as private pensions, and therefore exaggerates the effect of Social Security on preventing poverty. *Id.*

⁵ Kathryn L. Moore, *Reforming Retirement Systems: Why the French Have Succeeded When Americans Have Not*, 22 *ARIZ. J. INTL & COMP. L.* 251, 289 (2005) (arguing that reform in the U.S. has not been forthcoming in part because of a lack of an unwavering political commitment to reform).

⁶ The private accounts proposal gained prominence after President Bush appointed a commission to develop a plan to address the funding crisis in 2001. The privatization concept generally carries with it the idea that private investment yields a high rate of return in order to offset the reductions in Social Security benefits projected under the present system. See Lewis D. Solomon & Bryan L. Berson,

the face of widespread opposition from both Democratic and Republican lawmakers.⁷

The reasons behind the Social Security funding crisis are well documented. The intergenerational wealth transfer embodied by traditional Social Security funding is no longer sustainable. Under the current Pay As You Go (PAYGO) system of financing, the present working generation pays the benefits of the current retirees. Consequently, the bulk of the payroll tax collected in any given month immediately goes out to pay benefits. The excess of the payroll tax which is not paid out in benefits is invested in a Trust Fund consisting of special issue government bonds. Although the Trust is steadily building a reserve, it will not be nearly enough to pay out benefits when the Baby Boom generation retires.⁸

Under PAYGO, there are simply not enough workers paying into Social Security to fund the benefits of those who are or will be retired. The ratio of workers to retirees will drop from a baseline 3.3 workers per retiree to a projected 2 workers per retiree by 2041.⁹ The reasons for the decline in workers include the following factors: (1) Baby Boomers account for an abnormal bulge in the population; (2) the declining birth rate attributed to the widespread use of contraceptives and deferral of child-bearing by larger numbers of women entering the workforce;¹⁰ and (3) people retiring earlier and living longer.¹¹

Private Market Reforms for Social Security: A Comprehensive Guide for Composing Reform Legislation, 11 S. CAL. INTERDISC. L.J. 117, 121 (2001). Privatization also carries with it the traditional rights of ownership, including the right of one's heirs to inherit the balance. There is an expectation that privatization will increase the national savings rate and lead to an overall wealth creation as well. *Id.* at 120-21. I use the terms "private accounts" and "personal accounts" interchangeably, though Republicans reportedly changed their political rhetoric from "private" to "personal" when pollsters discovered that the former word didn't sell well with the electorate. See Molly Ivins, "Private Accounts" versus "Personal Accounts," THE FREE PRESS, Jan. 27, 2005, available at <http://www.freepress.org/columns/display/1/2005/1052>.

⁷ Jackie Calmes, *Elephant in the Room: Budget Wish Lists Come and Go, But "Entitlements" Outweigh All*, WALL ST. J., Feb. 3, 2006, at A1. The opposition to President Bush's private accounts proposal came not only from the Democratic Party but also from Republicans. The opposition, in part, may be because the president's provocative and uncompromising style on private accounts alienated voters who see Social Security as a safety net rather than a way in which their wealth can be increased through private investments. Janet Hook, *News Analysis: Social Security Pan Hits Shoals*, L.A. TIMES, June 27, 2005, at A1. Much has been written about the controversies surrounding private accounts. It is not within the scope of this article to rehash that debate. Rather, I focus on alternative financing schemes in view of the lack of political will to implement private accounts.

⁸ SCHIEBER & SHOVEN, *supra* note 4, at 196-97.

⁹ Patricia E. Dilley, *Taking Public Rights Private: The Rhetoric and Reality of Social Security Privatization*, 41 B.C. L. REV. 975, 988 (2000) (maintaining that economic rights arise in the maintenance of Social Security benefits as a result of participation and effort).

¹⁰ *Id.*

¹¹ *Id.* at 995.

In spite of the plethora of proposals and commentary which has been written by economists, academics, and politicians on the subject of Social Security reform,¹² yet another presidential commission has been convened to hash out a compromise.¹³ As good as any one solution might be, the debate is subject to the political realities of an electorate adamant about protecting their entitlements.¹⁴ No solution can survive without accommodating the desires of an aging population of voters.

Any proposal that the presidential commission recommends should try to leverage the stock market in order to maximize returns in the Trust Fund. Over the long term, the stock market nearly always yields a higher return than bonds.¹⁵ One intriguing idea which takes advantage of the stock market without the risks posed by private accounts is “full funding”¹⁶ of the Social Security Trust Fund. The principal characteristic of full funding proposals is investment of the payroll tax in a broadly diversified portfolio of stocks, bonds, and other assets. Over time, these investments would build up a reserve in order to transform the PAYGO system to a “savings” model where contributions made today are invested in order to pay out benefits in the future. The financing principle behind full funding (also referred to as “pre-funding”) is that “one dollar in benefits thirty-five years from now can be funded by setting aside a much smaller amount today” and then investing it wisely in the market.¹⁷ Using an assumed 7.5% rate of return and a present value calculation, one would need to set aside today only \$7.96 for every \$100 of benefits anticipated in 35 years.¹⁸ Switching to full funding is not without transition costs. Investment alone is not a panacea.¹⁹ Full funding proposals typically combine prudent, diversified investment with raising taxes²⁰ and some benefit cuts.²¹ However, long-

¹² SCHIEBER & SHOVEN, *supra* note 4, at 141-145.

¹³ Calmes, *supra* note 7, at A1.

¹⁴ Solomon & Berson, *supra* note 6, at 125.

¹⁵ JEREMY J. SIEGEL, STOCKS FOR THE LONG RUN 26 (3rd ed. 2002) (analyzing 200 years of financial data to conclude that a portfolio containing a broad-based index of stocks will nearly always outperform a bond-only portfolio).

¹⁶ The issue of whether to fully fund Social Security has been with us since the 1930s. In the early days of Social Security, a debate arose over whether to create a Trust Fund that accumulated enough assets to pay out benefits—as a traditional annuity or pension plan might—or alternatively to have the younger generation of workers pay for the benefits of the older generation of retirees in much the same way that a family took care of its grandparents. SCHIEBER & SHOVEN, *supra* note 4, at 66. The latter view won out, but as noted above, the PAYGO system of financing is no longer viable.

¹⁷ Martin Feldstein & Jeffrey B. Liebman, *The Distributional Effects of an Investment-Based Social Security System*, in THE DISTRIBUTIONAL ASPECTS OF SOCIAL SECURITY AND SOCIAL SECURITY REFORM 263, 267-268 (Martin Feldstein & Jeffrey B. Liebman eds., 2002).

¹⁸ *Id.*

¹⁹ Solomon & Berson, *supra* note 6, at 136.

²⁰ See, e.g., Laurence S. Seidman, *Funding Social Security*, 81 TAX NOTES 241, 242 (1998) (laying

term investment in the market will likely lessen the amount of benefit cuts or tax hikes that must occur in order to fund the PAYGO system.²²

Full funding is not a new concept.²³ The final recommendations from the 1994-96 Advisory Council on Social Security included three proposals—one of which was to move to a partially funded system by investing the Trust Fund in broad based stock indexes.²⁴ Like any proposal for Social Security reform, full funding is subject to contentious debate. Some commentators at the far left contend that the market has no role to play in providing social insurance.²⁵ Conservatives oppose centralized funding for three primary reasons: (1) they do not want the government to engage in social investing;²⁶ (2) there is an inherent conflict of interest when the government is both a regulator of business and a shareholder;²⁷ and (3) they think the government will use its voting rights as a shareholder with a large percentage of the capital stock of private business to advance political and governmental policies.²⁸

There are three principal solutions to the problems posed by government investment. The first two—personal accounts and passive investment by the government—have been the focus of recent debate. Personal accounts solve the problems posed by government investment

out the normative argument to transition from PAYGO to full funding of Social Security).

²¹ *Id.*

²² Feldstein & Liebman, *supra* note 17, at 319. One projection of tax increases under the PAYGO system suggests that if benefits are maintained at current levels, then by 2030 the payroll tax rate must be raised from its current level of 12.4% to 20% of taxable income—a 61% increase. SCHIEBER & SHOVEN, *supra* note 4, at 72-73.

²³ Seidman, *supra* note 20, at 241. The controversy over investing the Trust Fund in the markets is “as old as the social security program itself.” Kent A. Smetters, *Thinking About Social Security’s Trust Fund*, in PROSPECTS FOR SOCIAL SECURITY REFORM 201, 206 (Olivia S. Mitchell et al. eds., 1999) (analyzing the risks and impact of investing the Social Security Trust Fund in the stock market).

²⁴ Theodore J. Angelis, *Investing Public Money in Private Markets: What Are the Right Questions?*, in FRAMING THE SOCIAL SECURITY DEBATE 287, 288 (R. Douglas Arnold et al. eds., 1998). The Council proposed three different plans. The indexing option was labeled Maintain Benefits (MB). The MB Plan would have gradually shifted from a PAYGO model to a partially funded model by shifting Trust Fund assets into equities in order to earn a higher rate of return. The two other proposals were variations on the idea of personal accounts. In one scenario, labeled the Personal Savings Account plan, participants would personally invest their contributions in the equivalent of personally managed IRAs. The other plan, called Individual Accounts, also created personal accounts, but the choice of investments would be limited to a few options chosen by the government. *Id.* at 287-88.

²⁵ JOHN DIXON & MARK HYDE, *Welfare Ideology, the Market and Social Security: Toward a Typology of Market-Oriented Reform*, in THE MARKETIZATION OF SOCIAL SECURITY 1, 5 (John Dixon & Mark Hyde eds., 2001).

²⁶ See SCHIEBER & SHOVEN, *supra* note 4, at 348.

²⁷ *Id.*

²⁸ See PRESIDENT’S COMM’N TO STRENGTHEN SOCIAL SECURITY, STRENGTHENING SOCIAL SECURITY AND CREATING PERSONAL WEALTH FOR ALL AMERICANS 38 (2001), available at http://www.csss.gov/reports/Final_report.pdf.

since it is the individual who makes the ultimate choice and not the government.²⁹ In passive investing, political influence in the investment decision is weeded out by mandating that a central Trust Fund automatically invests in a broad based stock index such as the S&P 500, Wilshire 5000, or one of the many Russell indexes.

Both of these proposals have been thoroughly debated and dissected and the preferences split out along party lines. Each proposal would be effective in removing government influence from the investment process and in corporate governance. However, each proposal is also controversial and suffers from its own political backlash. For personal accounts, there are significant questions of distributional inequities and inefficiencies, though scholars, politicians, and economists have staked out positions on both sides of the issue. Regardless of how one comes out on those questions, it is clear that the private accounts proposals are not politically viable. The indexing approach is also problematic since indexing does not afford the Trust Fund the opportunity to invest in a fully diversified portfolio which includes private equity, real estate, and other investments, thus limiting the ability to reduce risk and maximize returns. In addition, indexing proposals generally provide that the fund cannot vote its shares on corporate governance issues, and such a restriction would exacerbate the agency problem inherent in corporate law and reduce the accountability of managers to the shareholders of companies in which the Trust Fund invests.

A third proposal deserves more thought—the creation of a private corporation charged with the public purpose of investing the Trust Fund assets. This federal government corporation would be separate from the government but accountable to Congress and the American public. The Canadian Pension Plan Investment Board, a private corporation owned by the Canadian government, provides a workable model for how such an entity might be structured. Such a proposal would likely be politically viable since it contains elements of privatization, which appeals to conservative lawmakers, yet seeks to maintain benefits for the elderly poor, which should appeal to progressives.

This article conducts a normative analysis in favor of investing the Social Security Trust Fund in a fully diversified portfolio of stocks, bonds and other assets. It is a central premise of this article that Social Security should seek to maintain benefits in order to prevent poverty among the

²⁹ In some personal account proposals, the government would create a limited set of funds from which participants would then choose, so the potential for government interference would still exist.

elderly. I argue that the best way to maintain benefits is to gradually move to a fully funded Social Security system by prudently investing the payroll tax in a centralized Trust Fund. Although many of the arguments in favor of investments through a central Trust Fund draw upon the analysis done in favor of personal account proposals, the ideological foundation and policy goals of a centralized Trust Fund are more in line with the original goals of Social Security than those of personal accounts. I maintain that any approach to investing Social Security funds in the markets should be done conservatively with risk-reducing diversification. I take a cautious and realistic view of the market³⁰ and also take into account the political realities of what can be achieved in both the short and long term. I do not offer any prognosis from an actuarial or economic point of view, though I draw on the widely accepted data of experts in those fields.

Part II of this article examines the ideological foundations of social insurance and whether market based reforms are consistent with the goals of Social Security. Will investment in the markets change the public policy goals of social insurance? I conclude that while centralized investing does not necessarily change Social Security's ability to prevent poverty among the elderly, the transition from PAYGO to full funding represents a fundamental paradigm shift that presents new problems.

Part III presents a normative analysis of central investing by examining the current investment of the Trust Fund in government bonds and the alternative strategy of investing in other asset classes when taking into account the factors of higher returns, risk, diversification, and the impact of central investing from a macroeconomic perspective. I draw on previous studies to show that equities are actually less risky than government bonds when inflation is taken into account.

Part IV examines the problems of government investing. A conflict of interest exists when the government is both a regulator and a shareholder. Moreover, political interference in the investment decision and corporate governance may lead to lower returns. I also examine the ideological constraints on government investment given the capitalist model.

Part V presents two widely discussed solutions to the problem of government investment and a third option that merits consideration. The first two solutions are private accounts and index-based investment. Both solutions are dismissed as either politically unfeasible or unsound because of associated risks. An intriguing third option would be a privatized government Trust Fund as the investment vehicle for Social Security. As a

³⁰ See Seidman, *supra* note 20, at 243.

corporate entity separate from the government but owned by the government, like the Post Office or the Tennessee Valley Authority, can the Trust Fund resolve the problems of government investment? What constitutional issues arise and can such an entity be held accountable? I conclude that enough evidence exists to suggest these problems can be resolved that the issue merits further study.³¹

II. IDEOLOGICAL FOUNDATIONS OF SOCIAL INSURANCE AND THE ROLE OF MARKET BASED REFORMS

Social insurance is a collectivist response to the problem of poverty among the elderly. In its purest form, the collectivist response to social insurance is a communist ideal that redistributes wealth from the rich to the poor.³² In the communist model, capitalist markets play no role in providing for social insurance.³³ While communist systems are few and far between, even more moderate policy makers on the left often view the markets with suspicion and argue that any use of the markets may result in inequities which are perpetuated by the capitalist system. It is a central premise of this article that market investments need not change the collectivist character of social insurance and will not hamper our ability to prevent poverty among the elderly.

The perception that the markets have no role to play in providing social insurance has been enhanced by the bad press and criticism generated over President Bush's personal accounts proposal. Personal accounts, also called private accounts, are widely perceived as a reform that would dismantle Social Security and expose many elderly citizens to an impoverished retirement.³⁴ Many commentators criticized the financial markets as being too risky for individuals to invest their Social Security contributions.³⁵ It is possible that one end result of the effort to stop

³¹ In a future article titled *The Public Trust in Private Hands*, I will offer a prescriptive solution to address the constitutional and corporate governance issues facing the privatization of the Trust Fund in order to remove political influence from the investment process.

³² Cf. DIXON & HYDE, *supra* note 25, at 4.

³³ *Id.* at 5.

³⁴ See Kathryn L. Moore, *President Bush's Personal Retirement Accounts: Saving or Dismantling Social Security*, in 2005 N.Y.U. REV. OF EMP. BENEFITS & EXECUTIVE COMPENSATION 5-1, 5-24 to 5-25.

³⁵ Gary Burtless, *Risk and Returns of Stock Market Investments Held in Individual Retirement Accounts, Task Force on Social Security Reform, House Budget Committee*, May 11, 1999, available at <http://www.brookings.edu/pagedefs/c57c7944e837ff3a7fff693d0a141465.xml>. (arguing that the risk inherent in the financial markets casts doubt on the claims that private accounts will yield higher returns and will ensure a safer retirement than the current Social Security system provides).

private accounts proposals has been to demonize any market reform in the minds of the electorate. Market investments are the hallmark of private accounts. Because of the negative commentary surrounding private accounts, any investment of Social Security funds in the markets may also be widely perceived as putting the goals of Social Security at risk.

However, the risks associated with market investments through private accounts are not of the same nature as the risks imposed by a central investment paradigm. President Bush's private accounts proposal would have shifted the very nature of Social Security from a "collective and cooperative action" of income redistribution to prevent poverty among the elderly³⁶ to a system of personal ownership and personal responsibility³⁷ in which the individual takes on the risk of a market downturn.³⁸ But the personal risk of stock market investments that makes private accounts a poor idea is not as destructive in the context of a centralized trust where risk can be distributed over generations. While the anti-privatization forces have demonized the stock market in their efforts to stop President Bush's proposal, the evil is not so much investments in the stock market as it is the political structure in which the individual takes on risk of a downturn. Examining the tension which exists between the historic policy goals of Social Security—the balance between adequacy and equity—gives insight into why investing in the market by itself is not in opposition to the objectives of Social Security.

A. Competing Goals: Adequacy v. Equity

Since its beginnings, Social Security has tried to strike a balance between two goals—equity and social adequacy.³⁹ In its present incarnation, Social Security achieves that balance by forcing the middle class to save for retirement and also by redistributing wealth from rich to poor.⁴⁰

The policy goal of "social adequacy" stands for the proposition that all workers who contribute to the system—regardless of the size of their contribution—should receive benefits sufficient to keep them out of poverty.⁴¹ To achieve social adequacy, Social Security became a redistribution scheme that not only moved wealth from a younger

³⁶ Moore, *supra* note 34, at 5-23, 5-24.

³⁷ See Dilley, *supra* note 9, at 980.

³⁸ Moore, *supra* note 34, at 5-24. In a purely personal accounts model, the individual assumes the risk of erratic market behavior, thereby putting some generations at risk of enduring poverty and placing the model at odds with the original goals of Social Security. *Id.* at 5-20 to 5-24.

³⁹ Moore, *supra* note 3, at 969.

⁴⁰ *Id.* at 988-90.

⁴¹ *Id.* at 969-70.

generation to an older generation but also from higher income participants to more needy participants.⁴² Adequacy and the redistribution of income is a collectivist response to the problems posed by poverty.⁴³ The goals and characteristics of social adequacy stand in sharp contrast to the concept of equity.

“Equity” stands for the principle that the benefits received in old age should be related to the contributions so that the more a taxpayer pays in, the more she gets out during retirement.⁴⁴ From an equity point of view, Social Security should behave like an insurance annuity in which the funds paid in secure a cash flow stream later in life.⁴⁵ The goals of equity have come to be associated with the private accounts proposal. Philosophically, advocates of a pure private accounts proposal reject the redistribution of income and advocate individual responsibility for retirement income. Private accounts transform the entitlements of Social Security into a property right⁴⁶ where citizens focus on wealth building during their working life.⁴⁷ While many of the personal account proposals would restore equity into the system—i.e., taxpayers would likely get a higher return on their payroll tax than that given by treasury securities⁴⁸—social adequacy may suffer.⁴⁹

⁴² See *id.* at 970. Some of the income redistribution from the wealthy to the poor is offset by the fact that poorer individuals live shorter time frames. Jeffrey B. Liebman, *Redistribution in the Current U.S. Social Security System*, in DISTRIBUTIONAL ASPECTS, *supra* note 17, at 11, 12.

⁴³ DIXON & HYDE, *supra* note 25, at 6-8.

⁴⁴ Moore, *supra* note 3, at 969-70.

⁴⁵ *Id.* at 969-70.

⁴⁶ Dillely, *supra* note 9, at 980. In contrast to the privatizers' desire to transform Social Security benefits into a property right, commentators view the present system as one in which the right to Social Security and old age economic autonomy is an economic right—something short of a constitutional right, but a claim that can be established on future productivity (i.e., a share of the Gross National Product (GNP)) by virtue of workers' lifelong labor and participation in Social Security during their working life. *Id.* at 979.

⁴⁷ *Id.* at 1014. In order to protect individuals and provide for adequacy under private accounts, there must be “equality of opportunity and access to markets.” *Id.* at 1021. Professor Dillely writes, “In this liberal, Lockean vision, the key to democracy is to insure the autonomy and independence of individual members of society through decentralization of property ownership. Individual rights are to be founded on ownership of property, while social equity and economic access are assumed to follow naturally.” *Id.* at 1043.

⁴⁸ Moore, *supra* note 3, at 977-78.

⁴⁹ *Id.* at 992. While private account advocates have addressed social adequacy by providing a defined flat benefit, *id.* at 981-82, the nature of a partial privatization system bifurcates the social adequacy/redistributive effects of Social Security from the equitable/wealth building role. *Id.* at 992. In this process of separating the two functions into two tiers, Professor Kathryn Moore contends that there is a threat that the social adequacy element may be lost. *Id.* In the partial privatization proposals, the first tier of funding goes to pay a flat benefit that acts as a redistribution of income from higher wage earners to lower wage earners. *Id.* at 983. The second tier of funding goes into private accounts that build equity for the individual worker. *Id.* Professor Moore suggests that if the second tier is successful in producing a higher rate of return, then such success may put the first tier of funding at risk,

The dichotomy between adequacy and equity is also expressed as a tension between collectivism and personal responsibility. The goal of adequacy, through the instrument of social insurance, is a collectivist response to the problem of elderly poverty.⁵⁰ The goal of equity, as embraced by the libertarians and pro-privatizers, is to promote personal responsibility. The conservative right trusts that the markets will provide a base income to any party so long as the individual seeks work.⁵¹

While this dualistic view of social insurance helps define the debate, U.S. Social Security sits somewhere in-between. In *The Marketization of Social Security*, John Dixon and Mark Hyde do not see collectivism and personal responsibility as absolutes. Rather, they created a spectrum of political thought which identifies five principal welfare ideologies running from pure “Communist Collectivism” to the “New Right” which relies on individual responsibility.⁵²

Those who favor the collectivist end of the spectrum view the problem of poverty as being created by the market failures of capitalism to adequately provide for a living wage income.⁵³ A collectivist ideal generally reflects the inherent social nature of humans—i.e., social cohesion or simple fellowship among human beings—which runs against the grain of capitalism and the free market. “The hierarchical and competitive nature of the market undermines . . . cooperation . . . [and] negates altruism[,] and the exclusion of the poor from mainstream standard of living precludes the possibility of social integration.”⁵⁴ At the far left, the markets play either no role in social insurance or a limited role in generating income which is then redistributed, whereas the markets dominate at the far right of the spectrum.⁵⁵

The New Right, on the other hand, contends that Social Security created welfare dependency and therefore poverty. In other words, the “‘hand-out culture’ . . . undermined the work ethic, giving rise to significant and sustained level of voluntary unemployment.”⁵⁶ While the American public has rejected personal accounts and, as a corollary, the libertarian

since workers will then want to *see* a higher return from the first tier of funding as well. *Id.* at 984-85. It could spell the end of the redistributive nature of social insurance entirely as workers begin to perceive that they have less of a stake in the collective system of social insurance. *Id.* at 985.

⁵⁰ Moore, *supra* note 34, at 5-20 to 5-24.

⁵¹ DIXON & HYDE, *supra* note 25, at 5.

⁵² *Id.*

⁵³ *Id.* at 12-13.

⁵⁴ *Id.* at 8.

⁵⁵ *Id.* at 5-8.

⁵⁶ *Id.* at 15.

philosophy of individual responsibility,⁵⁷ the question remains whether the markets can play a role in the collectivist model. Dixon and Hyde's model of "Reluctant Collectivism"⁵⁸ most closely describes the American system of Social Security in that it provides a "safety net below which no one should fall[,] but at the same time, [is] sufficiently parsimonious as to encourage individuals to make their own additional private arrangements."⁵⁹ Reluctant Collectivism requires "work participation as a condition of eligibility for public social security."⁶⁰ Yet, even in Reluctant Collectivism, which blames poverty on market failure rather than state failure, Dixon and Hyde suggest that the market has a substantial role to play in Social Security reform including the "contracting out" of services typically provided by the public entity to private entities.⁶¹

Thus, although market reforms are typically associated with private accounts, one need not completely reject the power of the markets in pursuing the goals of social adequacy through the collectivist model. There is a role for the market to play⁶² in eradicating poverty without necessarily changing the collectivist nature of social insurance. Without destroying the collectivist response, the markets can be leveraged by investing through a centralized trust without affecting the norms which govern benefits or the current balance that Social Security seeks to achieve between equity and adequacy. As is illustrated throughout this article, the markets can be harnessed in service to the economic rights created by Social Security, and this can be done without high risk.

The political, rather than ideological, issue is that market reforms may have become so linked with the now-tainted private accounts proposals that any market reform is likely to be suspect in the electorate's eyes. The anti-privatizers argued that the risk inherent in the market could wipe out personal life savings in a short period of time.⁶³ While that argument was valid when used against personal accounts, the risks associated with a centralized trust are far different. One result of this association is that, in the public mind, any investment of Social Security funds into the market may be perceived as inherently risky. Consequently, any attempt to gain political support for centralized investing will require a rehabilitation of the

⁵⁷ Calmes, *supra* note 7, at A1.

⁵⁸ DIXON & HYDE, *supra* note 25, at 12.

⁵⁹ *Id.* at 13.

⁶⁰ *Id.* at 13-14.

⁶¹ *Id.* at 18-20. Notably, Dixon and Hyde include portfolio management among the list of services to be outsourced. *Id.* at 20.

⁶² *Id.* at 13.

⁶³ Calmes, *supra* note 7, at A1.

role of the markets when put to service for the public good. It is one goal of this article to attempt such rehabilitation.

B. Paradigm Shift: The Demise of Pay As You Go

While the move to a fully funded central Trust Fund invested in a diversified portfolio will not affect Social Security's ability to provide social insurance, it will change one fundamental characteristic of the present system: the intergenerational wealth transfer inherent in the PAYGO system. The intergenerational wealth transfer need not be an inherent characteristic of Social Security in order to achieve the policy goal of preventing poverty among the elderly.⁶⁴ Rather, PAYGO should be seen merely as a politically expedient tool from the 1930s by which Social Security was able to fund benefits for the first generation of retirees after Social Security came into being.⁶⁵

This decision of whether to provide a fully funded system or the PAYGO intergenerational wealth transfer was a point of contentious debate in the formative years of Social Security.⁶⁶ The architects of the system argued whether Social Security should be a wealth accumulating device, similar to a bank on which workers would draw down on deposits made over a lifetime, or an intergenerational wealth transfer device.⁶⁷

In large part, PAYGO was conceived as a political response to the threat posed by large money reserves held in government hands.⁶⁸ The 1936 Republican candidate for President, Alf Landon, held the view that "the accumulation of a massive reserve fund would pave the way to political abuse and government misspending."⁶⁹ Landon thought the payroll tax would never be used to pay out benefits because Congress would be too tempted by such a large reserve. Such governmental mistrust tapped into the public's paranoia during the height of the Great Depression, so a political compromise was suggested to fund Social Security not

⁶⁴ *But see* Dilley, *supra* note 9, at 996 (contending that "the working generation must *always* bear the burden of providing goods and services to satisfy the claims . . . of the non-working, both elderly and the young" and labeling as "false hope" the notion that investing the trust fund in equities can be "shifted away from the generation who will be working at the time the baby boom retires"). Professor Dilley is likely correct given the timing. However, in the longer term, a fully funded system would seek to replace the PAYGO system.

⁶⁵ DANIEL BÉLAND, SOCIAL SECURITY: HISTORY AND POLITICS FROM THE NEW DEAL TO THE PRIVATIZATION DEBATE 98-101 (2005) (recounting the history of the political arguments and debate which formed Social Security and reform proposals).

⁶⁶ *Id.*

⁶⁷ SCHIEBER & SHOVEN, *supra* note 4, at 216.

⁶⁸ BÉLAND, *supra* note 65, at 99-101.

⁶⁹ *Id.* at 99.

through a centralized fully funded trust but through the PAYGO system.⁷⁰ One long-lasting effect of the PAYGO system, however, is that the first generation of retirees received more in benefits than they paid into the system.⁷¹

Consequently, the very nature of PAYGO led to the problem of an under-funded system and a “legacy debt”⁷² which now threatens benefits cuts. So long as there were enough workers paying into the system, PAYGO financing worked, but demographic changes have made PAYGO ineffective.⁷³ Consequently, any attempt to transform PAYGO into a fully funded system may actually bolster the adequacy goals of Social Security by supporting the elimination of poverty among the elderly through sound investment practices. Yet, mistrust of a large reserve held in the government’s hands is a view still held by a vocal conservatives.⁷⁴

Finally, it should be noted that the defeat of private accounts need not be viewed by Republicans and Libertarians as a total ideological loss. Even the libertarian economist Friedrich A. Hayek,⁷⁵ perhaps one of the most famous opponents to socialism, said in 1944 that state had a role to play in providing a “safety net” to help “individuals in providing for those common hazards of life.”⁷⁶ Moreover, the use of the private markets to invest Social Security funds is consistent with the ideologies, if not the ideals, of the New Right. Issues of government involvement in the markets and corporate governance arise, but models which address those issues also exist, as will be discussed in Parts IV and V.

III. MARKET INVESTMENTS: THE PROMISE OF HIGH RETURNS

The question of whether to invest Trust Fund assets into the market can be split into economic and political questions.⁷⁷ On the economic question,

⁷⁰ *Id.* at 99-102.

⁷¹ Moore, *supra* note 34, at 5-8 to 5-9.

⁷² *Id.*

⁷³ See Dilley, *supra* note 9, at 988. See generally SCHIEBER & SHOVEN, *supra* note 4, at 107-10 (discussing why some commentators consider PAYGO an elaborate Ponzi scheme, while others call it a brilliant financing mechanism so long as the population and worker productivity grows).

⁷⁴ See SCHIEBER & SHOVEN, *supra* note 4, at 347-51.

⁷⁵ See generally Virginia Postrel, *Friedrich the Great*, BOSTON GLOBE, Jan. 11, 2004, available at http://www.boston.com/news/globe/ideas/articles/2004/01/11/friedrich_the_great (describing how Hayek’s seminal work, *The Road to Serfdom*, led to the free market movement and was the basis for much of today’s libertarian philosophy).

⁷⁶ FRIEDRICH HAYEK, *THE ROAD TO SERFDOM* 120 (2nd ed. 1972), quoted in Bruce Caldwell, *Hayek and Socialism*, 35 J. ECON. LITERATURE 1856, 1870 (1997).

⁷⁷ Peter A. Diamond, *The Economics of Social Security Reform*, in FRAMING THE SOCIAL SECURITY DEBATE, *supra* note 24, at 38, 38-39 (analyzing the economic and political issues of reform

there is little room for disagreement. Over the long term, investing in a fully diversified portfolio of stocks, bonds, and other assets will yield better returns and do so with less risk of loss than a bond-only portfolio.⁷⁸ The investment strategy raises the possibility of solving the funding crisis without the same level of tax increases or benefit cuts that are anticipated under the PAYGO proposals. Economically, the evidence is clear and should not be in dispute. It is the political question of how to go about investing in the market where reasonable people can disagree.⁷⁹ I will explore the divisive political issues in Part IV.

The economic analysis of whether to invest in the market versus keeping the Trust Fund invested in bonds breaks down into several issues. I start my analysis by discussing the historical investment by the Trust Fund in government bonds and the nature of those instruments. I then examine four principal issues which arise when considering market investments: (1) the higher rate of return offered by the market, (2) the risks imposed by investing in a diversified portfolio, (3) the alternative investment of government bonds, and (4) the impact of a centralized Trust Fund on the national savings rate, market capitalization, and the management costs when compared to private accounts.

A. Government Bonds: Safest Investment in the World?

The bonds in which the Trust Fund is invested have been called everything from the safest investment in the world⁸⁰ to an accounting scam set up to defraud the American people.⁸¹ I first conduct a descriptive analysis of the bonds and then examine the debate of whether the bonds actually represent a real investment. I then analyze the impact on the federal deficit of shifting Social Security revenues out of government bonds and into market investments. I end with an analysis of whether the bonds are a prudent investment given the rate of return.

proposals).

⁷⁸ *See id.* at 39-40.

⁷⁹ *See id.* at 40.

⁸⁰ Barry Bosworth & Gary Burtless, *The Effects of Social Security Reform on Saving, Investment, and the Level and Distribution of Worker Well-Being*, CENTER FOR RETIREMENT RESEARCH AT BOSTON COLLEGE WORKING PAPER # 2000-02, 46 (January 2000).

⁸¹ ALLEN W. SMITH, *THE LOOTING OF SOCIAL SECURITY: HOW THE GOVERNMENT IS DRAINING AMERICA'S RETIREMENT ACCOUNT* 43-44 (2004).

Investment in special issue government bonds⁸² began when a surplus developed in the Trust Fund in 1937.⁸³ At the time, the investment in U.S. Treasuries seemed like a fairly good strategy.⁸⁴ The country was in the midst of the Great Depression, “[u]nemployment had reached 21.7%, the Gross National Product (GNP) had fallen by 25%, and the stock market had lost over 70% of its value.”⁸⁵ Since the U.S. Government had never defaulted on its debt, investing America’s retirement money in Treasuries must have been considered the most prudent of investments.⁸⁶

Fast-forwarding to 1983, the Trust Fund’s investment in special issue Treasuries grew after Congress adopted amendments to the Social Security Act.⁸⁷ A commission headed by Alan Greenspan made several proposals which were adopted to increase payroll taxes, cut benefits, and gradually increase the retirement age.⁸⁸ One result of the 1983 compromises was that the Trust Fund began to grow its surplus in anticipation of the retirement of the Baby Boomers. The surplus was again put into special issue U.S. Government bonds. By the end of 2005, the Trust Fund held \$1.7 trillion in special issue government bonds.⁸⁹

Investing the surplus in government bonds is mandated by the Social Security Act. The bonds earn interest and this interest income is reinvested in additional special issue bonds.⁹⁰ The interest rate is calculated by a formula set forth in the Social Security Act which specifies the rate as an “average market yield on marketable interest-bearing securities of the Federal government which are not due or callable until after 4 years.”⁹¹ In 2005, this worked out to be a nominal interest rate of 4.3%.⁹²

⁸² The government actually issues two types of debt to the Trust Fund. The first is a short term certificate of indebtedness, which is issued on a daily basis for the amount that is collected in taxes but which is not used to pay out benefits. On June 30 of each year, these certificates are then rolled into a longer-term bond, which has a maturity of one to fifteen years. SOCIAL SECURITY ADMINISTRATION, TRUST FUND DATA: SPECIAL ISSUE SECURITIES, available at <http://www.ssa.gov/OACT/ProgData/specialissues.html> (last updated November 8, 2005).

⁸³ SCHIEBER & SHOVEN, *supra* note 4, at 328.

⁸⁴ Solomon & Berson, *supra* note 6, at 135.

⁸⁵ *Id.*

⁸⁶ *Id.*

⁸⁷ SCHIEBER & SHOVEN, *supra* note 4, at 203.

⁸⁸ *Id.* at 192-95.

⁸⁹ SOCIAL SECURITY ADMIN., ACTUARIAL PUBLICATIONS: TRUST FUND DATA, available at <http://www.ssa.gov/OACT/STATS/table4a1.html>.

⁹⁰ U.S. GOV’T. ACCOUNTABILITY OFFICE, SOCIAL SECURITY FINANCING: IMPLICATIONS OF GOVERNMENT STOCK INVESTING FOR THE TRUST FUND, THE FEDERAL BUDGET, AND THE ECONOMY 2 (1998).

⁹¹ SOCIAL SEC. ADMIN., TRUST FUND DATA: INTEREST RATE FORMULA, available at <http://www.ssa.gov/OACT/ProgData/intrateformula.html>.

⁹² SOCIAL SEC. ADMIN., TRUST FUND DATA: NOMINAL INTEREST RATES ON SPECIAL ISSUES, available at <http://www.ssa.gov/OACT/ProgData/newIssueRates.html>. Nominal interest rates have

The bonds in the Trust Fund are not marketable, which distinguishes them from other bonds that the government issues. There is a large secondary market in regular treasury certificates, so a private investor who purchases the bonds always has an option to sell it on the open market before the bond becomes due. The Attorney General has offered the opinion that investments in other governmental securities that are backed by the credit of the US government would be possible,⁹³ though the trustee of the Social Security Fund has never made such investments.⁹⁴

Investing in government bonds is widely considered the safest use of Social Security funds. Although the return is lower than that of the equities market, government securities are considered risk-free. It is argued that the U.S. government will never default on a bond since it would ruin the government's credit to do so. If the government does not have the money to pay off the bonds, it will simply raise taxes or go further in debt by issuing additional bonds in the public market.⁹⁵ Consequently, bond rating agencies like Standard & Poor's give U.S. government bonds a triple-A credit rating—the highest available.⁹⁶ However, given the high budget deficits in recent years and increasing healthcare costs posed by Medicare, Standard & Poor's reports that the U.S. could not only lose its top rating as early as 2012, but it could also slip to the lowest investment grade—triple-B—by 2020, which is the same rate as that held by Mexico and Poland today.⁹⁷

Critics of Social Security put forward two questions regarding the bonds: (1) whether these bonds are worthless paper that the government will not and cannot honor,⁹⁸ and (2) whether the issuance of the bonds actually reduced the debt that the government would have issued in the public market and reduced the interest rate.⁹⁹

The question of whether the bonds are any good is tantamount to asking whether the U.S. Government is solvent. Some commentators suggest that

ranged as high as 12.5% in 1981 (representing a period of high inflation) to as low as 1.875% in the period of 1943-1945. SOCIAL SECURITY ADMINISTRATION, TRUST FUND DATA: MONTHLY INTEREST RATES, 1937-89, available at <http://www.ssa.gov/OACT/ProgData/interestrates1937-89.html>.

⁹³ Solomon & Berson, *supra* note 6, at 131.

⁹⁴ *Id.*

⁹⁵ SCHIEBER & SHOVEN, *supra* note 4, at 207.

⁹⁶ Serena Ng, *U.S. Could Lose Top Rating – By 2012*, WALL ST. J., June 7, 2006, at C6.

⁹⁷ *Id.* The report states that by 2025, U.S. debt could drop down to speculative or “junk” status if nothing is done to reduce the deficit. *Id.*

⁹⁸ SMITH, *supra* note 81, at 43-44 (charging that the special issue bonds have no commercial value and that the government will have to raise taxes and/or borrow massive amounts to satisfy the obligations). Professor Solomon contends that the current Trust Fund is “largely fictional” since “Congress routinely borrows from it.” Solomon & Berson, *supra* note 6, at 133.

⁹⁹ SCHIEBER & SHOVEN, *supra* note 4, at 203.

the notes are nothing more than worthless IOUs issued “to fund general government operations and mask the true size of the federal deficit.”¹⁰⁰ The concern that non-marketable government bonds would result in increased government deficit spending was actually voiced by conservatives during the Social Security debates in the late 1930s.¹⁰¹ Rather than invest in non-marketable bonds, Republicans sought but lost on a 1939 amendment to the Social Security Act that would have directed assets into marketable one-year Treasury bonds.¹⁰² The fact that the Trust Fund could then go out on the secondary market and resell the bonds for cash would give more legitimacy to the investment. To quell debate that the special issue bonds lacked legitimacy, the Social Security Advisory Council of 1937-1938 issued a statement that the bonds were as secure and accountable as any other obligation of the U.S. government.¹⁰³

Other economists contend that the government will never dishonor the debt and that the Trust Fund is actually invested wisely.¹⁰⁴ Putting aside the political rhetoric, it is difficult to believe that there was a coordinated effort to deceive the American public on such a massive scale, but the PAYGO system has evolved into such a giant funding mechanism for current government operations that one is bound to ask the question: do the bonds represent real savings?¹⁰⁵

The question is one which has been around since the very early days of Social Security when a surplus developed in the Trust Fund in 1937.¹⁰⁶ It could be argued that the American taxpayers pay for Social Security twice. The first time is through the payroll tax. The second time is when they have to pay taxes to redeem the bonds that are held in the Trust Fund.¹⁰⁷ One analyst suggests that the bond scheme is similar to a family that

¹⁰⁰ SMITH, *supra* note 81, at 39. Smith contends that the practice started in earnest with the Reagan administration, since that was the first time that large reserves were available to tempt politicians. The practice has continued with every administration—Republican and Democratic—since the 1983 amendments. *Id.* at 39-44.

¹⁰¹ NANCY J. ALTMAN, *THE BATTLE FOR SOCIAL SECURITY* 130 (2005).

¹⁰² *Id.* at 134. I contend that in order to shore up the legitimacy of the bonds, now would be a good time to reintroduce the sixty-seven-year-old legislation in order to make the bonds marketable.

¹⁰³ *Id.* at 132.

¹⁰⁴ Krugman, *supra* note 2, at 3. Krugman charges that the problem is with government spending in other sectors and that the demands to be made by Social Security are actually relatively well provided for.

¹⁰⁵ SCHIEBER & SHOVEN, *supra* note 4, at 328 (quoting Senator Vandenberg describing the practice of diverting payroll taxes to pay for general government operations as “one of the slickest arrangements ever invented”).

¹⁰⁶ *Id.* The first surplus of \$766 million was recorded in 1937, the first year of the fund’s existence. *OASI Trust Fund Data*, available at <http://www.ssa.gov/OACT/STATS/table4a1.html>.

¹⁰⁷ *Id.* at 329 (quoting an early social security analyst to the effect that taxpayers do not pay for Social Security twice).

creates an account for its children's college education but keeps borrowing from the account to pay current family bills. While they replace the money in the college account with IOUs, they still have to find a way to pay those IOUs once the children reach college age.¹⁰⁸

The answer to the question of whether the bonds represent savings can be answered by examining whether the investment in bonds reduced the federal deficit. Savings is an economic concept where assets that could be consumed in the present are invested to produce new output for consumption in the future.¹⁰⁹ If the purchase of special issue Treasuries by the Trust Fund actually resulted in the government issuing less debt in the public markets, then the investment could be considered a real savings and a sound investment.¹¹⁰ On the other hand, if the Social Security money that went into bonds resulted in the government increasing its current spending, then future wealth is not created,¹¹¹ the investment is largely fictional, and the bonds just represent a debt that the American people will later have to pay more in taxes to replace. The issue turns in part on the unanswerable question of what the government spends Social Security money on.

Some economists are skeptical that the purchase of the bonds actually reduces the deficit.¹¹² Other scholars assert that the government uses the excess raised by Social Security to lower the deficit.¹¹³ While it is possible that some of the funds spent by the government might be considered an "investment" for the future generations, probably more than half of the funds are spent on what can be best termed consumption for the present generation.¹¹⁴ Consequently, the bonds are less an investment than a debt that must be redeemed by raising taxes or replacing the debt with new debt.

Moving the Trust Fund from bonds to private investments will have an impact on the national budget and the deficit.¹¹⁵ "By reducing the Treasury's available cash, stock investing would make more visible the underlying condition of the government's finances excluding the Social

¹⁰⁸ *Id.* at 330.

¹⁰⁹ Deborah M. Weiss, *Pension Benefit and Legal Investment Law: The Regulation of Funded Social Security*, 64 BROOK. L. REV. 993, 994 (1998) (arguing in favor of a funded system through individual accounts managed by investment professionals).

¹¹⁰ SCHIEBER & SHOVEN, *supra* note 4, at 203.

¹¹¹ *Id.*

¹¹² *Id.* at 204-07.

¹¹³ Dilley, *supra* note 9, at 993.

¹¹⁴ SCHIEBER & SHOVEN, *supra* note 4, at 206-07 (suggesting that spending by the government on education is an investment in the future, whereas spending on agricultural subsidies is consumption by the present generation).

¹¹⁵ U.S. GOV'T. ACCOUNTABILITY OFFICE, *supra* note 92, at 7-10.

Security surplus.”¹¹⁶ Consequently, the government will have to issue additional bonds into the marketplace, raise taxes or cut spending since a cash flow is being eliminated. Since there is no way to track how Social Security funds are spent by the government, one must assume that debt issued by the government on the public markets will increase to replace the funds that are no longer available to the Treasury.

Can the markets sustain the increase in the issuance of debt? One prediction is that the issue of additional government securities would be offset by the purchase of stocks by the Trust Fund, but that the asset swap might drive up prices and lead to higher interest rates, thus increasing the government’s costs of borrowing and reducing the possibility of gains from equity investments.¹¹⁷ On the other hand, putting a halt of the diversion of Social Security funds into Treasury securities could focus the attention of the government on the deficit and lead to needed reductions in government spending or the raising of taxes to address the deficit.¹¹⁸

Was the “investment” of the surplus into bonds a prudent investment given the rate of return and the future needs of the Trust Fund? Although investment in U.S. Treasury bonds is generally considered to be the lowest risk investment one might make, so-called risk-free investments are not necessarily without other risks when considering the need to grow capital.¹¹⁹ If you forgo an opportunity to invest in a well-balanced, diversified portfolio that balances high-and low-risk investments to provide a low-risk, high-yield portfolio, then a risk-free investment like government bonds actually becomes riskier than a diversified portfolio of stocks. In other words, the risk you run with a risk-free investment is that you will not have the financing you need later on in life. In an ironic twist, the bonds that are considered the safest investment in the world are actually a risky investment in the sense that the bonds could lose money in a high inflation market.¹²⁰ Moreover, as will be seen below, stocks nearly always outperform bonds in the long term.

Will the government ever default on the special issue bonds—i.e., how risk-free are these bonds? Ultimately, the bonds are not like marketable

¹¹⁶ *Id.* at 9.

¹¹⁷ *Id.* at 8-9.

¹¹⁸ *Id.* at 9-10.

¹¹⁹ In the section *infra* titled *The Nature of Risk*, I draw on the research of Professor Jeremy Siegel to show that government bonds, which are normally thought to be risk-free, may actually have a negative real rate of return when inflation is taken into account, thereby making a bond-only portfolio riskier in the long term than a well-balanced, diversified portfolio, which will always outperform bonds in the long run without the risk of a negative real rate of return. See SIEGEL, *supra* note 15, at 26-29.

¹²⁰ *Id.*

U.S. Treasuries and therefore do not carry the characteristic of being risk-free. While it is true that marketable bonds are considered the safest and surest investment because the United States has never defaulted on its public debt, the debt held by the Trust Fund is arguably not public debt, and therefore the government risks nothing except the displeasure of the public if it cancels out those obligations. The U.S. Government could not default on its debt to foreign nations or other holders because the consequences would be devastating to the government's ability to borrow.

However, defaulting on the special issue bonds might be an entirely different matter. Some commentators think the possibility of a raid on Social Security funds by the government is a serious possibility.¹²¹ Today's investments in bonds could be viewed as no more than "bookkeeping entries at the Treasury"¹²² that could easily be wiped out with a simple vote by Congress. Moving funds out of bonds and into marketable securities makes it less likely that the funds will be subject to a "political raid" because "tapping the portfolio involves actual sale of stocks and bonds, rather than the canceling of non-marketable government securities."¹²³ The movement of Social Security funds into marketable stocks and bonds might actually increase the confidence of the public in the Trust Fund, since "the status of special non-marketable government securities is often questioned . . ."¹²⁴

Although the principles of portfolio diversification suggest that the Trust Fund should hold some bonds, the whole of the Trust clearly should not be invested in a single type of investment. Moreover, the bonds that the Trust does hold should be marketable so that the Trust can move money in and out of bonds using the secondary market. One alternative might be to pass legislation that makes the special issue bonds marketable so that the Trust Fund could sell the bonds on the secondary market to interested parties.

The use of the FICA tax to finance current operations of the government needs to end.¹²⁵ If the result of this policy means cutting off a cash flow for other government programs, then the consequence of that cut must be addressed through means other than the payroll tax, such as spending cuts. The payroll tax should be limited to funding Social Security and not other

¹²¹ Seidman, *supra* note 20, at 246.

¹²² *Id.* at 247.

¹²³ *Id.* at 242.

¹²⁴ *Id.*

¹²⁵ Professor Solomon suggests that "it would seem wise to 'cut Social Security loose'" from the current government budget, since it hides the real deficit behind government spending. Solomon & Berson, *supra* note 6, at 133.

government programs. Although an important source of government funding will be taken away as a result of this policy, this will force Congress and the President to act with more fiscal discipline.

B. Return on Investment: The Big Draw

The principal reason for central investing is that over the long term, the rate of return on stocks is higher than the yield on government bonds. This higher rate would minimize the Social Security funding deficit.¹²⁶ However, economists and actuaries debate the extent to which, and at what risk level, the market investments will reduce the funding deficit.¹²⁷ I first examine empirical evidence of the historical returns offered by the market and then examine anecdotal evidence of the returns offered by large trust funds. I then consider the extent to which the market will actually reduce the funding deficit. I note that market investments by a centralized trust might also yield intangible psychological benefits by giving taxpayers more of a sense that they are getting their money's worth in the assessment of the payroll tax when it is invested wisely.

Historically, equities return an annual rate of 7% over the last hundred years compared with a 2.7% return on risk-free Treasury securities.¹²⁸ Data shows that over time not only do stocks outperform bonds, stocks can do so with less risk when inflation is taken into account.¹²⁹ However, these numbers represent market returns on average. The question arises of whether a large public trust fund would yield similar returns.

Both empirical and anecdotal evidence suggest that large public pension plans also yield a higher return when investing in the market rather than in bonds. Social Security is, of course, not a pension fund, but a study of the investments and performance of both government-run and private pension funds sheds light on whether the Social Security Trust Fund might invest in the market successfully.¹³⁰ In an empirical study of public pension plans run by government agencies, Wilshire Associates and the Trust Universe

¹²⁶ SCHIEBER & SHOVEN, *supra* note 4, at 347.

¹²⁷ In arguing for private accounts, some economists estimate that swapping government bonds for a stock portfolio in a central government trust would worsen Social Security financing "roughly twenty to twenty-five percent of the time." Thomas E. MaCurdy & John B. Shoven, *Asset Allocation and Risk Allocation: Can Social Security Improve Its Future Solvency Problem by Investing in Private Securities?*, NATL. BUREAU OF ECON. RESEARCH WORKING PAPER 7015 (1999), available at <http://www.nber.org/papers/w7015>.

¹²⁸ Solomon & Berson, *supra* note 6, at 129.

¹²⁹ JEREMY J. SIEGEL, *THE FUTURE FOR INVESTORS* 16 (2005).

¹³⁰ U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 90, at 22.

Comparison Service found the public agencies to have returns that are competitive with private plans.¹³¹

The anecdotal evidence also supports the view that a central trust invested in the market would outperform the rate of return on government bonds. The Canadian Pension Plan (CPP)—Canada’s version of Social Security—uses a centralized government controlled trust fund¹³² that has a 5-year annual average rate of return of 8.8%.¹³³ The California Public Employees’ Retirement System (CalPers) ended its 2004 fiscal year with over \$167 billion in its coffers, showing an amazing 15.8% gain.¹³⁴ Teachers Insurance Annuity Association and College Retirement Equity Fund (TIAA-CREF), the retirement giant for U.S. education, research, and health workers, has a number of outperforming mutual funds for its constituencies. As of November 30, 2006, TIAA-CREF’s institutional mutual funds in the traditional small-cap, mid-cap, and large-cap equity funds had annual average returns from nearly 12% to 20%.¹³⁵ Even the TIAA-CREF institutional bond funds outperform the Social Security Trust Fund bonds—ranging from 3.88% to 5.40% annual average return since inception—though some of those bond funds represent high-yield private company bonds¹³⁶ that would naturally earn a higher rate than government bonds.

The bottom line is that “investing in the stock market is standard practice for state and local government and private sector pension funds.”¹³⁷ Typically, pension funds hold 60% of their assets in domestic equities, accounting for \$12.8 trillion or about 25% of the total market capitalization for U.S. stocks.¹³⁸ It is not so much a question of whether the Trust Fund has the potential for earning a better rate of return but why it has taken so long to move Social Security investments out of government bonds and into equities.¹³⁹

¹³¹ Solomon & Berson, *supra* note 6, at 136.

¹³² *Id.* at 134.

¹³³ CANADIAN PENSION PLAN INV. BD., FINANCIAL HIGHLIGHTS, *available at* http://www.cppib.ca/Results/Financial_Highlights (last visited December 12, 2006).

¹³⁴ CAL. PUBLIC EMPLOYEES’ RET. SYS., COMPREHENSIVE ANNUAL FINANCIAL REPORT YEAR ENDED JUNE 30, 2004, *available at* https://www.calpers.ca.gov/mss-publication/pdf/xN1HV9UySwv3I_caf-04.pdf.

¹³⁵ TIAA-CREF, FINANCIAL PERFORMANCE, *available at* <http://www.tiaa-cref.org/charts/mf-performance.html> (last visited December 19, 2006) (looking only at funds with a track record of at least three years).

¹³⁶ *Id.*

¹³⁷ U.S. GOV’T ACCOUNTABILITY OFFICE, *supra* note 90, at 3.

¹³⁸ *Id.*

¹³⁹ Smetters, *supra* note 23, at 206. The 1994-1996 Advisory Council on Social Security noted that trustees of both “private pensions and managers of state pension systems . . . would surely be castigated

To what extent would investments in the market help reduce the funding deficit? Some fairly respectable parties have predicted that investment in equities might solve the funding problem without raising taxes or cutting benefits. Early on in its deliberations, the 1994-1996 Advisory Council on Social Security showed support for investing part of the fund in equities. At one meeting, Tom Jones, the president of TIAA-CREF, claimed that investment in private equities alone could wipe out the Social Security deficit.¹⁴⁰ Council chairman Edward Gramlich characterized the proposal as a “magic rabbit” that would cure the deficit problem without resorting to benefit cuts or tax increases.¹⁴¹ As the Council’s deliberations progressed, the early support for the idea waned, and the proposal coming out of the Council merely suggested that the matter be studied.¹⁴² But the attitude towards stock market investments has shifted in the last decade. Even New Deal Democrats like Robert Ball, who had previously rejected the use of the markets, came to recognize that the market could play a role in fixing the Social Security funding problem.¹⁴³

Economic and actuarial predictions vary on the extent to which central investing can fix the funding problem. The 1994-96 Advisory Council on Social Security estimated that putting 40% of the Trust Fund into equities, “together with other structural changes, would keep the system in balance over the next seventy-five years and beyond.”¹⁴⁴ Bosworth and Burtless were more conservative and predicted that “if 30% of reserves were invested in equities . . . an increase in the payroll tax . . . could be delayed

if they pursued such an ultra-conservative investment policy” as that mandated for the Social Security Trust Fund. ROBERT M. BALL ET AL., 1994-1996 ADVISORY COUNCIL ON SOCIAL SECURITY, SOCIAL SECURITY FOR THE 21ST CENTURY: A STRATEGY TO MAINTAIN BENEFITS AND STRENGTHEN AMERICA’S FAMILY PROTECTION PLAN (1996), available at <http://www.ssa.gov/history/reports/adccouncil/report/ball1.htm>.

¹⁴⁰ SCHIEBER & SHOVEN, *supra* note 4, at 267 (noting that under the most optimistic scenario, investments could yield an additional \$4.4 trillion, thereby eliminating the deficit of, at that point in time, \$3 trillion).

¹⁴¹ *Id.* at 273.

¹⁴² *Id.* at 287.

¹⁴³ Former SSA head Robert Ball came around to supporting the idea of investing some of the Trust Fund into equities as the solution to keeping a defined benefit plan in place. EDWARD D. BERKOWITZ, ROBERT BALL AND THE POLITICS OF SOCIAL SECURITY 350 (2003). Ball initially had reservations about investing in the market because of concerns over government’s participation in corporate governance. However, with the impending funding crisis he came around to the idea of investing in a broad index that would represent the “entire American economy.” *Id.* Ball remained steadfastly against the conservatives’ notion of private savings accounts in part because of the transaction costs associated with private accounts. *Id.* at 349. When Bush began pushing private accounts, Ball urged the Democrats to have nothing to do with the commission appointed to study the issue. *Id.* at 356.

¹⁴⁴ Angelis, *supra* note 24, at 288.

for 16 years If 70% of reserves were invested in equities, the increase in tax rates could be postponed 53 years”¹⁴⁵ An even more conservative GAO report estimates that investing the Trust would add only 11 years before the fund is insolvent.¹⁴⁶ It is notable that none of these studies predicted that Trust Fund would be in a worse position by investing in the market.

Putting the Trust Fund assets to work in the market could also yield intangible psychological returns. One of the arguments in favor of private accounts is that workers were not getting their money’s worth¹⁴⁷—i.e., that the benefits received in relationship to the taxes paid were less than the net benefit available by investing the money in the stock market.¹⁴⁸ Typically, workers perceive that this “money’s worth” problem is “the result of systematic administrative inefficiency” and that they would receive more benefits if the money were invested in the market.¹⁴⁹ This perception is an “investment illusion,” since under the PAYGO system, money paid in immediately goes out to pay benefits of current retirees.¹⁵⁰ Under the proposal outlined here or any centralized investing scheme, benefits are not likely to increase just because the market performs well. Rather, successful investments should be kept as a nest egg to weather the cycles of the market. However, there is likely to be a psychological benefit if taxpayers know that the government is investing prudently. They are likely to have more peace of mind that their taxes are being used efficiently.¹⁵¹

¹⁴⁵ Bosworth & Burtless, *supra* note 80, at 6. The model also assumed that an immediate tax rate hike of 2% occurred in the year 2000, *id.* at 3, and thus these numbers may vary somewhat when applied to the current size of the trust and the current predictions on the rate of decline.

¹⁴⁶ Solomon & Berson, *supra* note 6, at 136.

¹⁴⁷ John Geanakoplos, Olivia S. Mitchell & Stephen P. Zeldes, *Social Security’s Money’s Worth*, in PROSPECTS FOR SOCIAL SECURITY REFORM 79, 140 (Olivia S. Mitchell et al. eds., 1999).

¹⁴⁸ SCHIEBER & SHOVEN, *supra* note 4, at 222. The data shows the intergenerational transfer of wealth resulted in early beneficiaries receiving a significantly better return on their Social Security contributions than they would have received if the money had been placed in the market. *Id.* at 217. However, the return takes a stark downward trend as subsequent cohorts retired. By the time we get to the generation born since the end of the 1930s, the return is less than would have been received if the money had been invested in government bonds. *Id.* at 222. If the payroll tax is raised in order to fund Social Security or benefits are cut, then the rate of return becomes even worse. *Id.* at 219-20. Anti-privatizers attack rate of return analysis on three grounds. First, there is no consensus on how to calculate rate of return. Dilley, *supra* note 9, at 998-99. Second, most workers will receive at least a small increase in the amount of benefits received in relation to the taxes they paid under the current system. *Id.* at 999. Third, rate of return analysis is inconsistent with how taxes are used generally. *Id.* at 999-1000.

¹⁴⁹ Geanakoplos et al., *supra* note 147, at 87.

¹⁵⁰ *Id.*

¹⁵¹ The psychological benefit may actually turn on how risk is perceived as being allocated to beneficiaries. Some households may alter their personal portfolios if the risk of a downturn is

The ultimate effect of central investing will, of course, depend upon how well the fund is invested and also upon a number of macroeconomic factors. Professor Diamond argues that a well-run defined-benefit plan will outperform an individual defined-contribution plan because of the increased administrative costs associated with the latter plan.¹⁵² However, any numbers are merely conjectures of what might happen. As anyone who has invested in the market in the last ten years knows, what might go up will almost certainly go down—sometimes dramatically. Some critics contend that the market is so risky that inevitable downturns will wipe out the retirement savings of future generations.¹⁵³ The risk of a downturn also needs to be assessed when considering central investing.

C. The Nature of Risk

One of the most pervasive arguments against investing Social Security Funds in the stock market is the risk incurred by the inevitable downturn. What are the risks of the Trust Fund assets being depleted? In the event of a downturn, who should bear the risks? To answer these questions, I first provide a descriptive analysis of stock market risk and the evolution of government policy regarding risk and market investments as they relate to Social Security. I then look at the arguments regarding risk used by both the anti-privatizers and the pro-privatizers. I next consider the question of who should bear the risk of a downturn—current or future generations of workers. Finally, I consider the risks faced by the Trust if funds are not invested in the market.

It is an axiom of investing that higher returns demand that the investor take greater risks.¹⁵⁴ As the last ten years have illustrated, the market can experience wild gyrations causing huge gains and losses. In the period between November 1996 and March 2000, the S&P 500 went up 98% in value. However, between March 2000 and February 2003, the S&P 500 lost 44% of its value. Between February 2003 and November 2006, the

perceived to have been shifted to the beneficiaries. *Id.* at 139.

¹⁵² Diamond, *supra* note 77, at 63.

¹⁵³ Jonathan Weisman, *Retirement Accounts Questioned: Paper Challenges Expected Benefits*, WASH. POST, Mar. 19, 2005, at E1.

¹⁵⁴ Solomon & Berson, *supra* note 6, at 130. The axiom and concept has a historical legacy which runs throughout Western civilization. The Greek historian Herodotus observed, "Only by great risks can great results be achieved." HERODOTUS, *THE HISTORIES* 392 (John Marincola ed., Aubrey de Sélincourt trans., Penguin Books 1996). What drives the elevated progress of modern history is that the science of risk management allows society to explore new technologies and use resources more efficiently while reducing the probability of failure. PETER L. BERNSTEIN, *AGAINST THE GODS: THE REMARKABLE STORY OF RISK 2* (1996).

S&P 500 went back up 67%.¹⁵⁵ Moreover, it has been theorized that the market will experience a downturn as the Baby Boomers liquidate their portfolios in retirement regardless of whether the overall economy is healthy or not.¹⁵⁶ If the Trust Fund is invested in securities, then such downward pressure would be magnified as the Social Security Trust Fund likewise liquidates assets to pay benefits to the Baby Boomers.¹⁵⁷

Critics of investing the Trust Fund in the stock market are for the most part asserting a surface analysis of risk. It stems from a fear that the principal will be sacrificed in a down market. Although the steep rise during the late 1990s and the subsequent fall of the stock market starting in 2000 are still fresh in our collective memories, this view does not take into account long-term returns on the market. There is, implicit in the critics' view, a misunderstanding of the nature of risk. Risk needs to be assessed not only from the point of view of being in the market but also from the alternative of not being in the market.

Generally, bonds are considered the safest investment,¹⁵⁸ but the reality is that an undiversified portfolio is actually not as risk-free as one that is fully diversified in different asset classes. It is without question that stocks, in the short-term, are riskier than bonds.¹⁵⁹ However, for the longer holding periods anticipated for the Social Security Trust Fund, historical data shows that stocks not only outperform bonds, but do so with less risk than a bond-only portfolio. In long holding periods bonds suffer from inflation risk, such that the interest earned on the bonds may be less than the inflation rate.¹⁶⁰

In Professor Jeremy J. Siegel's study of a 200-year span, during long-term holding periods of 20 years, "stocks have never fallen behind inflation, whereas bonds and bills once fell as much as three percent per year behind the rate of inflation. A three percent annual loss over 20 years will wipe out almost half of the purchasing power of a portfolio."¹⁶¹ Professor Siegel

¹⁵⁵ See Yahoo! Finance, Historical Prices for S&P 500 Index, available at <http://finance.yahoo.com/q/hp?s=%5EGSPC&a=10&b=30&c=1996&d=10&e=30&f=2006&g=m> (last visited December 12, 2006) (providing raw data). The S&P 500 is widely considered to be a proxy for the public equities market at large. See Standard & Poor's, Indices (2006), available at <http://www2.standardandpoors.com/servlet/Satellite?pagename=sp/Page/IndicesIndexPg&r=1&l=EN&b=4&s=6&ig=51&i=56&xcd=500>.

¹⁵⁶ Solomon & Berson, *supra* note 6, at 139.

¹⁵⁷ *Id.* at 139 (noting that once the outflows in benefits exceed the inflows, the Trust Fund will need to start selling off assets).

¹⁵⁸ Bosworth & Burtless, *supra* note 80, at 46.

¹⁵⁹ SIEGEL, *supra* note 15, at 26.

¹⁶⁰ *Id.*

¹⁶¹ *Id.*

notes that in periods of 17 years or more, stocks “have never offered investors a negative real holding period return yield,” whereas bonds and bills have.¹⁶² It is possible, though not probable, that bonds will outperform stocks. In the longer holding periods, however, historical returns show that there is an 80% chance of stocks beating bonds in ten-year periods, a 90% chance during 20-year periods and over a 99.4% chance during 30-year periods.¹⁶³ Given the long time spans and multiple cohorts that the Social Security Trust Fund serves, it is safe to say that stocks will earn more than bonds in the long run, and therefore are less risky.

The view of the government concerning the riskiness of the markets has evolved over time. The policy at the U.S. Treasury Department well into the late 1980s was that investing Social Security funds into the market was too risky and “would entail higher risk of loss or default than Treasury obligations.”¹⁶⁴ That fear seemed to dissipate at the U.S. Treasury Department, perhaps in part because of the dynamic quality of the markets in the mid-1990s and perhaps in part as the political landscape changed when the Bush administration became interested in pushing forward private accounts.

Critics of personal accounts used the risk inherent in the markets as an argument against Bush’s policy. The argument goes that a potential downturn could cause the funding crisis to come sooner than expected.¹⁶⁵ This analysis assumes that all equity investments are too risky to be compatible with a Social Security system geared to provide for the bulk of Americans.¹⁶⁶ Critics of equity investments reason that if a person’s retirement income is based on private investments, then they will less likely retire because that investment will always be at risk in the stock market, especially when the individual has no other source of earnings. Under this view, if a person’s retirement income is in the market, the income is characterized as a hope rather than an expectation and therefore the person will not retire.¹⁶⁷ Whereas, if retirement income is a claim on the future productivity of America’s workforce, then the inducement to retire is maintained across the economic spectrum.¹⁶⁸ Of course, working longer is not necessarily an undesirable result.

¹⁶² *Id.* at 26-27.

¹⁶³ *Id.* at 27-28.

¹⁶⁴ Seidman, *supra* note 20, at 245.

¹⁶⁵ Dilley, *supra* note 9, at 981.

¹⁶⁶ *Id.*

¹⁶⁷ *Id.*

¹⁶⁸ *Id.* at 981-82.

The anti-privatizers argued against personal accounts by attacking stock market investments as too risky.¹⁶⁹ However, the risk inherent in the market is different when we evaluate personalized accounts versus centralized funding. With a defined contribution plan, one cohort could be exposed to a long period of stock market decline and lose a substantial portion of its personal accounts, whereas “the risks in the portfolio for a defined-benefit system are spread over successive cohorts of workers.”¹⁷⁰ By spreading risk out over several cohorts, the negative effect of a downturn is dissipated over a much wider group of workers. Since the amount of investment is significant and the stock market operates in broad cycles of bull and bear markets, it is likely that over generations any downturn will be ameliorated. So long as the risk-reward ratio is low, critics of personal accounts should embrace the market as a solution when it is used as a tool for centralized trust investments.¹⁷¹

Oddly, proponents of private accounts have used risk as an argument against central investing in order to maintain private accounts as the only solution if we are to invest Social Security funds in the market.¹⁷² The argument is that market downturns are a reality and that if the central trust takes on the risk of a market downturn, then individuals have no choice but to accept that risk. Under this argument, investment by the Trust Fund in the market exposes elderly retirees to the possibility of a market crash.¹⁷³ Older workers typically do not invest their savings in equities but in more trustworthy bonds; consequently, central funding might unfairly expose such workers to unnecessary risk. The proponents of private accounts maintain that young workers should be given the choice of what risk to bear when it comes to investment decisions rather than imposing risk on all of Social Security participants.¹⁷⁴ In other words, risk tolerance should be up to the individual rather than imposed by the state under the personal account point of view. However, there has always been a degree of

¹⁶⁹ Moore, *supra* note 34, at 5-20 to 5-24.

¹⁷⁰ Diamond, *supra* note 77, at 48.

¹⁷¹ Some critics of personal accounts will always view the markets with suspicion. Philosophically, the far left often distrusts private markets as a solution to social problems and prefers governmental control and involvement in addressing social issues. DIXON, *supra* note 25, at 4. For such critics, the likely solution to maintaining benefits would be raising taxes.

¹⁷² Two Stanford economists in favor of private accounts concluded that based on historical stock prices, there was a twenty to twenty-five percent chance that the Trust Fund would be in a worse position financially if the government had invested a portion of the payroll tax in a diversified portfolio of equities. MaCurdy & Shoven, *supra* note 127, at 25.

¹⁷³ SCHIEBER & SHOVEN, *supra* note 4, at 379-80.

¹⁷⁴ *Id.* at 379-80.

paternalism in Social Security.¹⁷⁵ Since most citizens are not sophisticated investors, there is actually an upside to extending this paternalism to the investment decision. Experts are likely to make better decisions than individual investors.

There are actually risks incurred by not investing the Trust Fund in the market. There is a political risk that the commitments of the current program are larger than what our society is willing to impose.¹⁷⁶ As younger generations of workers gain political power, they may likely rebel against the idea of paying a payroll tax to support older workers while facing a retirement themselves in which they will receive less than they paid into the system.¹⁷⁷ Such a cohort could rebel and wield its political muscle to elect a Congress that would respond to the concerns of its generation.

Thus, there is also the risk of benefit cuts by Congress, since the program is seriously under-funded.¹⁷⁸ The Congressional amendments to the Social Security Act in 1977, 1983, and 1993 all contained some sort of benefit cut.¹⁷⁹ Moreover, many of the proposals that have been discussed or introduced in Congress contain further across-the-board benefit cuts.¹⁸⁰ The poorest 10% of workers hold 93.6% of their total wealth in the future payments that Social Security will pay out.¹⁸¹ Such benefit cuts create a real risk that those workers will face a retirement riddled with poverty. Given that the balance of their wealth is in the current high risk category of PAYGO financing (the risk being that Congress will probably cut benefits further), it might actually lessen their risk profile to brave the financial risks of the stock market. Probably the biggest risk is in the present unfunded PAYGO system, since Congress has legislated benefits without enough financial assets to back it up.¹⁸²

Even though it is clear from an historical, economic, and common sense perspective that it is less risky in the long term to invest in stocks than in bonds, to be prudent one should consider who bears the risk of a downturn if the stock market should dramatically go down in value. The question

¹⁷⁵ Kathryn L. Moore, *Privatization of Social Security: Misguided Reform*, 71 TEMP. L. REV. 131, 158 (1998).

¹⁷⁶ SCHIEBER & SHOVEN, *supra* note 4, at 374.

¹⁷⁷ Moore, *supra* note 3, at 982-83 (identifying that there may be "political insolvency" in the system in addition to the "fiscal insolvency").

¹⁷⁸ SCHIEBER & SHOVEN, *supra* note 4, at 373.

¹⁷⁹ *Id.*

¹⁸⁰ *Id.* at 381.

¹⁸¹ *Id.* at 380 tbl.22.1.

¹⁸² *Id.* at 307.

was considered by the Technical Panel of the 1994-1996 Advisory Panel on Social Security. One solution considered was to pass along the vagaries of the stock market to households more or less as the market fluctuated.¹⁸³

But, the recommended option was to transfer the risk to future generations—in effect maintaining benefits and forcing future generations to take on the risk of the present generation’s investment decisions.¹⁸⁴ If the Trust Fund investments fail to perform as expected, then “future workers are pre-committed to absorb fully any shortfall in the trust fund below its expected value, in the form of larger taxes.”¹⁸⁵ The question has arisen of whether it is fair to burden future generations with a risk when they have no say in the matter. However, as a matter of policy, we burden future generations in many ways. The current PAYGO system of financing Social Security creates “an enormous amount of tax rate uncertainty for future workers.”¹⁸⁶ In addition to Social Security financing, risk is shifted to future generations through the issuance of government debt and budget deficit spending.¹⁸⁷ From a policy point of view, the government is consistently making decisions that will affect future generations. When the historical data that stocks outperform bonds 99.4% of the time over 30-year periods is taken into account,¹⁸⁸ a decision to invest now is likely to be seen by future generations as one of the wisest decisions this current generation of lawmakers ever made.

With risk comes reward. Professional money managers are better able to manage risk and seek well-reasoned investments over the long term rather than immediately reacting to trends. While there are no guarantees of positive returns, risk can be diversified to increase the possibility of a higher return. As will be seen below, modern portfolio theory suggests that not only is individual risk desirable, but that risk can be diversified and minimized in order to maximize a positive return.

D. The Science of Finance: Diversification

The risk involved in holding stock can be greatly reduced by using modern portfolio theory to diversify assets and balance the risks.¹⁸⁹

¹⁸³ Smetters, *supra* note 23, at 206-07.

¹⁸⁴ *Id.* at 208.

¹⁸⁵ *Id.* Likewise, future workers would benefit from a reduction in taxes if the Trust Fund outperforms expectations. *Id.*

¹⁸⁶ *Id.* at 209. One estimate predicts a thirty percent increase in the payroll tax in order to maintain benefits.

¹⁸⁷ *Id.*

¹⁸⁸ SIEGEL, *supra* note 15, at 27-28.

¹⁸⁹ Weiss, *supra* note 109, at 995.

Modern portfolio theory demonstrates that the risk which is inherent in any given asset may be reduced by grouping that asset with another asset that is not exposed to the same sort of risk.¹⁹⁰ From a purely economic point of view, the Trust Fund should diversify its portfolio to include not only bonds but also stocks and other assets.¹⁹¹

Risk falls into two categories—individual company risk and market risk.¹⁹² Individual company risk, otherwise known as unsystematic risk,¹⁹³ is diversified away by combining non-correlated companies together in one portfolio.¹⁹⁴ Individual company risk may be due to the nature of the industry, the cost of supplies, location of the company, or any number of factors that are unique or particular to that company.¹⁹⁵ Risk is not cumulative¹⁹⁶ since stock prices on individual companies (or for that matter asset classes) do not move in unison.¹⁹⁷ Companies are correlated when they share the same risk factors—i.e., the same suppliers, industry, etc. Diversification merely means identifying a basket of companies in which the negative effects in one industry or company will not be felt in another industry or company. A classic example of non-correlated risks involves fuel costs. As oil and gas prices rise, profits for companies in the oil sector also rise, while profits for trucking companies and airline companies sink because of higher fuel prices.

Market risk, also called portfolio or systematic risk,¹⁹⁸ is often characterized as the risk of the overall market going up or down.¹⁹⁹ Market risk cannot be diversified away in the same fashion that company risk can be reduced by combining assets.²⁰⁰ Market risk reflects any risk that might affect a large number of assets and represents the true risk of any investment since it is the portion of risk that comes from an unanticipated surprise.²⁰¹ For example, surprise announcements about interest rates,

¹⁹⁰ Solomon & Berson, *supra* note 6, at 130.

¹⁹¹ Diamond, *supra* note 77, at 39 (stating that the question of whether to diversify from an economic perspective is not debatable). Clearly, the fund would be in a better position economically and from a risk reduction point of view than a portfolio of only bonds. However, political questions arise when the government becomes an investor. *Id.* at 39-40.

¹⁹² Solomon & Berson, *supra* note 6, at 130.

¹⁹³ STEPHEN A. ROSS ET AL., CORPORATE FINANCE 299 (2005).

¹⁹⁴ Solomon & Berson, *supra* note 6, at 130-31.

¹⁹⁵ Weiss, *supra* note 109, at 995.

¹⁹⁶ *Id.*

¹⁹⁷ Solomon & Berson, *supra* note 6, at 130.

¹⁹⁸ ROSS ET AL., *supra* note 193, at 275.

¹⁹⁹ Solomon & Berson, *supra* note 6, at 131.

²⁰⁰ Weiss, *supra* note 109, at 995.

²⁰¹ ROSS ET AL., *supra* note 193, at 299.

GNP, or inflation are likely to affect the economic outlook for almost all companies.²⁰²

One way to eliminate market risk would be to have the government act as the risk manager in the case of a market downturn, since it “could more easily absorb market shocks and make up the losses with general revenues than could low-income individuals, who are highly dependent on their benefits.”²⁰³ Of course, under those circumstances, the likely government response will be to raise taxes or somehow cut benefits—both of which we are trying to minimize by investing in the market in the first place. If it is foreseeable that the market will decline and there is not an effective hedging strategy, then it would not make any sense for the Trust Fund to even begin to invest in anything other than bonds or perhaps certificates of deposit.

Most of the legal literature has a very narrow view of risk. Many commentators equate market risk with stock market risk—i.e., they suggest that the risk of a stock market decline cannot be diversified away. In the case of private accounts, that would be true since, for private accounts, it was mostly anticipated that the only investments available would be in the public equities markets or bond markets. However, when taking a view of a centralized trust, the public stock market should be viewed as only one asset class in which the risk of a decline can be diversified out of the portfolio.

A well-balanced portfolio would include not only publicly traded equities but also other asset classes that are negatively correlated in order to reduce the risk of a public stock market decline. A well-balanced portfolio would be hedged against the risk of a stock market decline by including asset classes where there is a negative co-variance to the stock market. Such a portfolio might include government debt, real estate, cash holdings, and monetary metals, as well as other asset classes. For example, although the S&P 500 lost 49% of its value between 2000 and 2003,²⁰⁴ the Dow Jones AIG Commodity Index gained 42% during the same time period.²⁰⁵ So while the stock market went down, the prices of raw materials went up. Although hindsight is 20/20, it is clear that a less risky portfolio containing the S&P 500 stocks for this time period would have

²⁰² *Id.* at 299-300.

²⁰³ Solomon & Berson, *supra* note 6, at 139.

²⁰⁴ See Yahoo! Finance, *supra* note 155.

²⁰⁵ See Yahoo! Finance, Historical Prices, *Dow Jones AIG Commodity Index*, available at <http://finance.yahoo.com/q/hp?s=%5EDJC&a=01&b=3&c=2000&d=11&e=19&f=2003&g=m> (last visited April 24, 2006) (provides raw data).

also held an instrument mimicking the Dow Jones AIG Commodity Index. As can be seen, the risk of a downturn which is inherent in one asset can be minimized by gaining the upside of other assets that are negatively correlated to the risk inherent in the first asset.²⁰⁶

Many of the larger private trust funds already use such a diversification model to balance their portfolios and reduce stock market risk. One need not look any further than the Harvard and Yale trust funds for information on how to diversify out stock market risk. The Yale Endowment, which in 2004 stood at \$12.7 billion, had less than 15% of its portfolio in domestic publicly traded equities.²⁰⁷ The rest of the portfolio was spread across foreign equities, private equities, real assets, fixed income, absolute return strategies, and cash.²⁰⁸ During the stock market downturn of 2000 in which the S&P 500 lost 10%,²⁰⁹ the Yale Fund gained 41%.²¹⁰ When the S&P 500 lost an additional 13% in 2001, the Yale Fund gained 9.2%.²¹¹ During 2002 when the S&P 500 declined by 22%, the Yale Fund returned 0.7%.²¹² This is not to say that the Social Security Trust Fund would perform as well.²¹³ However, it demonstrates with a real world example that a well-balanced portfolio can be hedged against equity market downturns.

In addition to the asset classes in which the Yale Fund invests, such a portfolio might include foreign currencies and commodities as a hedging strategy against stock market risk. The Trust Fund may also benefit from investing in illiquid assets, such as venture capital,²¹⁴ leveraged buyouts,

²⁰⁶ Weiss, *supra* note 109, at 995.

²⁰⁷ YALE CORP. INV. COMM., THE YALE ENDOWMENT: 2004, Inside Cover (2004), available at http://www.yale.edu/investments/Yale_Endowment_04.pdf. Compared to the Yale Fund, some public pension plans are much less diversified. A 1999 study showed that public pension plans had over sixty-seven percent of their assets invested in equities. Solomon & Berson, *supra* note 6, at 136.

²⁰⁸ YALE CORP. INV. COMM., *supra* note 210, at Inside Cover.

²⁰⁹ See Yahoo! Finance Historical Prices, *S&P 500 Index*, available at <http://finance.yahoo.com/q/hp?s=%5EGSPC&a=00&b=1&c=2000&d=11&e=31&f=2000&g=d&z=66&y=0> (last visited April 24, 2006) (provides raw data).

²¹⁰ YALE CORP. INV. COMM., *supra* note 207, at Inside Cover.

²¹¹ *Id.*

²¹² *Id.*

²¹³ In a simple diversified portfolio of stocks, government securities, and corporate bonds, one economist predicts an average return of 4% with low risk, which is still better than the 2% inflation-adjusted return on government bonds. See Seidman, *supra* note 20, at 243.

²¹⁴ The Canadian Pension Plan Investment Board invested \$400 million in a private equity buyout fund and a venture capital fund of funds in 2005. Press Release, CPP Investment Announces \$400 Million Commitment to Canadian Private Equity and Venture Capital Market (Nov. 15, 2005) (available at: http://www.cppib.ca/News_Room/News_Releases/nr_11150501.html). CPP Investment Board has \$10 billion—over 10% of its fund—invested in private as opposed to public equity. *Id.*

oil and gas, timber, real estate,²¹⁵ company plants, and equipment.²¹⁶ Since the Trust Fund by definition has a long term horizon, it can exploit illiquid investments that normally only large institutional players or the very wealthy can leverage.

Another way to look at diversification of stock market risk is to consider that the Trust Fund needs to not only provide for retired persons, but build a cash flow for workers who are just starting out and others who are in mid-career. A portfolio for younger persons would naturally have some riskier equity investments. Thus, if the Trust Fund is meant to serve all of society—i.e., provide for the current needs of retired workers and build equity for present workers—then the trust should be invested in some mix of both bonds and stocks.

E. The Savings Rate, Market Caps, and Costs

Pre-funding and moving even a fraction of the \$1.7 trillion in the Trust Fund into the market will have desirable macroeconomic effects on the national savings rate and also increase the total market capitalization. Centralizing the investment of the Trust Fund will also likely be cost efficient since economies of scale can be achieved relative to the decentralization of private accounts.

One macroeconomic effect of investing Social Security funds in the market is an increase in the national savings rate.²¹⁷ Investing in equities increases the national savings rate more than investing in bonds.²¹⁸ If the Trust Fund saves money by investing in capital stock, then GDP will grow as well.²¹⁹ That growth in GDP will result in higher wages, which in turn will result in a higher cash flow stream into the Trust Fund since the amount of money collected by the FICA tax will increase without the necessity of raising the payroll tax.²²⁰

²¹⁵ YALE CORP. INV. COMM., *supra* note 207, at 5.

²¹⁶ ROSS ET AL., *supra* note 193, at 409.

²¹⁷ A debate exists over whether Social Security's present form of PAYGO financing decreases the national savings rate. Dilley, *supra* note 9, at 1008-09. However, we need not consider that debate here since the focus is on a fully funded system rather than PAYGO. Professor Diamond concludes that national savings would increase if a centralized fund earned a higher rate of return. Diamond, *supra* note 77, at 58 n.71.

²¹⁸ Seidman, *supra* note 20, at 246; Bosworth & Burtless, *supra* note 80, at 6.

²¹⁹ SCHIEBER & SHOVEN, *supra* note 4, at 384-85.

²²⁰ Bosworth & Burtless, *supra* note 80, at 6. Some econometric models suggest that pre-funding "leads to a 37 percent increase in the long-run capital stock, 4 percent increase in labor supply, 11 percent increase in output, 7 percent increase in wages, and a 19 percent decline in the cost of capital. This translates into a long-run 5 to 8 percent increase in full lifetime income . . ." Smetters, *supra* note 23, at 211.

Increasing the national saving rate will have a snowball effect on the wealth created in the Trust Fund, though it should be noted that if the monies are put solely into United States equities, “the resulting increase in the capital stock will improve productivity and real wages but depress capital returns.”²²¹ Yet when the increased saving is invested internationally, higher rates of return on capital are found but there is a loss of wage income.²²² Bosworth concludes that when reform increases the national savings rate, Social Security finances are improved by increases in wages, and that increase is greater when funds are invested domestically rather than internationally.²²³

Another effect of shifting \$1.7 trillion into the public market is the likelihood of increased valuations on price of stocks—i.e., an increase in the total market capitalization.²²⁴ In other words, stock prices will go up because so much more money is being invested in the same number of companies. The presence of so much new cash in the equity markets could drive up historic price/earnings (P/E) ratios. It is a simple model of supply and demand. If more investors are chasing the same number of shares, then prices will naturally rise. The investment decisions of many money managers (especially value investors) are based on historic P/E ratios,²²⁵ and consequently the shift in valuation may affect the ability of those managers to locate worthy investments for their clients’ portfolios.

Moreover, given the amount of money being invested, the Trust Fund would have to move in and out of stock positions slowly in order not to create downward or upward pressure on a stock price and therefore create distortions, speculations, or chaos.²²⁶ As the Baby Boomers retire and the Trust needs to sell assets, there could be a downward pressure on stock prices that escalates as the Baby Boomers sell off other assets as well.²²⁷

A market-timed econometric model needs to be developed to take into account these large inflows and outflows in order to make sure that the influx is reasoned, rational, and not upsetting to the economy. However, once these models are built and the presence of new money is accounted for, investors should be able to adjust to the new valuations. Alternatively, the presence of so much new money may just begin an era of rapid

²²¹ Bosworth & Burtless, *supra* note 80, at 50.

²²² *Id.* at 54-55.

²²³ *Id.* at 55.

²²⁴ Solomon & Berson, *supra* note 6, at 134.

²²⁵ For a discussion of the traditional value investor’s approach to historic price earnings calculations, see BENJAMIN GRAHAM, *THE INTELLIGENT INVESTOR* 159-160*n* (2003).

²²⁶ Solomon & Berson, *supra* note 6, at 138-39.

²²⁷ *Id.* at 134.

economic development as capital moves into the market to create new business and jobs.

When compared to private accounts, a centralized trust will achieve greater costs savings by reducing the transactions costs and administrative costs and by maintaining capital in the system rather than making it subject to inheritance. One of the main arguments against private accounts has been that the costs associated with creating and managing those accounts would cut into the better returns that were promised by investing in the market.²²⁸ There are two types of costs in moving to a private account system—the costs of transitioning and the on-going administrative costs.²²⁹ The present generation of workers will have to pay the transition costs in much the same way that the present younger generation will bear the cost of the Baby Boomers if nothing is done to rectify the problem of underfunding.²³⁰ The current costs of maintaining Social Security are extremely low—about one-half of one percent of the benefit paid in a single year.²³¹ In comparison, estimates of the cost of administrative fees for private accounts range from ten to twenty-five percent of the assets, which would reduce the overall return on such funds.²³² Of course, moving to a fully funded defined benefit system “requires taxing some workers (or retirees) now in order to benefit other workers who come later,” though additional returns earned through investment in a diversified portfolio could offset such costs.²³³

However, the administrative costs associated with private accounts are not present with a centralized trust. In addition to an increased rate of return and a reduction of risk through diversification, a centralized Trust Fund might, if run efficiently, lead to lower transaction costs in the purchase²³⁴ and sometimes the sale of securities²³⁵ than those incurred in transactions involving personal accounts. In the purchase of securities, a buyer in bulk can often demand a lower cost than an individual retail

²²⁸ “[P]ersonal retirement accounts could exacerbate, rather than solve, Social Security’s long-term deficit because they impose transition costs of at least \$1 to \$2 trillion.” Moore, *supra* note 34, at 5-6.

²²⁹ See generally Karen C. Burke & Grayson M.P. McCouch, *Privatizing Social Security: Administration and Implementation*, 58 WASH & LEE L. REV. 1325 (2001).

²³⁰ Dilley, *supra* note 9, at 1017.

²³¹ *Id.* at 1018 n.164.

²³² *Id.* at 1018.

²³³ Diamond, *supra* note 77, at 58.

²³⁴ Solomon & Berson, *supra* note 6, at 138.

²³⁵ In some limited circumstances, a premium over the market price for a security might be demanded if the amount being sold represents a controlling interest in the corporation. Such a “control premium” might be demanded by the Trust Fund since it is possible that a \$1.7 trillion fund could establish control of certain companies.

investor; however, at some point, such bulk buying will abnormally adjust the price upwards as demand soars.²³⁶ Consequently, cost reductions might actually have to be foregone in favor of easing trades into and out of the market in the interest of orderly trades that do not cause abnormal swings in the market price.²³⁷ Another cost reduction would be the administrative cost reduction of managing only one fund instead of millions of individual accounts.²³⁸

Using the market for central funding rather than personal accounts also helps achieve the redistribution of wealth goal of Social Security in two ways. A centralized fund would not have the administrative costs of personal accounts, and thus investments would yield a higher return, meaning more money for benefits. In addition, the money that accrues in the system would not be subject to inheritance as in the personal accounts proposal. After a beneficiary dies, any money that might have been reserved for benefits for that individual becomes part of the greater Trust Fund to be used to pay benefits for other workers.

IV. PROBLEMS POSED BY GOVERNMENT INVESTMENT

The upside of a centralized trust seems promising when risks are reduced through diversification. An objective view of the economics of investment clearly shows that over the long term, a diversified portfolio managed by a well-run centralized trust will reduce risk and earn higher returns.²³⁹ The opposition, then, to centralized investing is more a matter of political, rather than economic, arguments.²⁴⁰ President Bush's Commission on Social Security could not have been clearer when it declared in a 2001 report that "government must not invest Social Security funds in the stock market."²⁴¹

Critics have many concerns about government investing, including: (1) the sheer size of the Trust Fund will concentrate too much economic power in one entity; (2) economic power will lead to political interference in the investment decision, corporate governance, and appointment of trustees through the concept of "social investing;" (3) conflicts of interest between

²³⁶ Solomon & Berson, *supra* note 6, at 138-39.

²³⁷ *Id.* at 139.

²³⁸ *Id.* at 138.

²³⁹ See Diamond, *supra* note 77, at 39.

²⁴⁰ *Id.* at 38.

²⁴¹ PRESIDENT'S COMM'N, STRENGTHENING SOCIAL SECURITY, *supra* note 28, at 13. One interesting political result from holding to this principle is that the only way to then leverage the promise of the markets is through private accounts.

the duties imposed on the government as a regulator and the government's role as a shareholder will arise;²⁴² (4) inefficiencies of a government bureaucracy may lead to lower returns; and (5) an ideological shift will occur in the role of government versus the role of the private sector that runs counter to the capitalist model of free enterprise. I examine each argument against government investing in turn.

A. The Largest Shareholder in the World

One primary concern that has historically prevented government investment is that the concentration of economic and shareholder power in the government results in unwanted political pressure on the private sector through both the investment process and corporate governance. I first discuss the historical debate over government investment by the Social Security Trust Fund. I then examine the economic power that will be yielded by the Trust Fund and how much power will be concentrated in the government relative to the economy at large. Finally, I will look at the probability of government interference by examining the empirical and anecdotal evidence of political interference by state-run pension funds.

The debate over whether the payroll tax should be invested in the market has been around since the beginning of Social Security in 1935.²⁴³ Political bodies and government agencies have traditionally opposed government investment. Over half of the members of the 1994-1996 Advisory Council on Social Security²⁴⁴ opposed investment of the Trust Fund by the government.²⁴⁵ The Council in part feared that political pressure would "steer the Social Security Trust Fund's investments to achieve other economic, social, or political purposes rather than basing decision solely on the expected risk and return."²⁴⁶ In addition, the members felt that the government might attempt to influence both individual companies and entire industries by exercising its corporate stock

²⁴² SCHIEBER & SHOVEN, *supra* note 4, at 348-49.

²⁴³ Solomon & Berson, *supra* note 6, at 123.

²⁴⁴ The Social Security Act required that an Advisory Council convene every four years to assess the financing of the Trust Fund in light of the predicted commitments, SOCIAL SECURITY ADMIN., REPORTS & STUDIES: 1994-1996 ADVISORY COUNCIL, *available at* <http://www.ssa.gov/history/reports/adccouncil> (last visited April 24, 2006). However, this Council has since been replaced by a 7-member bipartisan Social Security Advisory Board for the purpose of "making recommendations to the President and to the Congress with respect to policies that will ensure the solvency of the old-age, survivors, and disability insurance program, both in the short-term and the long-term." Social Security Act, 42 U.S.C. § 903 (2006).

²⁴⁵ U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 90, at 3.

²⁴⁶ *Id.*

voting rights.²⁴⁷ Federal agencies also objected to the investment by the government. The official view at the Treasury Department has long been that if Social Security Trust Fund invested in equities, “significant problems would arise as to potential federal control of corporations, the allocation of investment resources, and the conduct of business.”²⁴⁸

The highest profile central investment proposal was made during President Bill Clinton’s 1999 State of the Union address when he proposed that the Trust Fund invest in a broad range of index funds.²⁴⁹ In part, the trend to invest in the market may have been driven by the bull market in stocks from 1983 to 2000. During this period legislation was introduced to authorize the Trust Fund to invest in the market,²⁵⁰ but the bills never gained support. The failure of President Clinton’s proposal may have been due to the political gridlock created by the impeachment of Clinton himself.²⁵¹

Are the fears of unwanted government interference in investment and corporate governance well-founded? The answer depends not on whether the Trust Fund would yield enough economic power to impact a single corporation, but whether it could affect a significant number of corporations that make up the economy. If the entire Trust Fund were evenly invested in publicly traded companies today, it could hold the capital stock of 10% of all companies traded on U.S. stock exchanges.²⁵² Other estimates range from 2% to 27.5% of all equities.²⁵³ No matter

²⁴⁷ *Id.*

²⁴⁸ Seidman, *supra* note 20, at 244.

²⁴⁹ Solomon & Berson, *supra* note 6, at 124.

²⁵⁰ H.R. 4076, 105th Cong. § 2 (1998) would have amended the Social Security Act to allow for a central fund that invests in a series of index funds. Weiss, *supra* note 111, at 1016 n.61. H.R. 3456, 105th Cong. § 2 (1998) would have established a trust fund for Social Security like the federal employee pension Thrift Savings Fund. *Id.*

²⁵¹ Michael Tanner, *Clinton Wanted Social Security Privatized*, CATO INSTITUTE DAILIES, July 13, 2001, available at <http://www.cato.org/dailys/07-13-01.html>.

²⁵² This estimate is based on an assumption that the entire \$1.7 trillion in the Trust Fund was in companies traded on U.S. exchanges, which have a total value of \$16.7 trillion. I derive the latter number from the Wilshire 5000 stock index for the month ending April 28, 2006. Wilshire 5000 Fundamental Characteristics, available at <http://www.wilshire.com/Indexes/Broad/Wilshire5000/Characteristics.html> (last visited May 8, 2006). The Wilshire 5000 is widely considered the broadest and most representative index of the American stock markets. Wilshire 5000 Total Market Index – TMWX, available at <http://www.investopedia.com/terms/w/wilshire5000equityindex.asp> (last visited May 8, 2006). As discussed above, the Trust Fund would likely not be entirely invested in public equities. Instead, the fund would seek to diversify risk and invest only a portion in public stocks. If the Trust Fund followed that Yale Endowment model, then only 15% would be invested in public equities, and the holdings by the government would represent 2% instead of 10% of all publicly traded stocks.

²⁵³ Smetters, *supra* note 23, at 207. The predictions are estimated for the year 2020 and are based on an assumption that 40% of the Trust Fund was invested per the Maintain Benefits Plan suggested by the 1994-96 Advisory Council on Social Security. The variation is a factor of real growth of all assets. SOCIAL SECURITY ADMIN., *supra* note 244.

whose numbers are used, the Trust Fund would likely be one of the largest shareholders in the world, though not necessarily the largest. The plans to privatize the Japan Postal Corp.—the Japanese governmental post office and bank—would create a private bank with assets of \$1.9 trillion.²⁵⁴ Some commentators suggest that these numbers do not give too much control to the government;²⁵⁵ however, even at the low end of 2%, shareholders can have a significant impact on the decision making of a corporation.²⁵⁶

The potential of government interference exists on two levels—“[1] refusing to invest in a company unless it changes a particular corporate policy, and [2] by exerting the voting rights attached to the common stock.”²⁵⁷ The historical patterns of political interference by public pension funds helps answer the question of whether the government will interfere through the Social Security Trust Fund. There is both anecdotal and empirical evidence that public pension plans are subject to political pressure when making investments and voting their shares. Such pressure is likely to align the “investment agenda” with special interest groups such as labor unions or lobbying groups asserting pressure on politicians. This sort of pressure is often labeled “social investing.”

B. Social Investing

Social investing is a values-based investment strategy which seeks, in broad terms, either to invest in assets that promote broader social purposes²⁵⁸ or to avoid unethical or immoral firms.²⁵⁹ Such investing takes many forms. Examples of promoting a broader social purpose include investing only in “green” companies that have adopted environmentally friendly policies or pursuing investments that will lead to economic development in underdeveloped regions,²⁶⁰ such as economically depressed inner cities or rural areas. Examples of avoiding unethical or immoral firms include prohibitions on investments in tobacco companies²⁶¹ or companies that operate in countries with repressive human rights policies.

²⁵⁴ *Japan Post Submits Plan for Privatizing Service—Proposal Will Create World’s Biggest Bank, Three Other Entities*, WALL ST. J. ASIA, Aug. 1, 2006, at 2.

²⁵⁵ Smetters, *supra* note 23, at 207.

²⁵⁶ Michael Tanner, *The Perils of Government Investing*, CATO Institute Briefing Paper No. 43, Dec. 1, 1998, at *3, available at <http://www.cato.org/pubs/briefs/bp-043es.html>.

²⁵⁷ Solomon & Berson, *supra* note 6, at 139.

²⁵⁸ Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 803 (1993).

²⁵⁹ Angelis, *supra* note 24, at 290.

²⁶⁰ *Id.* at 291-92.

²⁶¹ *Id.* at 290.

Prohibitions on investing in companies in South Africa were a feature of many public pension plans during the 1980s.²⁶²

Both anecdotal and empirical data suggests that “social investing may adversely affect fund performance.”²⁶³ Moreover, if the Trust Fund is required to divest itself of certain investments (as in the case where it becomes apparent that a company is acting unethically), then such divestiture “can cause large losses both at the time of sale, because of brokerage fees and depressed stock prices . . . and afterward as the narrower selection of stocks increases a portfolio’s riskiness.”²⁶⁴ The concept of social investing has not caught on in the private sector primarily because such investments yield lower returns.²⁶⁵ For example, the institutional Social Choice Equity mutual fund offered by TIAA-CREF underperforms on an annual basis every other institutional fund that has been in existence for at least three years.²⁶⁶

On the state and local level, there is evidence of manipulation by politicians to influence the investment decisions of pension plans for the purpose of social investing.²⁶⁷ Examples of this phenomenon include pressure on public pension funds to assist local firms that are struggling so as to reduce unemployment and foster in-state employment.²⁶⁸ Such investments might prop up a local company for a short period of time and keep jobs in the state, but often there are greater underlying problems that led to the firm’s problems, and the investment just acts to delay the inevitable.²⁶⁹ Some states mandate that public pension funds invest a portion of their assets in local firms in order to promote jobs, though sometimes such investments are qualified by the requirement that they

²⁶² *Id.* More recent examples include CalPers, which rejects investments in China because of that country’s record on worker’s and human rights as well as other factors such as a lack of transparency. See Lucien J. Dhooze, *Beyond Voluntarism: Social Disclosure and France’s Nouvelles Régulations Économiques*, 21 ARIZ. J. INTL. & COMP. L. 441, 457-58 (2004).

²⁶³ Romano, *supra* note 258, at 829. Some analysts argue that the effect of social investing is minimal and that potential lower investment returns resulting from social investing can be offset by formulating rules to limit the amount a fund would invest in pet projects and to provide for “an orderly exit” in the case of divestiture of an unethical firm. Angelis, *supra* note 24, at 292.

²⁶⁴ *Id.* at 290.

²⁶⁵ Romano, *supra* note 258, at 811.

²⁶⁶ See TIAA-CREF, FINANCIAL PERFORMANCE, available at <http://www.tiaa-cref.org/charts/mf-performance.html> (last visited December 19, 2006).

²⁶⁷ Smetters, *supra* note 23, at 217.

²⁶⁸ *Id.* at 796. In a reversal of roles, companies could hypothetically exert pressure on funds to vote a certain way with the threat of plant closings. *Id.* at 796-97.

²⁶⁹ *Id.* (noting that the Connecticut pension fund’s investment in Colt Industries allowed a leveraged buyout of the firm but that the company eventually filed for bankruptcy).

must be “prudent”²⁷⁰ in order to avoid investments in money-losing ventures.

Forcing public pension plans to invest in politically-driven investments is also another form of “camouflage” in government expenditure. Like the shell game that the federal government plays with government bonds, the use of pension assets to fund government programs hides the “true cost of local projects from the public.”²⁷¹ Moreover, requiring a pension fund to invest in public works projects at the expense of a greater probable return on a different investment acts as a sort of tax on the beneficiaries of the trust.²⁷² A fairer solution would be to fund the project from the general fund and spread the tax over all taxpayers.²⁷³ On the other hand, one might argue that using Social Security funds for a public investment is similar to using general tax revenues since, by and large, the majority of American taxpayers participate in Social Security. In this case, they get a return on their tax dollars. However, I reject that argument, since the hidden tax on the beneficiary through lower returns does not further the cause of full funding and just adds to the transparency problem in public spending.

When the government takes on the role of a socially conscious investor, it is extending its regulatory function into the investment sphere. This seems like a natural extension of the role of government as regulator—i.e., to encourage policies that promote the social good.²⁷⁴ The problem is that once social investments are mandated, there is pressure to move from what we can all agree on—e.g., preventing human rights abuse and protecting the environment—to social goals that are less clear. Some public pension plans have been forced into social investments at the expense of returns. Perhaps the most egregious example occurred when the New York legislature passed legislation authorizing the public pension fund to buy New York City bonds when the city was on the brink of bankruptcy.²⁷⁵

Once the door is opened to “ethics”-based investing, the debate then centers on what is ethical behavior by the corporation.²⁷⁶ We can certainly

²⁷⁰ *Id.* at 808.

²⁷¹ Romano, *supra* note 258, at 812.

²⁷² *Id.* at 813.

²⁷³ *Id.*

²⁷⁴ *Id.* at 801. In fact, public pension plans which do not engage in social investing are often criticized for their investments, and pressure is brought to bear to institute regulations and duties preventing certain investments, such a ban on tobacco investments. Benjamin J. Richardson, *Financing Environmental Change: A New Role for Canadian Environmental Law*, 49 MCGILL L.J. 145, 167 (2004).

²⁷⁵ Romano, *supra* note 258, at 802.

²⁷⁶ Angelis, *supra* note 24, at 292. Social investing “would add an ad hoc moral component with no clear boundaries.” *Id.*

all agree that a corporation should act in an ethical manner—i.e., within the laws, as a good corporate citizen, and without lying, falsifying, or cheating its shareholders, customers, or the general public. But can we all agree on the issue of domestic partner benefits to gay employees?²⁷⁷ Social investing might expose the Trust Fund to political lobbyists who seek to influence legislation. If the Trust Fund is subject to such lobbying, then to which special interests might it likely listen first? Will it be the Sierra Club or the Nuclear Energy Institute? When the decision to invest crosses the boundary into subjective morality decisions, then the entire purpose of the investment—to yield a suitable return—is thwarted for some other social goal.

Social investing should be distinguished from shareholder activism, though the goals of both actions may be the same. Shareholder activism might consist of filing proxy statements or shareholder derivative lawsuits challenging management's use of corporate assets. For example, legislators have directed public pension plans to vote shares in a way that may hinder a takeover if it would result in a loss of jobs to the state, despite the potential upside to the beneficiaries.²⁷⁸ Political pressure such as that exerted in the name of employment is likely to be “geographically constrained”²⁷⁹ and is usually isolated to a particular state. However, one can imagine that labor unions, focused on keeping jobs in the United States, are likely to exert pressure on the Trust Fund to not invest in a company that is outsourcing American jobs to a lower-cost international base, even if it improves the company's performance.

International investments deserve special concern, since such investments are likely to be politically charged and subject to the constraints of social investing. Social investing also often reduces diversification such that greater risk is imposed on the portfolio as a whole.²⁸⁰ For example, in an effort to promote jobs in Minnesota, pressure was brought on the state public pension fund to limit its international investments.²⁸¹ In this era of globalization, it is a basic tenet of prudent

²⁷⁷ For example, the Timothy Plan is a socially conscious family of mutual funds which “prohibit investing in companies involved in abortion and/or pornography, non-married lifestyles, as well as companies involved in the production of alcohol, tobacco or gambling.” FUND OVERVIEW FOR THE TIMOTHY PLAN FAMILY OF FUNDS, available at <http://www.timothyplan.com/Funds/frame-OurFunds-overview.htm> (last visited August 14, 2006).

²⁷⁸ Romano, *supra* note 258, at 814-15.

²⁷⁹ *Id.* at 797.

²⁸⁰ *Id.* at 806-07.

²⁸¹ *Id.*

diversification to include an international investment strategy.²⁸² Such restraints on investment would affect the ability of the Trust Fund to diversify and therefore yield a riskier portfolio that is more subject to downward trends. On the other hand, by opening up investment in international companies, the U.S. might incur “ill will from those countries who are excluded or receive a small share of foreign investment.”²⁸³

While social investing may result in poor performance,²⁸⁴ there is no positive correlation between shareholder activism and negative returns.²⁸⁵ However, the literature suggests that shareholder activism should increase corporate performance as shareholders put a check on management waste of corporate assets.²⁸⁶ Professor Romano contends, however, that the data suggests “there are serious limits on the expected benefits of increased shareholder activism by public funds.”²⁸⁷

It is not just the politicians who might try to influence the investment decision and corporate governance. Special-interest groups may seek to have the government invest in certain companies or vote their shares a certain way, thereby extending the controversies surrounding “traditional pork barrel spending such as defense contracts and infrastructure projects” into the sphere of the investment process.²⁸⁸ With political interference likely, the investment policy of a publicly-run trust will diverge from an agenda to maximize value and become whatever the agenda might be for special interest groups,²⁸⁹ thereby limiting the goal of Social Security to prevent poverty among the elderly by shifting the benefit of the investment dollars to a special interest group’s goals.

Since social investing typically results in lower rates of return, does social investing conceptually put other special interests (who benefit from the social investment) ahead of the interests of the beneficiaries? “Advocates [of social investing] view public pension fund assets as ‘free’ money or money belonging to someone other than the beneficiaries.”²⁹⁰ Thus, if the directors and managers of a trust fund have a fiduciary duty to

²⁸² Angelis, *supra* note 24, at 311. Research shows that approximately thirty-nine percent of a fully diversified portfolio should contain international investments. *Id.*

²⁸³ *Id.* at 311-312 n.102.

²⁸⁴ Romano, *supra* note 258, at 829.

²⁸⁵ *Id.* at 830.

²⁸⁶ Michael P. Smith, *Shareholder Activism by Institutional Investors: Evidence from CalPERS*, 51 J. FIN. 227 (1996).

²⁸⁷ Romano, *supra* note 258, at 831.

²⁸⁸ Angelis, *supra* note 24, at 292-93.

²⁸⁹ Romano, *supra* note 258, at 798.

²⁹⁰ *Id.* at 812.

the beneficiaries to maximize the returns of the fund, then social investing can be seen as a breach of fiduciary duty.

Is social investing a breach of fiduciary duty? Commentators note that the ERISA fiduciary standard prevents social investing, and thus private pension plans subject to ERISA (public funds are not subject to ERISA) could not engage in such investing without a breach of that duty.²⁹¹ Since the fiduciary standard embodied in the Restatement (Third) of Trusts is generally considered materially the same as that in the ERISA legislation, the prohibition on social investing could easily be applied to the Trust Fund if the prudent investor rule of the Restatement (Third) of Trusts applies.²⁹² Normally, such a standard would not apply since the Social Security Trust Fund is not a trust in the usual sense of the word, as the beneficiaries do not have an ownership interest. That said, such a fiduciary standard could be mandated through legislation. By subjecting the directors and managers of the Trust Fund to a fiduciary duty to the beneficiaries to maximize the wealth of the fund, we sidestep the complex moral and ethical debate of where investment dollars should go to achieve political and social goals and leave those decisions to lawmakers when funding social programs.

C. Conflicts of Interest: Regulator vs. Owner

Critics of central investing also contend that an inherent conflict of interest arises when the government—as a regulator of commerce—becomes a significant shareholder in the companies it is trying to regulate.²⁹³ For example, what if the Trust Fund held shares in Microsoft during a time when the Justice Department was investigating the company for antitrust violations? The government's role is to pursue a vigorous and thorough investigation despite the fact that such an investigation might adversely affect the stock price. However, as a shareholder, the government would also have a fiduciary duty to maximize the profits for the beneficiaries. If it does not pursue the antitrust investigations, then the government is failing in its role as a regulator. If it does pursue the investigations, then it fails the beneficiaries of the trust.

The conflict of interest becomes even more pronounced when the agency involved in regulation and investigation is the Securities and

²⁹¹ *Id.* at 811.

²⁹² *Id.* at 811-12.

²⁹³ SCHIEBER & SHOVEN, *supra* note 4, at 348 (pointing out that a conflict arises if the Trust Fund invests in tobacco companies and is then faced with passing regulation that would promote public health but adversely affect the share price of the companies).

Exchange Commission (SEC).²⁹⁴ How can the government act as a regulator of the stock market through the arm of the SEC when it is the largest investor in the market? SEC regulations govern not only the disclosure requirements and actions of companies; the investment activities of shareholders are also regulated. The SEC is often placed in the role of being an arbiter in the conflicts that arise between shareholders and corporations over issues such as proxy and disclosure rules that implicate federal law.²⁹⁵ If the government becomes the largest shareholder in the world, then surely accusations will arise that any rule change favoring investors was self-interested.

Further complexity arises when decisions are made by the Federal Reserve about the money supply.²⁹⁶ Decisions on interest rates move markets. Wall Street usually reacts to an increase in the interest rate by selling stocks, while a decrease signals a bull market. If every decision on whether to tighten or loosen the money supply will affect the status of the Trust Fund, then political pressure will be intense to favor the Trust Fund regardless of the economy as a whole.

Additional conflicts exist when the government does business with private enterprises in which it is a shareholder. Government contracts awarded to private companies reached \$244 billion in 2002.²⁹⁷ This raises the specter of self-interested transactions by a controlling shareholder. Controlling shareholders²⁹⁸ owe a fiduciary duty to minority shareholders to avoid self-interested transactions.²⁹⁹ Could the Trust Fund exert influence as a shareholder to force the corporation to enter into contracts with the government that favor the government? Conversely, in an interesting twist on the usual corporate dilemma of a shareholder or director receiving a sweetheart deal from the company, could the government misuse tax revenues to steer contracts to companies in which the Trust Fund has an investment? However, in that scenario, there would arguably be no breach of duty to the minority shareholder, since the worth

²⁹⁴ Angelis, *supra* note 24, at 312.

²⁹⁵ *Id.* at 312-13.

²⁹⁶ *Id.* at 314.

²⁹⁷ See Project on Government Oversight, *The Politics of Contracting* (June 29, 2004), available at <http://www.pogo.org/p/contracts/c/co-040101-contractor.html#ExecSum>.

²⁹⁸ A shareholder need not be a majority shareholder to be considered controlling. The shareholder need only own a dominant interest; thus a 20.6% interest has been deemed to be controlling when the next largest shareholder owned only 5% of the corporation. JAMES D. COX, COX & HAZEN ON CORPORATIONS § 11.11 n.1 (2003).

²⁹⁹ *Id.*

of the corporation would rise in value; rather, the breach in trust would be misspending taxpayer dollars.

D. Government Inefficiency

The question also arises of whether the government can be an effective money manager and make wise investment decisions. Even big government advocates should be skeptical³⁰⁰ of whether the entity that has created the largest deficit in world history would deliver a good return on investment. In order to have the incentive to choose the best investments, the governmental employees would need to be subject to the type of competition that exists between private companies in the mutual fund or trust industry³⁰¹—i.e., the pressure to maximize the portfolio returns drives stock pickers to invest the time and effort into making wise investment choices.

Clearly, professional money managers will be better equipped to do the research and make the decisions on where to invest than government employees who are not incentivized to seek higher returns. Such professional money managers, of course, should be qualified.³⁰² If government employees do handle the investment decisions, then such managers should be “professionally trained, highly skilled, and selected on the basis of proven track records.”³⁰³

E. Ideological Constraints of Government Investment

Some critics suggest that the notion of government investments in private enterprise runs counter to the ideological foundation of a capitalist system.³⁰⁴ The history of Social Security includes references to government investing as “socialism.” In the early days, politicians strenuously contended that the Trust was a vehicle for a “social investing” program that would fund low-cost housing, schools, and hospitals—an idea that was suggestive of “socialism.”³⁰⁵ Even more recently, the policy at the U.S. Treasury Department has been that investing Social Security funds into equities is equivalent to “socialism” since it leads to “government

³⁰⁰ Weiss, *supra* note 109, at 999.

³⁰¹ *Id.*

³⁰² *Id.* at 1011 (suggesting that the professional money managers who would work with individuals be subject to the Investment Advisors Act and provide a guarantee that they are not judgment-proof).

³⁰³ Solomon & Berson, *supra* note 6, at 132.

³⁰⁴ Krzysztof M. Ostaszewski, *Privatizing the Social Security Trust Fund? Don't Let the Government Invest*, Cato Institute, SSP No. 6, January 14, 1997, available at <http://www.cato.org/pubs/ssps/ssp6es.html>.

³⁰⁵ SCHIEBER & SHOVEN, *supra* note 4, at 69-70.

ownership and control of private corporations.”³⁰⁶ Government investment runs counter to the Republican and Libertarian underlying philosophy about the role of government in the private sector—i.e., that less regulation is better. Critics of centralized investing object on purely ideological grounds that government is already too big and that this concept intrudes on the lives and choices of citizens.³⁰⁷ Although Republicans and Libertarians want to leverage the marketplace, the concept of a centralized trust runs counter to their core values. From a Republican perspective, the only way the market can be leveraged is through private accounts. However, there are other alternatives that should be considered.

V. THREE ALTERNATIVES, ONE POLITICALLY VIABLE SOLUTION

Most of the literature has considered only two solutions to the problem of private investment by government agencies—private accounts and passive investing. I examine each—explaining why neither solution maximizes returns nor reduces risk—and then offer up a third solution, which is to create a federal government corporation that is not a public agency and therefore separate from political influence. This solution is used effectively by the Canadian government for its social insurance program, the Canadian Pension Plan, and by Alaska for the Alaska Permanent Fund, a private trust used to advance the public purpose of investing revenues from oil, gas, and mineral leases.

A. Private Accounts: The Impossible Republican Dream

Some variation of the personal accounts proposal advanced by President Bush is the preferred choice of Republicans and Libertarians to solve the problems posed by government investing in private enterprise. Such a solution would address politicization of the investment decision and voting of shares as well as the conflict of interest issues. Under private accounts proposals, the individual taxpayer makes the investment decisions rather than the government, though the government may be responsible for setting up a menu of investment choices from which taxpayers can choose. “With decisional power diffused across numerous plan beneficiaries, the likelihood that political pressure will push substantial pension fund assets into high-risk, low-return projects decreases.”³⁰⁸ To the extent that

³⁰⁶ Seidman, *supra* note 20, at 245.

³⁰⁷ Solomon & Berson, *supra* note 6, at 134.

³⁰⁸ Romano, *supra* note 258, at 844.

individuals want social investments, those choices could be packaged and made available to investors who wish to follow a socially responsible investment strategy.³⁰⁹ As to corporate governance, voting power would reside in financial intermediaries, such as the mutual funds, rather than the individual or the government so as to eliminate “political pressure on share voting.”³¹⁰

Although private accounts provide a compelling solution to the problems presented by government involvement in the investment process, there are a number of troubling economic and political questions that arise over private accounts. It is not within the scope of this article to go into great depth on the merits of private accounts. I note the principal arguments that anti-privatizers address below. Reasonable people can disagree on the merits of each issue. Regardless of the merits, the private accounts proposal has no political viability and therefore other solutions must be sought if the market is going to be leveraged to help with the funding of Social Security.

There are many arguments that could be made against personal accounts; however, I divide the criticisms into four principal issues. First, the viability of the plan was called into question in the face of widespread doubt that benefits would be maintained for the elderly poor and middle class. There are substantial concerns that private accounts “would reduce the nation’s commitment to protect the incomes of low-income retirees and would expose low- and middle-income workers to excessive financial market risk.”³¹¹ Moreover, particular groups such as women and African Americans are put at risk for lower benefits.³¹² Second, personal accounts expose individuals to the risk of a market downturn.³¹³ With a centralized Trust Fund, the risk of market swings can be spread across several generations of workers, but individual accounts may take away the safety net that Social Security has traditionally offered workers.³¹⁴ From an

³⁰⁹ *Id.* at 845 (noting that some money managers for public pension funds have packaged real estate and venture capital investments that target local businesses).

³¹⁰ *Id.* at 846.

³¹¹ Bosworth & Burtless, *supra* note 80, at 2. In composing a microeconomic model of a personal accounts system, Bosworth and Burtless found that although high-wage workers would receive more benefits under a defined contribution plan than they would lose in Social Security benefit cuts, lower wage workers would be in a worse position financially since their benefits from a defined contribution plan would be less than the benefit cuts that would have to be made under personal accounts. *Id.* at 4.

³¹² Greg Anrig, Jr., & Bernard Wasow, *Twelve Reasons Why Privatizing Social Security is a Bad Idea*, THE SOCIAL SECURITY NETWORK, Dec. 14, 2004, available at <http://www.socsec.org/publications.asp?pubid=503>.

³¹³ Moore, *supra* note 34, at 5-20 to 5-24.

³¹⁴ *Id.*

economic point of view, a defined contribution plan does not manage risk as well as a centralized defined benefit plan.³¹⁵ Third, some households may also make poor decisions in their investment choices.³¹⁶ Individual investors generally lack the knowledge needed to make good financial decisions.³¹⁷ Fourth, there are likely to be expensive administrative costs which will cut into the higher returns offered by the market.³¹⁸ Wall Street brokerage houses are likely to reap a windfall from management fees, and this will affect the returns offered in the market.³¹⁹ There are also likely to be costs associated with expanding the government bureaucracy to manage the accounts.³²⁰ In reality, transition costs in the form of higher taxes, benefits cuts, or more government debt are likely regardless of the reforms that are put in place. On the plus side, there are positives to implementing private accounts, including the psychological benefits gained by taxpayers having decision-making authority over the investment and a sense of ownership over their contributions.³²¹

Many of the concerns expressed about private accounts are subject to debate and have been hotly contested by economists and politicians on both sides. Individual political or economic opinion is of little relevance at this point in the political process. Private accounts are not a viable alternative since the idea has been tacitly rejected by the political process.³²² As a result, the question now becomes: what are the alternative methods for harnessing the upside of the markets while protecting against political interference?

B. Passive Investing: The Indexing Solution

Passive investing, or indexing, is often discussed as a way to reduce the pressure on “public pension fund managers to engage in social investing or non-value-maximizing share voting.”³²³ Passive investing, as it is used to describe a strategy for Social Security,³²⁴ involves indexing—i.e.,

³¹⁵ Diamond, *supra* note 77, at 40.

³¹⁶ John Geanakoplos, Olivia S. Mitchell & Stephen P. Zeldes, *Would a Privatized Social Security System Really Pay a Higher Rate of Return?*, in FRAMING THE SOCIAL SECURITY DEBATE, *supra* note 24, at 137, 156.

³¹⁷ See generally Anrig & Wasow, *supra* note 312.

³¹⁸ Geanakoplos et al., *supra* note 316, at 156.

³¹⁹ See generally Anrig & Wasow, *supra* note 312.

³²⁰ *Id.*

³²¹ Geanakoplos et al., *supra* note 316, at 156.

³²² Although no vote in Congress was ever taken on President Bush’s private accounts proposal, the President never received the political traction he needed to make the plan viable. Jackie Calmes, *Will Bush Bargain to Save Social Security?*, WALL ST. J., Nov. 22, 2006, at A6.

³²³ Romano, *supra* note 258, at 842.

³²⁴ Passive investing is a strategy that might encompass more than just indexing. Passive investing

purchasing assets that mimic the performance of a stock index.³²⁵ This might be done by purchasing the individual stocks that make up the index or through the purchase of equity instruments that represent the index.³²⁶

An index tracks the average of the gain and loss in value of a group of companies; thus, the Dow Jones Industrial Average (DJIA) is the “price weighted average of 30 actively traded blue chip stocks.”³²⁷ Some indexes, such as the DJIA, Standard & Poor’s Composite Index of 500 Stocks (S&P 500), and Wilshire 5000 Equity Index (Wilshire 5000), purport to represent the broader market and economy, while other indexes were created to represent particular sectors or industries.³²⁸ Various financial instruments exist to mimic an investment in a basket of companies representing a certain sector such as healthcare, financial services, and energy.³²⁹

Passive investing would eliminate the pressure on fund managers to invest in anything other than a preordained index fund and thereby would be an effective tool to eliminate the conflicts of interest that arise when the government invests.³³⁰ Moreover, a wide body of evidence suggests that passive investing yields the same or greater returns than most actively managed mutual funds, so theoretically there would be no performance downside to a passive strategy, and there might even be a boost in performance.³³¹

Some pension funds, notably the Federal Thrift Savings Fund (TSP) for federal employees, use passive investment strategies effectively in order to keep political influence out of the investment decision.³³² Congress in 1986 authorized stock index fund investments by the Federal Retirement Thrift Investment Board so long as the government did not retain voting rights.³³³ The TSP is protected in other ways from the political process as well. The board of directors is selected by the President with the advice

could include strategies “involving limited ongoing buying and selling actions,” so that an investor may choose to purchase a security and engage in a long-term holding strategy with limited involvement in securities. Investopia, *Passive Investing* (2006), available at <http://www.investopedia.com/terms/p/passiveinvesting.asp>. For purposes of this article, I adopt the narrower definition used by most writers in relation to Social Security wherein passive investing strictly means indexing.

³²⁵ Investopia, *Indexing* (2006), available at <http://www.investopedia.com/terms/i/indexing.asp>.

³²⁶ Solomon & Berson, *supra* note 6, at 137.

³²⁷ DICTIONARY OF FINANCE AND INVESTMENT TERMS 559-60 (4th ed., Barrons 1995).

³²⁸ *Id.* at 559-62.

³²⁹ See NASDAQ, *What Is a Sector-Based Index?* (2006), available at http://www.nasdaq.com/indexshares/index_shares_sector.stm, for a list of a variety of products which mimic industries and sectors.

³³⁰ Romano, *supra* note 258, at 842.

³³¹ *Id.* at 842-43.

³³² Weiss, *supra* note 109, at 997.

³³³ Seidman, *supra* note 20, at 244.

and consent of the Senate, but the day-to-day managers are selected by the board.³³⁴ The board cannot interfere with investment decisions of management, and choices of the managers are also limited by statute. The authorizing statute limits the board's fiduciary duties to be "solely in the interests of the participants and beneficiaries [of the TSP]" and applies the "prudent investor" standard of care on anyone who has authority over investment decisions.³³⁵

Yet, the protections afforded from the political process by the legislation authorizing TSP may not work as well when it comes to the Social Security Trust Fund. Notably, the fiduciary standard imposed on managers and directors is backed up by the fact that TSP is a defined contribution plan in which beneficiaries have an ownership interest.³³⁶ Social Security participants and beneficiaries have no such ownership interest and therefore, absent some legislation to give them such a right, may not enforce the fiduciary standard against those who might run a Social Security Trust Fund modeled after the TSP.³³⁷

There are other problems with passive investing. First, in a fund as large as the Social Security Trust Fund, an indexing approach would need to be spread over a larger number of shares than is represented by the DJIA or the S&P 500.³³⁸ While these indexes might prove useful indicators, an investment in only these select companies would create share prices disproportionate to the real value.³³⁹ Moreover, the government's percentage ownership of those select companies would be dramatic.³⁴⁰ If the entire \$1.7 trillion currently in the Trust Fund were invested in the S&P 500, it would represent nearly 15% of the index,³⁴¹ which is too much money to spread out over 500 companies, let alone the thirty companies in the Dow. Even without the Trust Fund investing in stocks, the mere addition of a company to the S&P 500 pushes the valuation of that

³³⁴ Angelis, *supra* note 24, at 293 (Howell E. Jackson responds to Angelis).

³³⁵ *Id.* at 293-94.

³³⁶ Tanner, *supra* note 256, at 7-8.

³³⁷ *Id.*

³³⁸ Smetters, *supra* note 23, at 207 (calling for the use of a broader index such as the Russell or Wilshire indexes).

³³⁹ SIEGEL, *supra* note 15, at 352 (arguing that if all investors follow a strategy of investing in the S&P 500, then stocks will be overvalued and the future returns will be depressed).

³⁴⁰ Smetters, *supra* note 23, at 207.

³⁴¹ Percentage is based on the August 3, 2006, market capitalization of the S&P 500 at \$11,586,143,000,000. The figure is a little misleading, since the mere announcement of the investment of the Trust Fund would likely drive the values up, thus lessening the percentage ownership of the fund. However, for our purposes, it is safe to say that even if the Trust Fund represented only ten percent of the index, that would be too large an investment to be spread out over the 500 leading American companies.

company up 34% one year after its addition to the index.³⁴² This price increase, commonly called the “S&P Effect,” represents an increase in valuation merely because mutual funds have bought the stock to replicate the S&P 500 and not because it represents a good investment. If the Social Security Trust Fund starts to invest in such indexes, the S&P Effect is likely to increase. Moreover, if the government automatically puts money into the index, then investors will be able to market time their investments in similar companies.

Second, the passive approach does not resolve the problem of government involvement in corporate governance.³⁴³ To address this issue, some commentators suggest that government funds using an indexing approach should not be allowed to vote the shares they hold. However, such a restriction creates problems in policing the corporation.

In order for the markets to function in a smooth manner, there are a minimal number of investors who must be involved in corporate governance.³⁴⁴ In some corporations, management may waste assets by diverting resources to their own benefit rather than maximizing shareholder value. Shareholder voting acts as a control against that waste. Consequently, there needs to be a number of active investors who are busily researching, investigating, and making judgments on companies—i.e., the well informed investors.³⁴⁵ “[P]assive management cannot exist without its more vigorous counterpart[—active management].”³⁴⁶ It is the judgment calls of active investors to buy, hold, or sell which ultimately determine demand in the marketplace and therefore the price of the investment.³⁴⁷

If all investors are operating with the same indexing strategy, then the volume of actual trading will be lowered.³⁴⁸ Everyone will hold the same basket of companies. Estimating the number of active investors required to make an efficient marketplace is difficult, but commentators suggest the number is already too low. The influx of the Trust Fund’s \$1.7 trillion into the market through a passive indexing scheme could lead to serious risks of reducing the level of active investing necessary to ensure a smoothly

³⁴² Roger Bos, *Event Study: Quantifying the Effect of Being Added to an S&P Index*, Standard & Poor’s, September 2000, at 3, available at <http://www.compustat.com/support/ri/event.pdf>.

³⁴³ Romano, *supra* note 258, at 843.

³⁴⁴ Weiss, *supra* note 109, at 997-98.

³⁴⁵ *Id.* at 997.

³⁴⁶ Solomon & Berson, *supra* note 6, at 137.

³⁴⁷ *Id.*

³⁴⁸ Weiss, *supra* note 109, at 998.

running market.³⁴⁹ Of course, voting rights could always be ceded to an intermediary. In the case of TSP, the voting rights lie with an outside investment manager.³⁵⁰ However, will vesting one manager with voting rights that are disassociated from ownership really yield votes that are in line with a fiduciary duty of trust fund managers to maximize the wealth of the fund? In fact, it is possible that ceding votes to an intermediary or not voting at all could be seen as a breach of fiduciary duty if failure to vote can be found to result in waste in the firm.

Finally, the gains of decreased risk and increased returns presented by a truly diversified portfolio are minimized by a passive investing approach. A passive investing approach is a strategy that can be applied to public stock market investments but cannot be applied as readily to other assets needed for a truly diversified portfolio. Broad diversified indexes do not exist for private investments such as those made by venture capital firms, real estate holdings, and other obscure investments used by the top performing trust funds, such as the fund for Yale University, to achieve full diversification.³⁵¹ Consequently, the wealth maximization that comes from true diversification cannot be achieved with a purely passive approach to investing.³⁵² One might mix a passive approach with some active investments in sectors in which there was no index, but such a strategy would not protect against social investing.³⁵³

In conclusion, a passive investment approach as a solution to the problems of government investing is not satisfactory because: (1) the influx of \$1.7 trillion into an index will artificially inflate the value of some companies; (2) the Trust Fund must be an active player in corporate governance since the influx of this money into the market mandates corporate oversight by the investors; and (3) a passive approach to investments using indexing will not yield the same returns as an active approach with a fully diversified portfolio.

C. Federal Government Corporation: One Step Removed From the Political Process

The third solution of privatizing the Trust Fund into a corporate entity separate from the government presents an intriguing and innovative middle

³⁴⁹ *Id.*

³⁵⁰ Angelis, *supra* note 24, at 294.

³⁵¹ YALE CORP. INV. COMM, *supra* note 207, at 5.

³⁵² Romano, *supra* note 258, at 843.

³⁵³ *Id.* (noting that asset classes such as real estate and small local start-up businesses are often the targets of social investing, though rejecting the idea that corporate governance issues are implicated since real estate holdings and venture capital investments typically do not involve shareholder voting).

ground approach that should appeal to both Democrats and Republicans. In this solution, a government-owned private corporation would be created for the public purpose of investing Social Security funds. By spinning off the investment arm of Social Security into a private company, decision-making is taken out of the hands of the government (as some Democrats would wish) or private individuals (as the private accounts advocates would like) and given instead to skilled financial professionals (where it belongs). The corporate entity would be one step removed from the political process, hence able to make investment decisions without the influence of politicians or lobbyists.

The United States has a long history of creating private corporations for public purposes.³⁵⁴ The legitimacy of such corporations is recounted in *McCulloch v. Maryland*.³⁵⁵ Success stories include not only the Second Bank of the United States in the 18th century, but also the Tennessee Valley Authority,³⁵⁶ the U.S. Post Office (net income of \$3.8 billion in 2003)³⁵⁷ and Comsat.³⁵⁸ Government-owned corporations have also been successfully used to invest public monies that are held in trust funds. Avoiding social investing was the reason Canada created a government-owned corporation to invest the Canadian Pension Plan trust fund, its version of Social Security.³⁵⁹ The Alaska Permanent Fund Corporation is a corporate entity charged with the public purpose of investing Alaska's oil, gas, and mineral revenues in a broadly diversified portfolio of stock, bonds, and other assets for the benefit of Alaskans.³⁶⁰

The use of a federal government corporation brings up the normative question of whether privatized services are desirable for the delivery of public services. Privatization of public services has generated controversy

³⁵⁴ A. Michael Froomkin, *Reinventing the Government Corporation*, 1995 U. ILL. L. REV. 543, 633 (1995).

³⁵⁵ *Id.* at 564. In *McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 316 (1819), the court held that the necessary and proper clause of the Constitution conferred upon the government the power to create a private corporate entity to handle the nation's banking needs, despite the fact that such authority was not among the enumerated federal powers.

³⁵⁶ Froomkin, *supra* note 354, at 580.

³⁵⁷ U.S. Postal Service, 2005 U.S. POSTAL SERVICE ANN. REP. 1 (2005), available at http://www.usps.com/history/anrpt05/usps_ar05.pdf. Critics contend that the earnings are misleading since the Post Office is exempt from taxes and certain other costs.

³⁵⁸ Museum of Broadcast Communications, *Communications Satellite Corporation*, available at <http://www.museum.tv/archives/etv/C/htmlC/communication/communication.htm>.

³⁵⁹ CANADIAN PENSION PLAN INVESTMENT BD., ANN. REP. 2005 1 (2005), available at http://www.cppib.ca/info/annual/ar_2005.pdf.

³⁶⁰ Each year the legislature declares a dividend from the fund to be paid to each resident of Alaska. The principal is invested and cannot be spent without amending the state constitution. THE ALASKA PERMANENT FUND CORP., 2005 ANN. REP. 1 (2005), available at http://www.apfc.org/iceimages/publications/2005_AR_nocov.pdf.

within academia.³⁶¹ The reasons to create the federal government corporation (FGC) to run the Trust Fund would be twofold—(1) political insulation and (2) efficiency.³⁶² By separating the Trust Fund from the government, there would be less risk of political influence being exerted over the investment decisions and voting of shares. A privatized Trust Fund run by professional money managers would be charged with one primary fiduciary duty: maximizing the wealth of the trust for the benefit of present and future retirees. Professional money managers whose compensation is tied to the fund's performance would act to maximize wealth, not to curry favor with politicians or lobbyists.³⁶³ Moreover, a privatized trust would have the capability to invest in assets that are normally closed to individual investors, such as absolute return strategies and certain private equity investments, and thereby to achieve a truly diversified, low-risk portfolio.³⁶⁴

A privatized Trust Fund would not replace the Social Security Administration, which is one of the most efficient government agencies;³⁶⁵ rather, it would supplement the SSA as the investment arm of the agency. Under this scenario, the government would retain the administrative duties of assigning Social Security numbers, determining eligibility for benefits, distributing checks, and everything for which it presently has responsibility.³⁶⁶

While privatization and the use of FGCs clearly represent a trend,³⁶⁷ their use is controversial. FGCs bring up a host of issues, not the least of which is whether privatizing government functions is consistent with the democratic values of “accountability, transparency, and legitimacy.”³⁶⁸

³⁶¹ See discussion *infra* note 371. Much of the controversy has focused on the privatization of prisons, schools, and agencies charged with delivery of Medicare services.

³⁶² Froomkin, *supra* note 354, at 557 (identifying four reasons why an FGC is created: efficiency, political insulation, subsidy, and subterfuge; only efficiency and political insulation are relevant).

³⁶³ Compensating Trust Fund managers with salaries and bonuses comparable to those on Wall Street will no doubt be one of the more controversial aspects of the FGC. Models exist, however, to tie executive salaries to performance. LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE* 189-200 (2004). These principles could easily be adapted to provide guidelines for bonus payments to fund managers.

³⁶⁴ See *supra* Part III for a discussion on how diversification reduces risk and improves returns.

³⁶⁵ Administrative costs of the SSA are only about seven tenths of one percent of annual revenue. SOC. SEC. ADMIN., *SOCIAL SECURITY FACT SHEET*, http://www.senate.gov/~sarbanes/pages/social_security/social_security_fact_sheet.html (last visited Apr. 24, 2006).

³⁶⁶ The Treasury Secretary has responsibility for the decision on how to invest the Trust Fund, so privatizing an investment arm should take little or no responsibility from the Social Security Administration.

³⁶⁷ Froomkin, *supra* note 354, at 546 (FGCs are part of a larger trend to privatize government services).

³⁶⁸ Donna M. Nagy, *Playing Peekaboo with Constitutional Law: The PCAOB and its*

There are a number of constitutional doctrinal issues when a federal government corporation is created, including state action doctrine,³⁶⁹ non-delegation doctrine,³⁷⁰ separation of powers,³⁷¹ appointment clause,³⁷² and other issues.³⁷³ Affording citizens due process rights is a principal concern when regulatory and investigatory functions are ceded to a private entity,³⁷⁴ though such concerns are not likely to impact a privatized Trust Fund whose actions would be limited to making investments. Indeed, an FGC can be formed in such a manner that it comports with the constitutional requirements.³⁷⁵ Authorizing legislation that satisfies the Appointment Clause and other constitutional safeguards should not inhibit the goals of political insulation and greater efficiency through privatization.

Even getting past the constitutional issues, there is also the question of whether sufficient controls exist to hold the FGC accountable. The danger in removing political influence is that political accountability also

Public/Private Status, 80 NOTRE DAME L. REV. 975, 980 (2005) (analyzing whether the Public Company Accounting Oversight Board, an FGC, is in essence a public agency for purposes of constitutional law question under the state action doctrine).

³⁶⁹ Froomkin, *supra* note 354, at 560. The state action doctrine separates entities delivering government services into two camps: the “state” actor on which constitutional restraints (due process, First Amendment protections, etc.) are imposed, and the private actor to which the government just outsources some function and on which constitutional constraints are not imposed. The Court will find that a FGC is a state actor “only if (1) the government created the corporate entity by special law, (2) the government created the entity to further government objectives, and (3) the government retains permanent authority to appoint a majority of the directors of the corporation.” Nagy, *supra* note 368, at 1040.

³⁷⁰ The non-delegation doctrine “prohibits governments from delegating certain powers to private actors.” Gillian E. Metzger, *Privatization as Delegation*, 103 COLUM. L. REV. 1367, 1437 (2003). While the leading case of *Carter v. Carter Coal Co.*, which invalidates delegation of state power to private entities, has not been overruled and is “alive in theory, it is all but dead in practice. Almost all private delegations [of state power] are upheld.” *Id.* at 1440.

³⁷¹ If the FGC is deemed a state actor under the state action doctrine or through the authorizing legislation and therefore is a public/private entity, then in order to comport with the separation of powers doctrine, oversight, including the power of removal of directors, must be vested in the executive, and any authorizing legislation that takes away that power may be unconstitutional. Nagy, *supra* note 368, at 1053-55.

³⁷² If an FGC is a state actor, then it is subject to constitutional restraints and the appointment of directors and officers must comport with the Appointments Clause. Any attempt to move the appointment process out of the hands of the President would undermine the president’s constitutional power. Froomkin, *supra* note 354, at 610.

³⁷³ For example, state actors must afford employees certain due process rights not available to employees of private employers. Nagy, *supra* note 368, at 1044-45.

³⁷⁴ An FGC that takes on an adjudicatory role as a state actor must give citizens their constitutional due process rights of notice, balanced hearings, neutral decision-makers, and stated reasoning for the decision. *Id.* at 1047.

³⁷⁵ As to the state actor doctrine, the authorizing legislation could designate the FGC as an arm of the government, much like the Federal Deposit Insurance Corporation. Such a designation would subject the entity to constitutional restraints in the protection of individual liberties, but this should not interfere with the investment process since such decisions typically do not infringe on individual liberties. In a subsequent article, I will analyze this issue in more depth.

disappears. Without political accountability, will vesting an FGC with \$1.7 trillion create a rogue economic power? Can a private government-owned corporation be held accountable to the same degree as a federal agency, or, for that matter, to the same degree as a corporation in which private citizens are the shareholders? The challenge concerning a privatized Trust Fund is to make it immune from the political process but still accountable in order to prevent corporate waste and self-dealing. Whenever a corporate entity is present, an agency problem arises, since ownership by the shareholders is separated from control by management.³⁷⁶ The usual methods of policing corporations for self-dealing, mismanagement, and inefficiencies are: (1) shareholder voting rights, (2) market mechanism (i.e., takeovers of inefficient firms), (3) shareholder derivative suits, and (4) government regulation. When the government is the shareholder and the authorizing legislation is not a well-developed body of corporate law but a usually-inadequate federal statute, these controls become moot and leave a void in terms of internal governance and external policing. Moreover, the sole shareholder, the government, would hardly be motivated in prohibiting political influence in the investment decision, since political influence is a distinguishing characteristic of how the government functions. Thus, the agency problem is enhanced, since the actual beneficiaries of the Trust Fund are the taxpayers who paid into the system. The real stakeholders are not the shareholder (the government) but the beneficiary (the American workers who contributed), and those stakeholders do not have even the less-than-perfect policing mechanisms afforded shareholders. Means other than proxies and derivative lawsuits must be crafted to police the corporation. Several models exist both in the public and private spheres to address both of the governance problems. The Canadian Pension Plan Investment Board is held accountable through the authorizing legislation by constraints to ensure that managers only invest in a broadly diversified portfolio of stocks, bonds, and other assets with the view to maximize the wealth of the trust.³⁷⁷ Through a combination of appointment protections and regulations regarding how the Social Security Trust Fund can invest, political influence is lessened, but accountability can be maintained.³⁷⁸

³⁷⁶ Romano, *supra* note 258, at 795.

³⁷⁷ CANADIAN PENSION PLAN INVESTMENT BOARD, ANN. REP. 2005, available at http://www.cppib.ca/info/annual/ar_2005.pdf.

³⁷⁸ It is beyond the scope of this article to detail the legal structures that could be put in place to accomplish both of these goals. I will take up the issue in another article.

A politically viable solution to the Social Security funding process is the Holy Grail of Social Security reform. If a suitable legal structure could be found to prevent politicization but maintain accountability, then a federal government corporation may be the only politically feasible solution for investment of the Trust Fund in the markets. The other two solutions—personal accounts and indexing—are not politically viable. Democrats put the kibosh on private accounts³⁷⁹ and Republicans feel likewise about government investment through an indexing scheme.³⁸⁰ A privatized Trust Fund using the vehicle of a federal government corporation provides a reasonable middle ground approach in which the markets can be leveraged but political influence kept out of the investment process. Both Democrats (as evidenced by the policies of Bill Clinton and Al Gore³⁸¹) and Republicans favor privatization of certain government functions. Privatizing the Trust Fund into a centralized federal government corporation would insulate the fund from the political process in order to maximize investment returns for the benefit of the public.

VI. CONCLUSION

Investing Social Security assets into private investments is sound fiscal and economic policy. Historical returns clearly show that a diversified portfolio outperforms bonds in the long term nearly 100% of the time and does so with less risk of loss than a bond-only portfolio. Given the funding crisis facing Social Security, the mounting federal deficit, and the need to prevent poverty among the elderly, Congress and the President need to find tools to leverage the public and private markets to maximize the value of the assets of the Social Security Trust Fund.

The question is not so much whether to invest in the market, but how to accomplish the task while keeping politics out of the equation. Two solutions have been the focus of the debate, but a third alternative provides an intriguing and politically viable alternative. The first commonly proposed solution to government investing would be to create personal accounts. However, the personal accounts proposals that have been floated have been uniformly criticized for changing the very nature of Social Security and putting some population groups at risk for dramatic cuts in benefits. Moreover, personal accounts proposals are no longer politically

³⁷⁹ Calmes, *supra* note 7, at A1.

³⁸⁰ See generally PRESIDENT'S COMM'N, *supra* note 28.

³⁸¹ Froomkin, *supra* note 354, at 546.

feasible given widespread opposition from both Democrats and Republicans.

A second popular suggestion to keep politics out of the investment process is to use a model like that of the Federal TSP, which uses indexing to automate the investment decision and the prohibition of voting rights to prevent interference in corporate governance. However, such a plan does not leverage diversification into non-public assets such as private equity, real estate, and currencies, which are necessary for a truly diversified, low-risk, high-reward fund. Moreover, passive investing would take a significant shareholder out of the role of corporate governance during a time when corporate managers need more oversight and not less.

A third and more creative approach would be to create a private corporation charged with the public duty to invest social security assets. Such a model has been used successfully by the Canadian Pension Plan and the Alaska Permanent Fund. Federal government corporations are a unique corporate form that present an opportunity to insulate the Trust Fund from the political process. However, government corporations also have a number of challenges in making sure that the corporate structure and appointment of directors comports with the constitutional requirements. Issues of accountability and oversight also arise. The presidential commission convening to study solutions to the funding crisis should study the economic, political, and constitutional impact of privatizing the Trust Fund through the use of a federal government corporation. Attention should be paid to the success of this model in the Canadian system.

Any solution to Social Security funding is going to require the political willpower and the joint cooperation of both political parties in Congress and the President. Such willpower is unlikely to manifest unless there is either “an immediate funding crisis or an unwavering commitment to reform.”³⁸² There is widespread agreement that long-term financing needs to be addressed, and the longer we wait, the fewer options we have, and the more severe the reform must be.³⁸³ Whatever is done about Social Security, it needs to be done quickly.³⁸⁴ By harnessing the investment potential of the fund now, we would take advantage of the time value of money³⁸⁵ in order to grow the fund to meet the needs of future generations.

³⁸² Moore, *supra* note 5, at 289.

³⁸³ *Id.* at 282-83.

³⁸⁴ DAVID M. WALKER, SOCIAL SECURITY REFORM: EARLY ACTION WOULD BE PRUDENT, U.S. Gov't Accountability Office, Publication # GAO-05-397T (2005), available at <http://www.gao.gov/new.items/d05397t.pdf>.

³⁸⁵ Solomon & Berson, *supra* note 6, at 126.