Statement of
Bruce K. MacLaury
Chairman of Subcommittee on Social Security Reform
Committee for Economic Development

Introduction

Thank you Mr. Chairman. My name is Bruce MacLaury. I am President Emeritus of the Brookings Institution and currently serve as Chairman of the Emergency Transitional Education Board for the District of Columbia. However, today I am appearing before this Committee in my capacity as a Trustee of the Committee for Economic Development (CED), a research and policy organization whose Trustees are 210 national business and academic leaders.

At CED I was Chairman of a group of Trustees that spent a year studying Social Security and proposals for reforming the system. In February 1997 we issued a policy statement, entitled ***Fixing Social Security***, that discussed Social Security's problems, specified criteria for evaluating proposed changes in the system, and described an approach to structural reform recommended by CED Trustees. The statement has been distributed to the Committee today.

The specific issue now before this Committee -- the ownership of private corporate stock by Social Security trust funds -- was discussed by the CED subcommittee and addressed in our policy statement (pp. 44 to 47). After careful consideration, **the CED strongly opposed proposals for the Social Security trust fund to invest in the stock of private corporations**. The primary reason for CED's opposition is that federal government ownership of private securities involves an undesirable risk of political interference with private business operations primarily through investment decisions of fund managers and the exercise of stock voting rights. In addition, we believe that government ownership of private securities is a less desirable approach for dealing with the Social Security problem arising from the aging of the American population than for individuals to supplement their retirement savings through tax-deferred Personal Savings Accounts invested in private securities.

Corporate Governance

Advocates of federal government ownership of equity securities issued by private corporations point out that state pension funds have invested in private securities for many years. But the record of these pension funds indicates that they are sometimes used to achieve an unrelated political or social agenda. In some cases, these funds have not been able to avoid political pressures to select investments according to criteria other than the expected return on investments, or to exercise voting rights in a way that is inconsistent with their fiduciary responsibilities. Such behavior can be damaging not only to the pension funds themselves but to economic progress more generally, because it may divert resources away from the most productive uses.

It is quite clear that some state government pension fund managers have become more involved in corporate governance issues than is needed to satisfy their fiduciary responsibilities. Some states have detailed policies pertaining to the exercise of employee pension fund voting rights. For example, the California Public Employee's Retirement System (CalPERS), which is the largest state employee pension fund, has developed comprehensive guidelines on a wide range of governance issues. Although, the guidelines indicate that "...nonfinancial considerations cannot take precedence to pure risk/return considerations in the evaluation of investment decisions," the guidelines specify voting positions in considerable detail with respect to appointments to corporate boards, corporate capital structure, management compensation, and other issues of corporate governance, including limited involvement in corporate social responsibilities. Should any company not meet CalPERS criteria, the Board is authorized to take action including "...as a last resort, liquidation of system holdings in the company, if the sale is consistent with sound investment policy." In a number of instances CalPERS, like other state pensions, has been required by the state legislature to use its power in pursuit of specific social objectives.

There is no reason to believe that the Social Security Administration could avoid political pressures in investment decisions and in the voting of corporate stock. The current debates in Congress concerning appropriate public policy toward tobacco companies offers a glimpse of the possibilities. Indeed, because of its size, special interests would find the Social Security trust fund a more attractive target than state pensions systems. Limiting equity investments to broad-based indexed funds would not eliminate the possibility of political interference, as some have suggested. Congress could simply enact legislation to exclude investments in "inappropriate" activities. Moreover, managers of indexed funds might feel a great need to apply pressure on corporate management when voting stocks, because they could not pursue their fiduciary goals by avoiding investments in particular stocks included in the index.

It has frequently been pointed out that the Thrift Savings Plan (TSP) of the Federal Employee's Retirement System has largely avoided these issues by delegating authority to vote its stock to the Fund Manager. The success of this policy may be due to the fact that the TSP is still a relatively small fund and offers limited investment options. Moreover, it is worth pointing out that the TSP has not been immune from manipulation. In late 1995, when Congress refused to raise the federal debt limit, Treasury Secretary Rubin turned to the TSP for help, delaying interest payments in individual accounts and withdrawing funds from the "G Fund" (government securities) to avoid default on the national debt.

If Social Security invested a significant portion of the trust fund surplus in private securities, these investments would be extremely large, giving the federal government effective controlling interest in many private companies. It is hard to believe that some future Congress would not take advantage of the opportunity to achieve political and social objectives through these investments. The potential adverse effects could be severe, given the size of the Social Security system.

Investing in private securities without other actions would only postpone need to liquidate trust fund balances by a few years. Moreover, if Social Security first invested, then disinvested, in private equities as would be required, equity markets would be whip-sawed, at best, and at worst the markets would be devastated if disinvestment occurred during a decline in the market.

Budget

The objective of investing Social Security trust fund balances in private securities is to improve the fiscal position of the system. Based on long-term historical trends, the return on a stock portfolio is expected to exceed the return on the Treasury's special issues, now held by the trust funds. But, as noted above, a portfolio of corporate stocks would merely provide temporary relief and postpone bankruptcy. Furthermore, higher returns are associated with higher risks; there is no guarantee that the performance of a stock portfolio -- including a broad-based, indexed portfolio -- will match past experience.

More importantly, although investments in equities could improve the fiscal position of the Social Security system, the federal government's overall fiscal position would not change when looked at from an economic perspective. Because Social Security surplus funds will no longer be available to finance other spending, the Treasury would find it necessary to issue additional debt to the public, unless other spending were cut or taxes raised. The government (as a whole) would be neither richer nor poorer because it would merely exchange additional public debt for private stock. But with present budgetary conventions, the purchase of corporate equities by the trust funds would be recorded as an outlay in the federal budget, which would raise the reported unified budget deficit. (The unified budget is intended to provide a guide to future borrowing by the Treasury). This fact has led some to propose a change in budgetary definitions to discontinue the practice of classifying the purchase of equities as an outlay. One problem with this idea is that other more questionable "investments" might also be excluded from outlays, leading to much budgetary mischief.

In any case, equity investments by the Trust Fund would not be a "free lunch" for society: the higher returns on equities would be transferred from private holders of equities to the Trust Fund. The increased sale of Treasury debt to the public might also raise interest rates and the cost of public borrowing by the Treasury.

National Saving

CED believes that it is critically important that Social Security reform generate a significant increase in national saving. Increased saving will raise worker productivity, and a larger economic pie will make it easier for a reduced ratio of future workers to bear the burden arising from an aging population. This criterion was a very important consideration in the choice of recommendations contained in ***Fixing Social Security***.

The proposal for Social Security to invest in equities fails to raise saving at all. The purchase of equities by the Social Security Administration does not in itself affect the government's net fiscal position. Nor would it directly affect private saving. Equity investing would not enlarge the national economic pie.

Conclusion

Mr. Chairman, I conclude that there are far better proposals for fixing Social Security than the proposal for the trust funds to invest in corporate stocks. The proposal put forth by CED, for example, would simultaneously restore Social Security's solvency and raise national saving and, thereby, reduce the burden on future generations -- all without jeopardizing the independence of private industry.