

## COMMENT ON NEIL H. BUCHANAN'S *SOCIAL SECURITY AND GOVERNMENT DEFICITS: WHEN SHOULD WE WORRY?*

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Professor Neil Buchanan is not alone in questioning whether a Social Security funding crisis actually exists. Despite widely accepted predictions by the Social Security Administration, there is a small but growing cadre of respected scholars who are rightly skeptical of actuarial figures geared to motivate policymakers toward a certain political agenda.<sup>1</sup> However, even if Professor Buchanan and others are correct that there is no funding crisis, does that preclude prudent policymakers from applying sound money management principles to invest the Social Security Trust Fund in higher-performing assets?

Professor Buchanan prefers to maintain the status quo as regards structural changes to Social Security financing, though he suggests that a more progressive FICA tax would fulfill distributive justice objectives. These objectives are legitimate, but policymakers should couple any such strategy with a rethinking of how we invest the Social Security Trust Fund. The 1983 amendments, which created the current Trust Fund, transformed Social Security's financing from a purely nonfunded system to a partially funded system.<sup>2</sup> If Professor Buchanan is right about the funding needs of Social Security, then an opportunity exists through prudent investment to move to a fully funded system without painful tax hikes or benefit cuts.

Full-funding proposals merely suggest that policymakers move the Trust Fund's assets—about \$1.9 trillion as of the writing of this Comment<sup>3</sup>—out of low-performing government bonds<sup>4</sup> into a diversi-

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<sup>1</sup> See, e.g., Paul Krugman, *Confusions About Social Security*, 2 *ECONOMISTS' VOICE*, Dec. 2004, at 1, 1, <http://www.bepress.com/ev/vol2/iss1/> (contending that Social Security is relatively well funded and other government spending has created the funding crisis).

<sup>2</sup> See SYLVESTER J. SCHIEBER & JOHN B. SHOVEN, *THE REAL DEAL: THE HISTORY AND FUTURE OF SOCIAL SECURITY* 5 (1999).

<sup>3</sup> THE 2006 ANNUAL REPORT OF THE BOARD OF TRUSTEES OF FEDERAL OLD-AGE AND SURVIVORS INSURANCE AND FEDERAL DISABILITY INSURANCE TRUST FUNDS, H.R. DOC. NO. 109-103, at 2 (2006), available at <http://www.ssa.gov/OACT/TR/TR06/tr06.pdf>.

<sup>4</sup> Professor Buchanan adopts the popular view that government bonds are the safest investment in the world, but Standard & Poor's Ratings Services recently warned that the United States is in danger of losing its credit rating and could drop to junk bond status by

fied portfolio of stocks, bonds, and other assets.<sup>5</sup> Over the long term, these investments would build a reserve that would transition the PAYGO system<sup>6</sup> toward a “savings” model—where the government invests contributions in the present to pay out benefits in the future.<sup>7</sup> By leveraging the private markets and the time value of money, fewer taxes will be required to pay the same amount of benefits.<sup>8</sup> Such a move could have a dramatic effect on Social Security’s funding requirements. Estimates vary, but economists Barry Bosworth and Gary Burtless predict that if seventy percent of the Trust Fund were invested in the equities market, the predicted tax rate hikes could be delayed for as long as fifty-three years.<sup>9</sup>

Higher market returns was one of the principal arguments that lobbyists marshaled in favor of private accounts.<sup>10</sup> However, Democrats, in their efforts to halt the privatization of Social Security, demonized market investments as being too risky.<sup>11</sup> The public debate over private accounts has, in effect, made all such investments suspect, including those made by a centralized Trust Fund. Though market risk makes the return on private accounts uncertain since individuals might lose their savings over the course of a lifetime, the government can reduce such risk by spreading investments throughout several generations. Over long periods of time, a diversified portfolio will not

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2025 if the government does not stop deficit spending. See Serena Ng, *U.S. Could Lose Top Rating—By 2012*, WALL ST. J., Jun. 7, 2006, at C6.

<sup>5</sup> Most full-funding proposals assume that the actuarial predictions are correct, so in addition to prudent, diversified investment, such proposals usually include some increase in taxes and cuts in benefits. See, e.g., Laurence S. Seidman, Special Report, *Funding Social Security*, 81 TAX NOTES 241, 242 (1998) (advocating a gradual payroll-tax increase and slow-down in benefits as part of a funded program).

<sup>6</sup> With a pure “pay as you go” financing system (or “PAYGO” system), the government does not save or invest funds but transfers funds from workers to retirees. See SCHIEBER & SHOVEN, *supra* note 2, at 71. Therefore, the total benefits that the government pays out year-to-year must equal the revenues that the government takes in. See *id.* at 72. Such a system involves a small trust fund to aid in years when revenues do not match benefits. See *id.*

<sup>7</sup> See *id.* at 243.

<sup>8</sup> See *id.*

<sup>9</sup> Barry Bosworth & Gary Burtless, *The Effects of Social Security Reform on Saving, Investment, and the Level and Distribution of Worker Well-Being* 6 (Ctr. for Ret. Research at Boston Coll., Working Paper No. 2000-02, 2000), [http://www.bc.edu/centers/crr/papers/wp\\_2000-02.pdf](http://www.bc.edu/centers/crr/papers/wp_2000-02.pdf).

<sup>10</sup> See, e.g., PRESIDENT’S COMM’N TO STRENGTHEN SOC. SEC., STRENGTHENING SOCIAL SECURITY AND CREATING PERSONAL WEALTH FOR ALL AMERICANS 35–36 (2001), [http://www.csss.gov/reports/Final\\_report.pdf](http://www.csss.gov/reports/Final_report.pdf); MICHAEL TANNER, CATO PROJECT ON SOC. SEC. CHOICE, THE BETTER DEAL: ESTIMATING RATES OF RETURN UNDER A SYSTEM OF INDIVIDUAL ACCOUNTS 18 (2003), <http://www.cato.org/pubs/ssps/ssp31.pdf>.

<sup>11</sup> See, e.g., DEMOCRATIC NAT’L COMM., STRONG AT HOME, RESPECTED IN THE WORLD: THE 2004 DEMOCRATIC NATIONAL PLATFORM FOR AMERICA 26 (2004), <http://www.democrats.org/pdfs/2004platform.pdf> (“Democrats believe in the progressive, guaranteed benefit that has ensured that seniors and people with disabilities receive a benefit not subject to the whims of the market or economy.”).

only outperform a portfolio composed of bonds; it will do so with less risk. In studying 200 years of market data, Professor Jeremy Siegel found that over seventeen-year periods, stocks have never had a negative return;<sup>12</sup> the interest rate paid on bonds, however, may be outpaced by inflation, and therefore bonds, during some periods, had a negative real rate of return.<sup>13</sup> In fact, during thirty-year periods, stocks outperformed bonds more than ninety-nine percent of the time.<sup>14</sup> While the market may be too risky for private accounts, when considering the central Trust Fund, it is actually less risky to invest in a diversified portfolio where the risk is spread over several generations.

While economists do not dispute the economic upside of a diversified portfolio,<sup>15</sup> the political question of how the government should invest the Trust Fund is quite controversial. Indeed, politicians have debated the possibility of investing government funds in private markets nearly as long as Social Security has been in existence.<sup>16</sup> Republicans and libertarians are concerned that if the government invests Trust Fund assets, it will engage in politically motivated social investments<sup>17</sup> and interfere in corporate governance.<sup>18</sup> Further, they worry that there is an inherent conflict of interest where the government is both an investor and a regulator of commerce.<sup>19</sup> Most commentators on this matter have considered only two solutions to the problem of government investment: passive investing<sup>20</sup> and private accounts.<sup>21</sup> Both solutions address the fundamental problems of government involvement in private investment, but neither is politically viable. President Bush's private accounts proposal ran into opposition from both

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<sup>12</sup> See JEREMY J. SIEGEL, *STOCKS FOR THE LONG RUN* 26–28 (3d ed. 2002).

<sup>13</sup> See *id.* at 26.

<sup>14</sup> See *id.* at 27.

<sup>15</sup> Economists universally agree in theory that a diversified portfolio is a less risky investment than a portfolio invested only in bonds. See, e.g., Peter A. Diamond, *The Economics of Social Security Reform*, in *FRAMING THE SOCIAL SECURITY DEBATE* 38, 39–40 (R. Douglas Arnold et al. eds., 1998).

<sup>16</sup> See Lewis D. Solomon & Bryan L. Berson, *Private Market Reforms for Social Security: A Comprehensive Guide for Composing Reform Legislation*, 11 S. CAL. INTERDIS. L.J. 117, 123 (2001).

<sup>17</sup> Social investing is a values-based investment strategy that seeks, in broad terms, to invest in assets that promote social purposes such as environmentally friendly companies. See Theodore J. Angelis, *Investing Public Money in Private Markets: What Are the Right Questions?*, in *FRAMING THE SOCIAL SECURITY DEBATE*, *supra* note 15, at 287, 290–92. Both anecdotal and empirical data suggest that “social investing may adversely affect fund performance.” Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 828–29 (1993).

<sup>18</sup> See SCHEIBER & SHOVEN, *supra* note 2, at 347–51 (1999).

<sup>19</sup> See *id.* at 348.

<sup>20</sup> Passive investing, also known as indexing, is an investment strategy where investors automatically invest their funds in a broad-based stock market index such as the Russell or Wilshire indexes. See SIEGEL, *supra* note 12, at 51–52, 351–52.

<sup>21</sup> See, e.g., Angelis, *supra* note 17, at 287–88 (focusing on these two solutions).

Democrats and Republicans.<sup>22</sup> Conservative policymakers are adamantly opposed to any solution—passive or active—where the government makes the investment decision.<sup>23</sup> A third solution that has not received as much attention is to form a private government corporation for the public purpose of investing the Trust Fund in the market. The State of Alaska employs this model to invest oil and gas revenues,<sup>24</sup> and Canada uses it for administering the nation's social insurance system.<sup>25</sup>

Historically, the United States—more than other governments—has trusted the markets and private corporations to make decisions of “national importance.”<sup>26</sup> As early as the eighteenth century, the U.S. government was a shareholder in private corporations whose purpose was to carry out public functions.<sup>27</sup> During the twentieth century, federal and state agencies commonly used government-owned corporations because the corporation could take advantage of private sector business practices better than the public entity under which it operated.<sup>28</sup> Particularly in the government's management of the personal finances of taxpayers, using the federal government corporation as an entity to manage funds is almost the norm.<sup>29</sup>

Political insulation is probably the paramount reason to privatize the Social Security Trust Fund. President George W. Bush could not have been clearer: Republicans are adamant that the government stays out of the investment business.<sup>30</sup> Consequently, the only politically feasible route to harnessing the private markets to help grow the Social Security Trust Fund is to take the investment decisions out of the hands of the government. By moving the Trust Funds assets into a

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<sup>22</sup> See Jackie Calmes, *Elephant in the Room: Budget Wish Lists Come and Go, but 'Entitlements' Outweigh All*, WALL ST. J., Feb. 3, 2006, at A1.

<sup>23</sup> See *Investing in Private Markets: Hearing Before the Subcomm. on Social Security of the H. Comm. on Ways and Means*, 106th Cong., 41–43 (1999) (statement of Michael Tanner, Director, Health and Welfare Studies, Cato Institute), available at [http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=106\\_house\\_hearings&docid=f:57507.pdf](http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=106_house_hearings&docid=f:57507.pdf).

<sup>24</sup> See, e.g., Joan Kasson, *The Creation of the Permanent Fund: A Short History*, TRUSTEES' PAPERS, Feb. 1997, available at <http://www.apfc.org/reportspublications/TP5-2.cfm>.

<sup>25</sup> See CANADIAN PENSION PLAN INV. BD., ANNUAL REPORT 13 (2006), [http://www.cppib.ca/info/annual/ar\\_2006/pdf/CPPIB\\_Annual\\_Report\\_2006.pdf](http://www.cppib.ca/info/annual/ar_2006/pdf/CPPIB_Annual_Report_2006.pdf).

<sup>26</sup> A. Michael Froomkin, *Reinventing the Government Corporation*, 1995 U. ILL. L. REV. 543, 633.

<sup>27</sup> See, e.g., *Lebron v. Nat'l R.R. Passenger Corp.*, 513 U.S. 374, 386–91 (1995) (tracing the history of government-chartered corporations by discussing the creation of the Bank of the United States in 1791, an entity in which the government was a 20% subscriber).

<sup>28</sup> See Froomkin, *supra* note 26, at 546, 557–59.

<sup>29</sup> For example, consider the Federal Deposit Insurance Corporation, Federal Home Loan Mortgage Corporation (Freddie Mac), the Federal Agricultural Mortgage Corporation (Farmer Mac), and the Student Loan Marketing Association (Sallie Mae).

<sup>30</sup> See PRESIDENT'S COMM'N TO STRENGTHEN SOC. SEC., *supra* note 10, at 13 (adopting as one of the President's principles that the government should be prohibited from investment).

private corporation, professional money managers, rather than politicians, would invest the assets in a broadly diversified portfolio of stocks, bonds, and other assets.

The use of federal government corporations is not without controversy. In general, privatization of government services for such things as prisons, schools, and the delivery of welfare benefits have raised normative questions in academia.<sup>31</sup> The specific use of federal government corporations for public purposes has also raised constitutional questions, including those involving the state action doctrine, the non-delegation doctrine, and the Appointments Clause.<sup>32</sup>

In the authorizing statute, Congress can easily settle the threshold question of whether a federal government corporation is a state actor and therefore subject to constitutional restraints when wielding power. It need only concede that the privatized Trust Fund is akin to a state agency for constitutional purposes. Since the privatized Trust Fund would not engage in any investigatory, regulatory, or rulemaking function, it is unlikely that the entity would infringe on the protections that the Constitution affords citizens. In this manner, concerns scholars have raised over current federal government corporations would be irrelevant for a privatized Trust Fund. While some risk exists that political influence would seep into the process through the political appointment of directors of the privatized Trust Fund,<sup>33</sup> legislation could specify minimum requirements so that only financial professionals would be eligible.

This then leaves the thorny problem of policing the corporation. By moving \$1.9 trillion into a private entity, would we be creating the potential for a rogue economic power? Federal government corporations may enhance the agency problem that complicates corporate governance in the private sector. Typically, oversight of corporate-manager inefficiency and self-dealing is accomplished through board of directors' oversight,<sup>34</sup> shareholder voting rights,<sup>35</sup> derivative lawsuits,<sup>36</sup> market takeovers,<sup>37</sup> and government regulation.<sup>38</sup> A federal government corporation presents the challenge of preventing un-

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<sup>31</sup> See, e.g., Gillian E. Metzger, *Privatization as Delegation*, 103 COLUM. L. REV. 1367 (2003).

<sup>32</sup> See Donna M. Nagy, *Playing Peekaboo with Constitutional Law: The PCAOB and Its Public/Private Status*, 80 NOTRE DAME L. REV. 975, 1031–60 (2005).

<sup>33</sup> Comporting with the Appointments Clause of the Constitution would require the President to appoint the directors with the advice and consent of the Senate, since it is unlikely that the managers of a \$1.9 trillion trust fund would be considered "inferior officers" under the Constitution. See U.S. CONST. art. 2, § 2.

<sup>34</sup> See Froomkin, *supra* note 26, at 587.

<sup>35</sup> See *id.* at 585–86.

<sup>36</sup> See *id.* at 591.

<sup>37</sup> See *id.* at 577.

<sup>38</sup> See *id.* at 627.

wanted political influence onto the corporate regime. The usual mechanisms of director oversight, shareholder voting, and derivative suits may be ineffective corporate governance tools when the goal is to prevent the politicization of the investment process. Market takeovers are irrelevant since the government is the sole shareholder. The final remaining control becomes government regulation—the extent to which a revised Social Security Act provides for regulation of the entity.

Fortunately, we have a successful model in the Canadian Pension Plan Investment Board Act.<sup>39</sup> There are lessons we can learn about government corporation control and the depoliticization of the investment process by examining the Canadian system. For example, the authorizing legislation could require broad diversification with limits on asset classes, types of investment, and holding percentages.<sup>40</sup> The recently convened presidential commission on Social Security would be wise to consider whether the Canadian solution would work for the United States.

Moving the Trust Fund into a diversified portfolio not only makes economic sense, but the use of a private government corporation vehicle makes it politically viable. Republicans should be amenable to the concept since it advances key policies of the party—leveraging market solutions and applying the principles of privatization.<sup>41</sup> Democrats should support it since it keeps the centralized Trust Fund intact and avoids private accounts, thus aiming to maintain the level of benefits currently paid out. It is notable that Franklin D. Roosevelt, the biggest proponent of Social Security,<sup>42</sup> also oversaw the increased use of federal government corporations during the 1930s and 1940s.<sup>43</sup> It would be fitting if current policymakers advanced Roosevelt's vision of social insurance by using one of his standard tools to create efficiency in government.<sup>44</sup>

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<sup>39</sup> CANADIAN PENSION PLAN INV. BD., *supra* note 25.

<sup>40</sup> For example, the Canadian government promulgates regulations mandating that the Canadian Pension Plan Investment Board seek investments that maximize returns without incurring undue risk and limit holdings in any one asset. See *Pension Plan Investment Board Regulations*, CANADA GAZETTE (PART II), May 12, 1999, at 1235, available at <http://canadagazette.gc.ca/partII/1999/19990512/pdf/g2-13310.pdf>; CANADIAN PENSION PLAN INV. BD., POLICY ON RESPONSIBLE INVESTING 2 (2005), [http://www.cppib.ca/files/PDF/policies/policies/Responsible\\_Investing\\_Policy.pdf](http://www.cppib.ca/files/PDF/policies/policies/Responsible_Investing_Policy.pdf). This mandate results in an investment strategy which maximizes diversification. See CANADIAN PENSION PLAN INV. BD., *supra* note 25, at 8.

<sup>41</sup> See REPUBLICAN NAT'L COMM., 2004 REPUBLICAN PARTY PLATFORM: A SAFER WORLD AND A MORE HOPEFUL AMERICA, <http://www.gop.com/media/2004platform.pdf> (laying out the GOP's economic policy goals, including such market-based proposals as personal retirement accounts, health savings accounts, and school vouchers).

<sup>42</sup> See SCHIEBER & SHOVEN, *supra* note 2, at 26.

<sup>43</sup> See *Lebron v. Nat'l R.R. Passenger Corp.*, 513 U.S. 374, 388–89 (1995).

<sup>44</sup> See Froomkin, *supra* note 26, at 580.