Policy Analysis

Cato Institute Policy Analysis No. 236: Whose Pension Is It Anyway? Economically Targeted Investments and the Pension Funds

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Executive Summary

The "new ethic of stewardship," touted by Secretary of Labor Robert B. Reich in an attempt to justify "economically targeted investments" (ETIs), is a highly questionable effort to promote the use of private pension funds for risky public purposes. Under the common law, trustees, in addition to being generally prudent in the discharge of their duties, must act solely in the interest of the participants with the exclusive purpose of obtaining tangible benefits for them and their beneficiaries. The Employee Retirement Income Security Act (ERISA) of 1974 sought to safeguard private pension funds by codifying those duties. Reich now seeks to undermine the statute by proposing that trustees invest in ETIs, which might have some "ancillary" or "collateral" benefits for the economy as a whole. Clearly, such an approach contravenes both the letter and the spirit of ERISA.

There are also economic problems with ETIs. The Department of Labor insists that ETIs will bring a risk-adjusted rate of return equal to or higher than that of traditional investments. Study after study, however, has shown that ETIs generally produce a subpar rate of return.

The public pension funds can ill afford philanthropy. Vulnerable to political pressures and unprotected by ERISA, a significant number of them are substantially underfunded. ETIs will further compromise funds that already show strain, leading to reductions in benefits or to higher taxes.

Careful investment designed solely to benefit plan participants, whether in the public or the private sector, should be the exclusive objective of all pension fund managers. Congress should nip in the bud the Department of Labor's ETI initiative by passing the Pension Protection Act of 1995.

Introduction

The honey pot of $4.8 trillion in pension funds has proved irresistible to stalwarts of the Clinton administration. In September 1994 Secretary of Labor Robert B. Reich outlined his department's plan to bolster "a new ethic of stewardship," which "retains the conventional imperative of financial return yet also casts a wider net in the search for good investments."[1] He claimed that economically targeted investments (ETIs) would benefit not only retirees but the economy as a whole and thus, indirectly, the well-being of pensioners.

The secretary has also recommended that pension funds monitor the workplace, looking for companies with superior workplace performance and above-average returns. Reich went on to suggest that funds intervene by "exercising the corporate vote" to help the bottom line. Funds adhering to such guidelines would do well by doing good; that is, they would boost not only returns to the funds, and their participants and beneficiaries, but also the vitality of the economy as a whole.

Although Reich is careful to distinguish "economically targeted" from "social" investing--arguing that the latter permits the subordination of profit to other concerns, whereas ETIs would simply seek "collateral benefits" that would be "in addition to, not instead of," a competitive rate of return--there may be room for doubt.

Rep. Jim Saxton (R-N.J.), then a member and now vice chairman of the Joint Economic Committee, certainly seemed to think there was. In a letter to the Wall Street Journal, he noted that Reich's effort to establish a boundary between social investing and ETIs amounted to a "distinction without a difference." He then catalogued several egregious investment failures of the public employee pension funds.[2]

After enumerating analyses demonstrating that public pension funds invested to promote targeted social or economic goals run greater risks and produce lower yields than funds not so invested, Saxton went on to excoriate ETIs as "politically targeted investment." Retirees suffer from the lower returns on such investments, and, ultimately, if the funds cannot keep their promises, the taxpayers will have to pay. Despite those problems, the Department of Labor was moving to establish an "ETI clearinghouse" to promote investments the returns on which are, at best, uncertain.

In defense, Secretary Reich wrote a letter to the Journal claiming that the purported raid on pension funds "just ain't so." Insisting once again that ETIs represented a horse of a different color, he claimed that they would "provide pension funds with competitive, riskadjusted rates of return plus ancillary benefits, such as affordable housing, infrastructure improvements and jobs."[3] Significant successes, among them the housing construction program of the California Pubic Employees Retirement System (CalPERS), the secretary asserted, eclipsed the failures cited by Saxton; the studies cited by Saxton were far from conclusive. Reich concluded by insisting that pension plan officials, not the government, would make all investment decisions.

The Evidence

The secretary protests too much. Evidence of a raid on the pension funds has been growing since President Clinton promised during his 1992 campaign to create a $20 billion "Rebuild America Fund" for federal investment in infrastructure leveraged with private and public pension funds. The controversy touched off by Secretary Reich simply brought to public attention federal and local efforts to subvert the common law doctrine of fiduciary responsibility and long-established principles of trust law by tapping the pension funds for political purposes. Henry Cisneros, secretary of the U.S. Department of Housing and Urban Development, sent up a trial balloon to that effect in August 1994 when he announced a "precedentsetting initiative to attract pension fund investments to housing for lowincome people."[4] Six pension funds had agreed to invest in affordable housing projects, developed under HUD's Section 8 program, the rental income from which would be guaranteed in part by a $100 million federal grant. The secretary was seeking to expand the project and hoped that eventually pension funds would invest without federal backing. He went on to assert that "pension investments in affordable housing are as safe as pension investments in stocks and bonds and will earn pension funds at least as good a return." Given the sorry state of federally subsidized housing projects, fiduciaries are extremely unlikely to make such investments without a government (i.e., taxpayer) guarantee.

Despite risks in housing that would give a prudent investor pause, Assistant Secretary for the Pension and Welfare Benefits Administration E. Olena Berg was quoted as claiming that participation by pension funds in the affordable housing initiative was "totally consistent" with the fiduciary responsibilities of the funds under the Employee Retirement Income Security Act (ERISA) of 1974, intended to safeguard private pension funds from encroachment.[5] That the funds taking part in the HUD initiative were all public funds, which operate differently, seems to have given her no pause.

The same report cited HUD assistant secretary Nicolas Retsinas as asserting that his office was being "flooded" with applications from pension funds "eager to participate in the program." The phrase brings irresistibly to mind the doomed oysters of "The Walrus and the Carpenter," who rushed up "all eager for the treat," only to be eaten, and illustrates once again the veiled power of federal initiatives. Ignoring or soft-pedaling risk, pension funds, whether public or private, may well elect to participate in order to conciliate the government. That possibility underlines the need for the strongest of federal guarantees and the inherent danger of weakening the legislation enacted to safeguard the savings of millions of workers.

A Matter of Definitions

Before embarking on the choppy seas of policy debate, it may be useful to map more carefully the universe of the pension funds. The first major division lies between public and private funds. Governmental entities, whether federal, state, or local, establish public pension funds for their employees. Unionization in that sector is estimated to reach 40 percent by the year 2000; public funds are expanding in tandem with unionization and so are the pressures to invest in a "socially responsible" manner.

The pension plans of corporations, small businesses, foundations, and universities fall into the private domain. Members of the AFLCIO, with plans established jointly by the union and one or more employers, constitute another important element in the private sector.[6] Although technically in the private domain, unionsponsored plans resemble public-sector plans in their sensitivity to political pressures. The AFL-CIO's Housing Investment Trust, for example, is participating in the HUD venture.[7]

The second major division is between types of plans. Under a defined benefit plan, a company guarantees a pension, according to a formula based on salary and years of service, that is independent of the value of the assets of the fund. Although the benefits generally vest after five years, meaning that the employee has the right to receive a pension even if he leaves the company, his account is not segregated and assets attributable to him are not portable. An employee may find employment and a new pension plan elsewhere, but control of the assets in the first pension fund remains with that plan's trustees.

In contrast, the foundation stone of the defined contribution plan is the segregated account. The pension of a person who works for an employer who chooses to create such a plan depends ultimately on the value of the financial assets in the worker's account and may fluctuate with the market. Generally, both employer and employee contribute to such a plan; whatever its structure, however, the employee owns his own contributions immediately and can take them with him to a new employer.[8] Some of those plans do an end- run around political pressures, since the participants control the funds.[9]

Although defined benefit plans dominate the public sector, 457 plans, the equivalent of defined contribution plans, such as 401(k)s, in the private sector, have established a strong and growing foothold. Those plans now cover 1.7 million participants and hold roughly $50 billion in assets. CalPERS administers the largest 457 plan with nearly 600,000 participants and $1.8 trillion in defined contribution assets.[10] The state controls those funds, however, and can tap them to finance a pet governmental project. Small wonder that CalPERS so often finds itself in the federal spotlight.

Historical Background

In the early 1970s defaults by a number of companies with underfunded pension plans, in particular Studebaker Packard and RaybestosManhattan, which closed plants and failed to pay all the benefits on which their workers were depending, highlighted the importance of pension security.[11] Hearings revealed "such abuses as excessive investments in employer stock, absence of diversification, and use of plan assets for the benefit of plan fiduciaries," which led in 1974 to the passage of ERISA, designed to protect private retirement plan assets.[12]

The act codified long-standing common law principles of trust law and set key federal standards governing the investments of private pension plans. Its central provision, section [404](a)(1)(A), stipulates that "a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and(A) for the exclusive purpose of: (i) providing benefits to participants and their beneficiaries."[13]

The statute reinforced the "prudent man" doctrine of trust law by specifying in section [404](a)(1)(B) that the fiduciary "shall discharge his duties" with the care, skill, prudence, and diligence that a prudent man "would use in the conduct of an enterprise of a like character and with like aims." The prudent man diversifies his investments to minimize the risk of loss. The legislation created a federal insurance agency, the Pension Benefit Guaranty Corporation (PBGC), to act as a backstop for failed defined benefit plans.

Public pension plans, those established by states and municipalities, enjoy no such guarantees. Certain legal constraints do, however, apply. The common law fiduciary standard as enunciated by the Restatement of the Law differs very little from that of ERISA.[14] In particular, the common law prudent investment standard applies to the trustees of public funds, who therefore cannot escape liability for hazardous investments.[15] Nevertheless, the public plans, which are controlled by the establishing entity, present an inviting target for state and local officials facing budgetary difficulties or anxious to curry political favor. While holding the line on wages, for example, an official can "sweeten" labor contracts with promises of generous pension benefits to be paid, of course, by his successors.

The Public Sector at Risk

In summary, it is important to remember that even the defined contribution, or 457, plans are vulnerable to governmental marauders. Like the public sector's defined benefit programs, 457 plans are not common law trusts in the accepted meaning of the term. The state, the county, or the municipality still owns the investments and can tap the assets to meet a financial "emergency," such as the need for new snow plows, or to fund a pet governmental project.

It should come as no surprise, therefore, that the vast majority of ETIs are found in the public sector. With the exception of the AFLCIO Housing Trust, the examples enumerated by Secretary Reich are all public pension plans. They represent only $1.4 trillion of the total; the administration would like to tap into the other $3.4 trillion in private pension funds.

The Legislative Obstacle

ERISA bars the way. The Department of Labor and HUD have found the clearly enunciated requirements of "solely" and "exclusive" most inconvenient and have been doing their best to circumvent the restrictions. On June 22, 1994, to assuage the compunctions of pension fund managers who might feel uneasy about considering factors other than the sole interest of their participants and beneficiaries and might even fear running afoul of ERISA, the Department of Labor unveiled Interpretive Bulletin 941, which set an official seal on ETIs. To give it color of legitimacy, the bulletin was made retroactive to January 1975, the effective date of ERISA. Nothing had changed, it was suggested; the bulletin simply clarified existing law. To extend its reach, the Department of Labor had two weeks earlier requested proposals for a clearinghouse to collect and disseminate information on ETIs in the hope of encouraging fiduciaries and pension fund managers to make "appropriate" investments.[16]

Called upon to promote that policy before the Joint Economic Committee, at a time when the committee was dominated by Democrats who favored the initiative, Reich began by declaring that the interpretive bulletin had changed nothing at all. He stated that ERISA forbids "social investing," that is, investment entailing the sacrifice of a "comparable, riskadjusted rate of return," since the "first and primary and foremost obligation" of private pension funds is to invest on behalf of their participants. The secretary then made an adept volte-face by enunciating "another proposition which is equally true": provided that the alternatives have similar values of risk to return, it is "entirely permissible for private pension funds to seek out economically targeted investments that have corollary, ancillary benefits to the economy overall." Such investments, in "affordable housing," in "infrastructure," in "startup companies," would benefit not only the beneficiaries but the country as a whole, albeit indirectly.[17]

Reich's testimony on affordable housing, however, had an internal inconsistency. After noting that it "can be a very, very good investment," provided that the fiduciary invests "at that rate which provides a return comparable to alternative prudent investments with similar levels of risk," the secretary added that there would be a "social, ancillary, economic benefit."[18] The evidently inadvertent inclusion of "social" betrays Reich's underlying philosophy and the fundamental purpose of the interpretive bulletin, namely, the promotion of supposedly forbidden social investments.

The Orwellian exercise in definitions continued throughout the hearing. Olena Berg, who had been deputy treasurer of California responsible for CalPERS under Kathleen Brown, reinforced the secretary's testimony. She emphasized the "flexibility" of the statute and the willingness of the department as a long-standing principle of policy to countenance a wide spectrum of investments under ERISA. She also managed to redefine the "prudence standard" by noting that the department had "adopted a broad interpretation of that term precisely for the purpose of encouraging plan fiduciaries to look beyond traditional types of investment."[19] Presumably, the ETI clearinghouse, put forward by Reich, would help them to do so. Once educated (or indoctrinated) concerning their proper role, the fiduciaries could advance fearlessly into the terrain of nontraditional investment.

Clearly, Berg's intent was to soothe the anxieties of Jim Saxton and those responsible for managing private pension funds. Nothing had changed; the goal of the department's interpretive bulletin was simply "to clarify and consolidate" its position "into one easy document" accessible to all in the pension community. The bulletin would put to rest the concerns of pension fund managers that ETIs would conflict with their fiduciary duty.

The semantics of "solely" and "exclusive" led to a pointed exchange between Saxton and Reich. Saxton emphasized the apparent conflict between ERISA's "solely" and "exclusive purpose" and the Department of Labor's interpretation of the statute to mean "first and primary purpose," a reading that would allow the "collateral benefits" under discussion. The secretary denied the glissando in interpretation, insisting that "this is a mere codification" posing no threat to the fiduciary standard of ERISA. Only when a fiduciary stood at the "riskreturn frontier" was it permissible for him "to consider the collateral effects on the economy as a whole."[20]

Berg entered the fray to point out that "exclusive" did not really mean "exclusive." The department's interpretation of the statute allowed the consideration of ancillary factors, provided that the fiduciary lived up to his obligation to obtain the best possible rate of return. With Sen. Barbara Boxer (D-Calif.), who chaired the hearing, she shared the questionable assumption that one investment could equal another. Citing "methodological problems," Berg brushed off the objection raised by Saxton that one study, at least, showed substandard returns for ETIs. She begged his question about a possible limitation on the percentage of funds a pension plan could put in ETIs, asserting only that ERISA's requirement for diversification provided a safeguard against overinvesting in ETIs.[21]

Affirming his conviction that "affordable housing and community investments can be made safe and attractive for even the most careful of fund investors," HUD secretary Cisneros elaborated on the scheme later outlined in the Journal article. HUD was trying to build lowincome housing through joint ventures with pension funds. Initially $100 million of "the government's money" would leverage the investments of public-sector retirement plans in construction. The government's money, of course, is the taxpayer's dollar, a fact of which the secretary seemed unaware. HUD would also be "looking around for additional capital sources," among them foundations, universities, and religious endowments. In other words, no plan would be safe. Like Reich, Cisneros spoke glowingly of superior returns and of opportunities awaiting pension funds willing to use their assets to meet "key economic and social needs."[22] A fundamental question raised by the testimony of both secretaries remained unanswered: if the opportunities are so good, why has the private sector not rushed in to take advantage of them? It is, instead, conspicuously absent.

The lower rate of return on socially beneficial investments may explain the hesitancy. Following an outline of rosy scenarios in New York, Pennsylvania, and California, Saxton noted a study showing that funds with ETIs earned returns two to five percentage points lower than funds without ETIs.[23] Cisneros claimed that he had never seen the data and was thus unable to respond.

After a morning filled with bonhomie, William Niskanen, chairman of the Cato Institute in Washington, D.C., found himself relegated to the closing moments of the hearing. He said that the new bulletin "was either meaningless or mischievous--meaningless if it does not weaken the strict ERISA standards, mischievous if it does"--and pointed out that plan participants would lose if political pressures were brought to bear on pension managers. Echoing Saxton, he noted that several studies have shown lower rates of return for public-sector plans with ETIs than for those without them. Although individual investments could have a higher yield, average returns have been lower.

Niskanen also stressed a critical point: if government, whether federal, state, or local, stepped in to make up a shortfall, the ultimate loser would be the taxpayer. Rather than commandeer pension funds, those who believe in the value of economically targeted projects should use their own funds to support them. Otherwise, he admonished the committee, "Keep your sticky fingers off my pension fund."[24] Finally, Niskanen added, "May I caution you against thinking this $4 trillion is a fund for government to allocate. It doesn't belong to the government. It doesn't belong to the taxpayers. It belongs to the plan participants."[25] It seems doubtful that the representatives of the current administration would agree.

The Fortress of the Common Law

Secretaries Reich and Cisneros, in their attempts to foist ETIs on unsuspecting plan participants, are attempting to subvert the long-established common law doctrine of fiduciary responsibility as defined by the law of trusts. A pension fund establishes a specific relationship between its trustees, who hold the assets in trust for the plan participants, and those participants. A trustee has certain well defined duties: to be prudent in the conduct of his duties, to carry out the terms of the trust, to be loyal to the trust, to give personal attention to the affairs of the trust, and to account to the beneficiaries.[26] The "flexible standards" proposed by the Department of Labor and HUD call all of those duties into question, but the principle of loyalty to the trust deserves particularly close examination.[27]

ERISA springs directly from the precept that a trustee is under a duty to act solely in the interest of the participants as to matters that directly and indirectly involve the trust property. The legislation simply "codifies this duty for fiduciaries of employees' pension plans." For fiduciary duty, "there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions."[28] In other words, to take collateral benefits into account would be a breach of fiduciary duty. To be more blunt, it would be unethical.

Investing for socioeconomic or political goals divides the loyalty of the trustee. No longer is he concerned solely with the financial goals of the trust; he must consider a multitude of ancillary issues. As one commentary says, "The reader will not go far wrong if he understands social investing to be pursuit of an investment strategy that tempers the conventional objective of maximizing the investor's financial interests by seeking to promote non- financial social goals as well."[29] Using the assets of a trust to further a trustee's own social and political goals constitutes "a clear case of indirect self-dealing."[30] As such, it is impermissible. The trustees can neither change nor abrogate their burden. Only the courts or the legislatures may define exceptions to the duty of undivided loyalty "in a way that establishes reasonable limits on the trustee's right to promote with the trust estate personal political or social goals or the goals of third parties."[31] Despite the disclaimers, ETIs function as social investments, whatever the riskadjusted rate of return. Viewed from the legal perspective, the administration's rationale is specious.

John Langbein and Richard Posner evince much the same skepticism, concluding that "social investing involves a combination of reduced diversification and higher administrative costs not offset by net consumption gains to the investment beneficiaries." More emphatically, they assert that "the duty of loyalty, the prudentman rule, and cognate doctrines, forbid social investing in its current form." If the participant can opt out of a socially targeted fund for one "that pursues investor financial welfare single- mindedly," social investment may be "reasonable" and "legally permissible." Within the universe of defined benefit plans, however, opting out seems an infeasible alternative. For those with defined contribution plans, whose retirement benefits fluctuate with the performance of the trust fund, it may be possible to elect a "socially responsive" plan instead of or in addition to a plan focused on financial goals. (Teachers Insurance and Annuity Association/College Retirement Equity Fund [TIAACREF], which serves much of the academic world, has such a fund, as do several mutual funds and university endowments.) Diversification of the fund as a whole still poses a problem. Langbein and Posner comment, "We are skeptical that a portfolio constructed in accordance with consistent, and consistently applied, social principles could avoid serious underdiversification."[32] Given the choice, a participant may, of course, knowingly take that risk.

Two additional problems arise. According to Langbein and Posner, modern (1980-81) finance theory suggests the futility of trying to beat the market. Every stock is as good an investment as every other stock in the same risk class ex ante. Provided a portfolio is evaluated as a whole, rather than investment by investment, it will make little difference to the rate of return whether the pension fund manager adheres to social principles or aims solely to maximize the wealth of the investors.[33] The analysis would appear to give credence to the flip-of-the-coin hypothesis.

From an economist's point of view, however, the reasoning is faulty, for the manager who excludes a number of firms on social grounds restricts his options. The firms whose stock he buys will tend to be less profitable since they will sacrifice some profit for what they deem social welfare; the stock of those firms will be at a comparative disadvantage. Overall, the manager is unlikely to do as well as if he bought from the entire set. Even if the manager mixes social and traditional investments, lower returns on one or more socially inspired investments will depress the average return of the portfolio.

Excluding the theoretical considerations outlined above, there remains the problem of administrative costs. For the social investment portfolio, Langbein and Posner note, the costs for securities analysis and trading will be higher, resulting in a lower net expected return.[34] On all counts--risk and diversification, return, and management and brokerage fees--the social investment portfolio is thus inferior to the traditional market basket.

The question of the consumption function remains as well. Does social investing confer a compensating utility on the investor? Lack of free and informed choice undermines the presumption of consumption value. The worker knows little if anything of the principles on which even socially sensitive pension fund trustees base their investment decisions. And trustees could not please everybody in the fund, even if they attempted to inform the participants of the reasons for their decisions. Thus, the consumption aspects are likely to be a wash and "one can conclude that social investing involves a probable reduction in the overall wealth or utility of investors."[35]

For the individual participant, the disutility will be small, "but the sum of these disutilities across all the affected individuals may not be small, which supports our conclusion that . . . it is probable that social investing results in a net diminution of the overall utility of the investment."[36] Translation: participants will fare less well, both financially and psychologically, under plans that promote social investment. Only broadened disclosure of a plan's actions and assets could allow participants to choose freely the goals to pursue and might confer a net benefit. Defined benefit plans, the universe in question, rarely if ever offer such a choice.

The Context of the Debate

Viewed from a broader perspective, the current controversy over social or economically targeted investing and the extent of ERISA's constraints on private pension funds is simply the latest in a series of skirmishes. In 1979, for instance, the Employee Benefit Research Institute sponsored a policy forum to outline and debate critical issues. At that forum James Hutchinson and Charles Cole divided investment policies into three categories: totally neutral, socially sensitive, and socially dictated.[37] By definition, the first is irrelevant to social investing. In socially dictated investing, the third category, a fiduciary who sacrifices traditional investment quality or undertakes investments "which cannot clearly be related to the interests of plan participants and beneficiaries in their capacity as such" runs the risk of being labeled imprudent and of breaching his fiduciary duty of loyalty. Socially sensitive investing becomes the only candidate for close inspection.

Hutchinson and Cole noted that "the federal prudence and diversification rules [ERISA 404 (a)(1)(C)] neither absolutely preclude nor specifically authorize the selection of investments that have been affected by nonfinancial considerations." ERISA's stipulations that investments be undertaken "solely in the interest of the participants and beneficiaries" presented a stickier wicket. After reviewing the two most relevant cases, the authors focused on the question central to the debate, "whether an investment policy that confers benefits upon plan participants as part of a much larger group . . . is consistent with a proper interpretation of the 'solely in the interest' standard."[38] The statute's declaration of policy "makes no reference to the objective of providing nonfinancial benefits to the employees through a socially responsible investment policy, nor does it refer to any larger group of beneficiaries of the statute." Instead, concern centers on fiduciary standards that will ensure soundness and stability.[39]

The legislative history shows that Congress failed to enact any one of "several proposals designed to encourage social investing." In particular, the plea of Walter Reuther of the United Auto Workers in 1970 before the House Subcommittee on Labor fell on deaf ears. Reuther had asked that the subcommittee relax federal standards sufficiently to allow the trustees of his union's pension fund to invest "with proper safeguards" a portion of the trust funds in "high social priority projects."[40] Hutchinson and Cole asserted,

In light of these congressional responses to specific proposals for social investing, it seems inappropriate to stretch the "solely in the interest" language of 404(a). Congress enacted ERISA with the relatively narrow objective of assuring adequate financial security for retired workers. An investment policy which seeks to improve the lot of some group of people unrelated to the pension plan participants would appear to be outside the permissible range contemplated by the statute.[41]

Could a social investment policy be tailored more narrowly to benefit plan participants "as one small fragment of the community of American citizens or as one small segment of the community of American workers?"[42] Once again, the answer is no. Indeed, the ability to make good on pension promises, whether those of Social Security or those of private and public pension plans, depends on the vibrancy of the economy as a whole. Tailoring investments in the pursuit of social goals will restrict the freedom of trustees or pension fund managers to take advantage of promising opportunities. Decisionmakers forced to wear social blinkers can only debilitate the overall economy and thus harm each group within it.

Hutchinson and Cole conceded that, on rare occasions, investments could be so equal that a fiduciary might be able to decide between them by flipping a coin.[43] In those instances, "a socially sensitive investment policy which may produce some extra benefits for the participants" might be permissible. They added immediately, however, that "the problem with this analysis . . . is that its assumptions may be unrealistic." Slight differences in economic considerations might dictate a fiduciary's choice. Unfortunately, "once noneconomic considerations are permitted to enter into the analysis, there is a real danger that the fiduciary may be tempted to choose one investment on the basis of its perceived general utility to the community rather than to refine the comparison of financial characteristics to determine whether there is actual equivalence between the investments." The fiduciary may be attempting "to vindicate his own interests or views," rather than to benefit the plan participants.[44]

In concluding their analysis of "solely in the interest of," Hutchinson and Cole anticipated the claims of Secretary Reich and suggested that they lack a firm foundation. To the question, "Will not a stronger local economy, or a free society, also benefit the plan participants in their retirement years?" they answered, "Perhaps, but with such a tenuous link, it is hard to say that the primary purpose of such an investment is to benefit the plan participants, rather than to achieve some other purpose for some other group of beneficiaries." Indeed, the language of the act "raises some questions as to whether a fiduciary can seek to maximize any benefits other than the purely financial ones to be paid from the plan's assets."[45]

In other words, a fiduciary worthy of trust will seek only to benefit plan participants. If he acts prudently, he is likely to benefit the economy as a whole. It is critical to underscore the advantages of effective investing in the market. Study after study has shown that investing directed only by market forces tends to be more profitable than investing guided by external considerations, such as collateral benefits. That is a lesson the current administration has yet to learn.

Hutchinson and Cole's analysis of "exclusive purpose" buttressed those conclusions. The benefits envisioned, they argued, refer to cash received directly by participants or beneficiaries, not to indirect benefits of possible moral or psychological value. As a result, "the 'exclusive purpose rule' could have a restrictive impact which goes beyond that of the 'solely in the interest' requirement, prohibiting policies which are socially sensitive as well as socially dictated investment practices."[46] Basing their analysis on the language of the statute, Hutchinson and Cole construed "exclusive purpose" very narrowly indeed. They declared finally,

The "exclusive purpose" language suggests that trusts covered by ERISA are to be established and maintained for the limited purpose of providing retirement benefits, not for other, socially desirable purposes which provide collateral or speculative "benefits" to plan participants or appeal to the philosophical leanings of the plan sponsor or other parties related to the plan.[47]

In other words, the "social, ancillary, and collateral" benefits so dear to Secretary Reich have no place, under ERISA, in a private pension plan.

Complementing the HutchinsonCole paper at the EBRI forum was a study by Roy A. Schotland, a professor of law at Georgetown University. Whereas Hutchinson and Cole dealt with ERISA's statutory restrictions on social investing, Schotland attacked the economic misperceptions and fallacies supporting the nebulous goal of doing good through divergent investing. He highlighted the distinction between private pension plans, protected by ERISA, and public plans, established by state and local governments. Protection of public-sector employees varies from state to state. Schotland emphasized the inherent weakness of public pension plans: "They combine political vulnerability with unusually large assets."[48] It should come as no surprise that the examples of successful economically targeted investing touted by Secretaries Reich and Cisneros come from the politically susceptible public sector. Moreover, state and local governments can draw the veil over failure, either by raising taxes or by dismissing administrators and fund managers. In the private sector, failure often has well-reported repercussions, and ERISA encourages caution on the part of fiduciaries.

Although Schotland opposed social or divergent investing, he recognized the attractiveness of the concept and the belief of many of its proponents that it constitutes a tool for bettering the world. A final comment on social consciousness, however, prefigured an objection raised during the June 1994 hearings.

There are always people who need something to advocate. I don't fault such people, but not all divergent investing advocates are blameless: some of them are hypocrites, urging that other people's funds be exploited in ways they wouldn't dream of allowing for their own.[49]

In other words, use your personal funds to advance your beliefs; leave the savings of others alone.

More pressing, however, is the economic argument. "The prime objection to divergent investing is that any interference with pension funds' maximizing investment returns (at acceptable levels of risk) undeniably interferes with retirement security."[50] Schotland then outlined the frightening disparity between promises to pay and assets held. The overriding goal of fund managers should be the reduction of unfunded liabilities through the building of assets to meet present and future obligations. Divergent investing appears to have little place in such a strategy, especially given the serious underfunding of many governmental and private plans.

In contrast to the spokesmen for Labor and HUD, Schotland emphasized the major threat posed to retirement security by inflation and the urgent need to expand assets to meet it. Only a handful of companies sponsoring private plans provide costofliving adjustments; many state and local systems have COLAs, but most cap the increases at 4 percent or less a year. (Four percent may seem reasonable in 1995; it would have been sorely inadequate in the early 1980s.) In any case, COLAs have rarely kept up with the rate of inflation. To safeguard against inflation, all pension funds, whether private or state and local, should address themselves to maximizing investment returns and to increasing the nominal dollars promised.[51] Pursuing the elusive goal of collateral and ancillary benefits will diminish returns and hurt pensioners.

Schotland, too, addressed the issue of choice. If pension funds choose divergent investing as a goal, who is to select the projects to be supported and establish priorities? Even though their funds are in question, employees and, especially, retirees infrequently sit on boards of governance, a situation Schotland found intolerable. As a result, those most deeply affected by social or divergent investing have little control over investment decisions. As a remedy, Schotland advocated improved disclosure of funds' performance, information too often buried in the footnotes of annual reports.[52]

Finally, Schotland noted the difficulty of weighing efforts "to further the divergent goal." Long-established procedures govern the evaluation of traditional investments, but those procedures seem inapplicable to divergent or social investing. An additional problem thus presents itself: the difficulty of measuring the performance of fund managers and holding them accountable.[53] Obstacles in the form of choice, priorities, and evaluation stack the odds heavily against the very small number of investments that might further alternative goals without subsidizing them at the expense of retirees. All in all, divergent or social investing seems a bad risk, a poorly funded wager likely to compromise the financial security of those who depend most heavily on pension plans.

On the Cutting Edge

A more recent study addresses many of the same problems, with the Department of Labor's IB 941 specifically in mind. In addition to reinforcing the conclusions of the previous analysts, law professor Edward Zelinsky of Yeshiva University highlights the potentially dangerous consequences of the supposedly innocuous bulletin. Zelinsky characterizes the ETI concept advanced by IB 941 as "unsound as a matter of logic and policy and . . . incompatible with the statutory standards governing the investment decisions of pension fiduciaries." To make matters worse, IB 941 and the ETI clearinghouse represent "the reincarnation of the discredited theory of industrial policy."[54]

In contrast, Zelinsky concludes that if "ETIs generate competitive rates of return, there is no need for pension trustees or the DOL to extend particular solicitude toward those investments; they will be undertaken by someone because of normal market forces." The bulletin is superflu- ous; competitive investments will make their own way. If market failure exists, the remedy is "to correct that failure structurally rather than to inspire pension trustees to invest in flawed markets." In sum, "investments generating competitive returns will generally be undertaken by market forces."[55] Markets usually disseminate knowledge efficiently. Should the market shun an investment, it is likely that it will be unable to generate a competitive return. To use ETIs as a crutch to support projects too questionable to make it on their own is to distort the market while creating the risk, if not the probability, of suboptimal returns for those whose funds are being used.

The vaunted ETI clearinghouse constitutes "not merely an ambiguous proposal but an incoherent one." Zelinsky underscores the importance of functioning markets that obviate the need "to assist ETIs by considering their collateral benefits since ETIs, as defined by the DOL, carry rates of return adequate to attract capital under normal market criteria." If markets are malfunctioning, "those financial opportunities generating supplemental advantages are more, rather than less, likely to be identified and promoted." If there is market failure, Zelinsky emphasizes, "the appropriate remedy is to correct the market."[56]

Zelinsky notes the difficulty of identifying collateral economic benefits, pointing out possible negative effects. Using state pension funds for projects located within the state may Balkanize the capital markets, as states withdraw funds from other states for use at home. The result might well be a net loss of capital for the state making major withdrawals as other states also repatriate their funds. As states concentrate their capital locally, underdiversification begins to loom as a major problem.[57]

Economic arguments aside, the statutory language of ERISA fails to justify the bulletin.[58] The benefits promoted by Secretary Reich's policy proposal fail to satisfy the "exclusive benefit" rule used in the Internal Revenue Code as a criterion for pensions plans' tax status. Retirement, disability, and death payments for retirees and their dependents qualify under the rule; the expanded preretirement employment opportunities envisioned by Reich as a corollary of ETIs do not. Nor does the statute warrant "supplemental economic bounties for nonemployee constituencies, indeed for the economy as a whole." Zelinsky buttresses the position of the previous analysts: "exclusive benefit" means just that, however inconvenient the statutory language may be. In a sweeping conclusion, he asserts that "a single-minded concern for the welfare of participants and beneficiaries" on the part of pension trustees is "both a compelling standard as a matter of policy and the standard embodied in the statute." The administrative precedent cited by the Department of Labor as grounds for bending the statute to its will is a weak reed, for the pronouncements "cannot be reconciled with the language of ERISA and contain no authority for disregarding the exclusive benefit rule."[59]

Zelinsky gives equally short shrift to the much promoted use of ETIs as a "tiebreaking device." Market forces will clear investments without resort to ancillary considerations. Determining such benefits is costly for trustees, while the prospect of collateral advantages will induce groups hoping to profit from the tiebreaker to bring pressure to bear on the trustees.[60]

Although the arguments presented by Zelinsky have been voiced by others, albeit in less cogent form, the final section of his paper unveils a new and unsettling perspective. The interpretive bulletin, if accepted, will alter "the dynamics of fiduciary decisionmaking," shifting investments toward ETIs and thereby increasing the risk of loss "by subjecting trustees to pressures to subordinate financial concerns for the pursuit of collateral benefits."[61]

The losses engendered will weigh most heavily on those with employerdirected defined contribution plans who will find their accounts and thus their retirement benefits reduced. People with defined benefit plans are not immune to losses, either. Employers with poorly funded plans are unlikely to increase benefits, possibly causing employees, at great personal cost, to move to firms with better funded plans. The alternative, to stay and accept reduced compensation upon retirement, sounds almost equally unattractive. Nevertheless, should his employer default, a worker who stays with an underfunded plan may find his pension reduced, for the PBGC guarantees only a limited level of benefits.[62]

As in so many other cases, it is the taxpayer who ultimately pays for the poor investment performance of below-market ETIs. In publicly sponsored plans, a shortfall becomes a form of hidden taxation, for the citizens of the state must replenish the fund. The problem created in Maryland is a case in point. An employer faced with noncompetitive returns of a private plan must bail out the defined benefit plan, thereby reducing returns to the shareholders.

The greater danger of the proposed policy, however, is the probability of mandatory ETI requirements. Asked about the possibility of coercion by Senator Boxer, Secretary Reich responded, "No, absolutely not."[63] The denial is suspect. If ETIs actually produce ancillary benefits not found in traditional investments, as the secretary maintains, it would be logical to argue that government should require them. That reputable private analyses point in the opposite direction is probably inconsequential. Those who believe that the government should intervene in the marketplace care little for facts that contradict their social creed. Pressing for certain types of investments becomes an article of faith.

Encouraging ETIs would, in fact, revive the discredited doctrine of industrial policy, according to which government should guide the market. According to that view, capital is to be allocated not merely in response to market signals but to encourage through subsidies and tax advantages those industries that could benefit the economy as a whole. Secretary Reich has shown himself a strong supporter of such policy in the past. Although he appears to have recently moderated his position, it is unlikely that his basic economic philosophy has changed.

Government planning has generally reduced output and income, most notably in Eastern Europe, under the guise of investing to benefit the people. The foregoing analyses make clear the ample economic grounds on which to oppose the Department of Labor's attempt to insinuate government controls into fiduciary decisionmaking. Resistance is unlikely to be confined to the analysts. Once the details were known, public opposition to the administration's health plan became intense and vocal. Detailing the implications of the Department of Labor's interpretative bulletin should arouse an equally vigorous response.

Trust Betrayed

Theoretical considerations aside, ETIs with their record of subpar returns will further undermine the financial stability of the current pension system. Although governments are unwilling to discuss the problem, a significant number of the nation's 2,400 public pension systems are substantially underfunded.[64] The General Accounting Office's 1993 report, which analyzed pension plans from 47 states and Puerto Rico, found that most of the 189 plans that provided complete funding data were underfunded. Eightynine state- wide plans and 100 local plans had an average funded ratio of 83 percent of reported liabilities. Only 61 plans were fully funded.[65]

Despite improvements touted by the administration in 1994, significant underfunding and management problems persist in all sectors, public, private, and unionized. A recent analysis of teachers' retirement plans points out underfunding of pension plans in 36 states and the District of Columbia; nationwide promised benefits exceeded assets by $63.4 billion. Under such circumstances, it would seem prudent to seek the best possible investment advice as a way of increasing returns. Yet the American Federation of Teachers, a powerful union, has refused to set minimum qualifications for trustees, referring to efforts to establish standards as "unacceptable preconditions." Evidently, the union fears a challenge to its stewardship of $342 billion in teacher pension assets, control that enables it to select many of the members of the pension funds' investment boards.[66]

Interestingly, the GAO report raised hackles rather than alarm. The Public Pension Coordinating Council commented that "this report paints a distorted picture of the financial health of publicemployee retirement systems," and the National Council on Teacher Retirement bemoaned the fact that the GAO's biased view had panicked thousands of retirees.[67] Given the shaky underpinnings of the teachers' plans, panic may be the appropriate response.

As a group, present and future pensioners have reason to feel anxious; and disclosure, unwelcome though it may be, would go a long way toward rectifying the problems by spotlighting the need for reform. Although state governments have been solvent since the 1830s, at least in theory, municipalities and small government agencies do go bankrupt with some degree of regularity.[68] In a private plan, the trustee's bankruptcy has no effect on the assets, since the trustee has no beneficial interest in them. In public plans, as noted previously, bankruptcy may beggar the pensioners. Whether the plans are of the defined benefit or the 457 variety, the assets remain the property of the employer; in a bankruptcy, they "are subject to the claims of general creditors."[69] Equally disturbing, the pensioners may find that the state, in order to stanch a fiscal hemorrhage, has simply asserted that it is unable to pay and has reduced their benefits.

Public employees have yet another reason to raise questions about the security of their pensions. Most public employees are ineligible for full Social Security benefits, since Congress drafted them into the system quite recently; there is no ERISA to safeguard investments and no PBGC to provide insurance for failures. Inflation is a certainty; COLAs are far from ensured. To stay in business, governors and mayors may, in fact, balance the pension plan books by raising taxes. They may also reduce or defer contributions. In either case, public employees find themselves on the short end of the stick. Faced with those practical problems, people in control of public plans should be doing their best to ensure safe, secure investments with the highest possible riskadjusted rates of return. Dabbling in the uncertain waters of ETIs is ethically reprehensible.

The problem is long-standing. As far back as 1983, Alicia H. Munnell, then a vice president of the Federal Reserve Bank of Boston, testified before Congress on the increase in state and local efforts to use pension assets for "socially oriented goals." The results had been far from exemplary.

Although advocates of social investing generally contend that these goals can be achieved without sacrificing the overall return on the pension portfolio, a recent survey of the experience of public funds with privately insured, mortgagebacked securities showed that fund managers frequently failed to exact appropriate returns . . . once they focused on social considerations. Specifically, between 1980 and 1982 at least 10 states invested in privately insured, mortgage-backed securities that were significantly riskier and less liquid than the government-insured "Ginnie Maes" at yields that were generally below the Ginnie Mae rate.

Munnell went on to advocate "clarification of the guidelines for investment decisions, so that returns are not sacrificed for the sake of social considerations."[70] It has become abundantly clear, however, that such considerations depress average returns. There is, in other words, no such thing as a free lunch.

However, Munnell seems to have changed her position since 1983. Now an assistant secretary at Treasury and a possible nominee for the Board of Governors of the Federal Reserve Board, she has recently attacked the tax deductibility of pension benefits by proposing as a source of new government revenue a 15 percent tax on all private pension funds.[71]

A Dismal Summary

A catalogue of public fund investments that have gone sour suggests the extent of the risk. Political pressures--whether overt or subtle, whether from legislatures, elected or appointed officials, or even public fund boards that favor local investment--have produced dismal results.

The problem has a long history. Schotland, for example, noted that in the 1930s and early 1940s the state of Wisconsin mandated that 70 percent of trust monies be invested in the state, a mandate that brought the State Teachers Retirement Fund near disaster before it was finally repealed in 1945.[72]

Three of the most outstanding recent failures of local boosterism, the result of pressures to invest within the state, appear in the study referenced by Representative Saxton during the June hearing; they also confirm the negative effects of underdiversification produced by insistence on instate investment explored by Zelinsky in his analysis.

* In 1980 the Alaska public employees and teachers retirement funds loaned $165 million (35 percent of total assets) to make mortgages in Alaska. When oil prices fell in 1987, so did home prices. Forty percent of the loans became delinquent or resulted in foreclosures.[73]

* In 1989 the State of Connecticut Trust Funds invested $25 million in the Hanfordbased Colt's Manufacturing Co. to save jobs; but the company filed for bankruptcy three years later, endangering the trust funds' 47 percent stake.[74]

* The Kansas Public Employees Retirement System (KPERS) invested $65 million in Home Savings Association, an investment that became worthless when federal regulators seized the thrift. And a $14 million investment in a Kansasbased company, Tallgrass Technologies, Inc., became virtually worthless. KPERS has written off $138 million from its ETI programs; some estimate that the total could reach $236 million.[75]

It may be worth noting that the KPERS's ETI programs were held up in the late 1980s as models of ambitious programs to stimulate the economy. Moreover, HUD had approved the collateral benefits of the uneconomic investment in public housing.[76]

In other cases, the funds avoided disaster but had to make do with subpar results. In 1987 the Missouri legislature mandated that the Missouri State Employees' Retirement System (MOSERS) create the Missouri Venture Partners Program. The program required 3 to 5 percent of MOSERS's assets to be used as venture capital investments in small companies based in Missouri. Three years and $5 million later, the program was terminated. In addition to the unsatisfactory results, it produced two lawsuits.[77]

It is doubtful that any of those investments would have been undertaken without political pressure from the state. Despite protestations to the contrary, the investment in Colt may well have been an election-year bailout of a failing firm.[78] Only political anxieties can explain the Maine State Retirement System, which loaned $10 million to the state's finance authority for ETIs, even though the pension fund has one of the worst funding levels of all public funds in the nation. A 1993 study summarized the problem by noting that public-sector pension plans "required to devote a portion of their assets to instate investments" obtained lower investment returns.[79]

Legislatures are not the only culprits. In an attempt to defeat a term-limits initiative, Mayor Victor Ashe of Knoxville, Tennessee, approved a large pension increase for police officers and firemen who then became leading opponents of limitation. Nonetheless, term limits won.[80]

An Object Lesson: Prince George's County

A particularly flagrant example of political abuse comes from Prince George's County, Maryland.[81] In 1990 three county executives, appointed as trustees of the county's pension plan by Parris N. Glendening, then county executive, created a supplemental pension plan for about 3,000 nonunion employees, ostensibly to bring their benefits closer to those of police and firefighters. Since the county had decided to credit participants for past service without requiring corresponding contributions, the supplemental plan proved attractive. About 1,200 of those eligible signed up.

Fiscally, however, the county's generosity resulted in a significant unfunded liability. By January 1993 the difference between the plan's assets and its obligations totaled more than $25 million. Despite the growing shortfall, in 1992 the three trustees, Eric M. Tucker, Michael J. Knapp, and Frank Stegman, had "enhanced" the plan for workers with 15 years of service who were "involuntarily separated" from their jobs. Thus, a plan widely thought to apply only to nonelected general schedule employees, when liberally interpreted, grew to encompass the political appointees who had established it.

The enhancements were indeed generous. Covered employees could receive pension payments immediately, rather than at age 55, and the benefits were to be 50 percent higher than normal. In addition, those eligible could recover 100 percent of their unused sick leave, instead of the standard 50 percent.

None of that seems to have occasioned comment until it was discovered that Glendening, elected governor in November by the thinnest of margins, had asked 30 of his top aides to resign a month before leaving his post. Major L. Riddick Jr., his chief of staff, and Knapp and Stegman, two of the three trustees, were then offered posts in the new state administration. Their proffered resignations constituted involuntary separation, making them eligible for thousands of dollars under the supplemental plan. The governor himself qualified for higher benefits, given a legal opinion that he, too, had been involuntarily separated when the term limits passed by Prince George's voters in a 1992 referendum prevented him from seeking another term as executive.

Glendening pleaded ignorance, claiming that his appointees had engineered the 1992 changes without his knowledge. He and three aides returned or deferred most of the money, but Knapp and Stegman had to face rough confirmation fights. Ultimately, both were confirmed, but charges and countercharges weakened the nascent administration.

The failure of the trustees to disclose the amendment they were engineering became a pivotal issue. The county council, which opened hearings on the controversial plan, had evidently never been consulted. The minutes of the pension trustees' meetings failed to mention details of the enhanced benefits approved in 1992. The following year Riddick sought an opinion from the Maryland attorney general on the eligibility of elected officials in Prince George's

County for the enhanced benefits and was assured that they could indeed accept them since term limits had involuntarily separated them from office. In a second opinion solicited by the Glendening administration in 1993, the ethics board of Prince George's County asserted that trustees like Knapp could vote on pension changes that might benefit them, provided they filed an annual disclosure of their interest in the plan with the board. Given common law prohibitions on selfdealing, that seems a curious position.

The reaction of the trustees was even stranger. Interviewed by the Washington Post, Glendening's communications director, Tim Ayers, said that "the trustees did not realize that they were required to file disclosures" despite the opinion requested by the administration. Stegman said that he was never notified of the obligation to disclose. The prize for the most disingenuous explanation, however, should go to Knapp, who said that he had learned "only a week ago" of the annual disclosure requirement, explaining that "he thought his general obligation to disclose was fulfilled through the letter requesting that opinion."

The failure to disclose cloaked the underlying breach of the traditional fiduciary duty of loyalty, a far more grievous fault. The common law is explicit on the duties of the trustee: he must "act solely in the interest of the beneficiaries"; he must "not allow personal interests to compete with the interests of the beneficiaries under the trust."[82] Establishing and expanding a pension plan significant underfunding of which would compromise the financial stability of the county and its ability to meet its obligations to retirees constitute a signal example of self dealing. The trustees were to reap the financial rewards, leaving future county administrations to pay the piper, that is, to cover a budget shortfall projected in February 1995 at $130 million, including the pension fund liability.[83] County and state taxpayers will be the ultimate fall guys. The episode offers a dismal reminder of the shaky underpinning of many public pension plans and of wide-ranging detrimental effects.

Gubernatorial Sleight of Hand

The pressures are ongoing, but they become particularly fierce when governors are attempting to cope with deficits. Under such circumstances, trust fund boards, with large assets and shaky independence, find themselves especially vulnerable.

In 1991, for instance, California's governor proposed transferring $1.6 billion earmarked for COLAs for pensioners from CalPERS to general funds to help reduce a $14 billion deficit. He also proposed replacing the existing board with a new board, a majority of whose members he would appoint himself. Another proposal aimed to transfer actuarial responsibilities from the fund to the governor's office, evidently in the hope that the new actuary, by selecting a different set of actuarial assumptions, would enable the state to reduce required contributions.

Although the governor claimed that he was merely safeguarding taxpayer dollars, it was widely believed that the political activism of the board, which had criticized certain California businesses, had prompted the maneuver. The board was able to fend off part of the attack: the legislature transferred the funds to general revenues and the actuary's appointment to the governor but left the board's composition unchanged. The move scaled down COLAs for retirees, significantly worsening their position.[84]

The California Connection

Whatever its relations with the governor, the CalPERS system remains a favorite of the Department of Labor and HUD. Its board is politically activist; in addition to the criticism of business, it has made workplace practices a criterion for managing investments. Moreover, with Massachusetts and Connecticut, it makes direct investments in "affordable" multifamily housing. According to one analyst, U.S. housing is "overbuilt and overnourished," an appraisal that has the ring of truth, despite the plaints of HUD and the professional housing advocates.[85] In general, investments in real estate are likely to be more risky and less profitable than other types of loans.

Nevertheless, in 1992 CalPERS announced that it was allocating $375 million to five real estate investment firms "to seek out and help finance singlefamily housing all over the state."[86] The 90 projects chosen were unable to obtain funding from traditional sources. By October 1994, 7 of the 90 had been spectacularly successful, enabling CalPERS to post a 20 percent return on its investment. As Bennett noted, the timing had been superb. The state had a backlog of demand; but, in the recessionary climate of the early 1990s, financing was scarce and few people were building.

Moreover, "land was relatively cheap, because so much of it belonged to the banks, and mortgage rates were low."[87] Although the return has been touted by the Department of Labor and HUD, that constellation of circumstances is unlikely to repeat itself. The banks owned land as a result of the wave of foreclosures that swept California during the recession, and mortgage rates have been climbing. The evidence suggests that lucky breaks in housing are rare and that losses, like those sustained in Kansas and Missouri, are far more common. Returns on the remaining 83 projects, about which little has been said, should be examined carefully.

Moreover, in 1993 the CalPERS board compounded the problem of construction costs by adopting "a policy favoring investment in real estate projects that hire union labor, or at least provide 'fair wages.'" Analysts warned that favoring the contractors paying the highest wages would reduce income or increase risk, but the board forged ahead.[88] Essentially, the board was observing the standards established by the Davis-Bacon Act, a holdover from the depression, that exacts a tax of up to 10 percent on inner-city construction, the equivalent of adding a full percentage point to an 8 percent, 30year mortgage. "You want to know how to solve the lowincome housing crisis? Get rid of DavisBacon," said Federal Reserve governor Lawrence Lindsey.[89] The Department of Labor, however, stands firmly behind Davis-Bacon, and the CalPERS board stands firmly behind the Department of Labor.

Despite the inherent uncertainty of the real estate market, a hazard compounded by the board's insistence on high-priced labor, CalPERS may be embarking on two projects of palpably greater risk. In March 1995 its board was reported to be considering an investment in DreamWorks SKG, a sketchily outlined entertainment venture in which CalPERS and perhaps two or three other investors would invest $900 million for a onethird interest in a project that would, among other benefits, create jobs in California. The second proposal was even more disturbing. Magic Johnson, the former basketball star, and developer Victor MacFarlane "urged the [CalPERS] board to approve a joint venture to build shopping centers in otherwiseneglected urban areas, arguing that 'such investments would bring a high return--and do much social good.'" CalPERS would invest $50 million.[90]

The CalPERS board seemed content to ignore the enormous risk inherent in movie and television production and dismissed the wisdom of the market about investing in high-risk urban areas. If high returns compensating for the risk involved were available in those areas, the market would already have built the shopping centers. Neither the jobs to be created by Dreamworks SKG nor the vague economic opportunities to be afforded by the shopping centers are likely to benefit California's public-sector retirees. Nor would the social good, touted as a beneficent consequence of the real estate proposal, confer on them a particular advantage. In both instances, the CalPERS board was flouting the "exclusive benefit" rule in the pursuit of hypothetical returns best characterized as pie in the sky.

Noting the dismal results of local boosterism in Kansas and Alaska, one commentator did recognize the risk of under-diversification that might arise from putting California first. Analysts contended, however, that CalPERS's size was an advantage. It could invest both at home and abroad. In other words, "large sums still can be invested in local projects without making much of a dent in the fund's $78 billion market value."[91] Perhaps, but there remains a niggling doubt that there might be potentially higher returns from safer investments than DreamWorks and questionable real estate.

Overall, the investment practices of CalPERS are disturbing. It is often singled out as the bestmanaged public pension system in the country, yet its 9 percent average annual return for the three years ended December 31, 1992, was three points below the 12 percent median return for public pension funds, according to the widely respected Trust Universe Comparison Service, despite an expenditure of $53 million in 1991-92 for management.[92] The more than 250,000 beneficiaries who are now receiving monthly payments are in no position to evaluate the policies of the fund or to rein in the board if its investment decisions threaten their benefits. In the event of a state default, unlikely though that may seem, even their 457, or defined contribution, plans could fall prey to creditors.

Follow the Leader

The siren song of social benefits has enticed 18 states, in addition to California, to pass laws directing pension fund managers to invest in programs that foster economic development. The percentage is small, "usually one to five percent of their assets."[93] But state intervention in the marketplace runs counter to the principles of a free society. More important than philosophy for a retiree, perhaps, the investment performance of ETIs threatens their financial health. An occasional happy accident aside, returns range generally from uncertain to subpar to disastrous.

Hartford, Connecticut, has leveraged $1 million of its pension money to build 155 lowincome housing units and claims that the project will provide a 7.25 percent return over the loan's sixyear term.[94] That may sound reasonable until one notes that the Standard and Poor's 500 index had a return of 9.64 percent for the three months ending March 31, 1995, and 15.24 percent over one year.

Further afield, Retirement Systems of Alabama has invested more than $100 million to build a series of seven golf complexes across the state. A payoff, if one materializes, is five to seven years in the future. Meanwhile, a marketing director enthuses, "Where else can you play 18 holes for $20, get in your car and drive one-and-a-half hours, and play a class course with a completely different terrain?" [95] How do those marvelous courses and the expenditure of funds benefit participants and beneficiaries who do not play golf?

Such projects underscore the validity of the assessment by Yale law professor Roberta Romano:

Using public pension fund assets for social investment is not intelligent public policy. Advocates mistakenly view public pension fund assets as "free" money or money belonging to someone other than the beneficiaries. This perception is deeply flawed. If the fund's return declines due to problematic, politically driven investments, either employees' retirement benefits will be reduced or the state will have to increase its pension fund contributions, with a resultant reduction of other state services.[96]

Such projects merely "camouflage the true cost of local projects from the public or transfer wealth from future to current taxpayers."[97]

Romano understands the externalities of such transfers. Olivia Mitchell and Ping Lung Hsin, in their study for the Institute for Labor Market Policies, miss the central point. They note that "yields on public pension fund assets have frequently been low, with public plans earning rates of return substantially below those of other pooled funds and often below leading market indices." They underscore the downside of local boosterism. "Public plans required to devote a portion of their assets to statespecific projects carried lower returns." They continue by casting doubt on economically targeted investing. "A central question is whether the social costs of underfunding and below-market return investments can offset their social benefits."[98] Their premise, however, is flawed. Neither social costs nor social benefits should be part of the equation. Pension funds, public or private, should be focusing on the exclusive benefit rule, attempting to maximize returns for their participants. The common law, coupled with concern for the financial security of retirees, requires that they do so.

rofit and the Private Sector

Recent actions of TIAA/CREF provide the strongest possible contrast. TIAA/CREF has more than $66 billion in stocks alone, making it the world's largest pension fund. It entered the board room battle at W.R. Grace & Company, a specialty chemical and medical services company, "in order to make money."[99] As Robert Monks, a principal at Lens, Inc., a Washington money management firm, and former assistant secretary for the Pension and Welfare Benefits Administration, observes, that breed of shareholder activism "represents the passage from the ideologically driven positions taken by many public pension funds, most notably the California Public Employees' Retirement System, to one that is based on economics."[100] Shareholder activism has its perils, but it is reassuring to note that there now exists a counterpoise of intellectual stature and financial strength.

The majority of CREF shareholders apparently share the managers' frame of mind. At the annual meeting in November 1994, about 82 percent of CREF proxies were voted against a proposal that CREF divest its holdings in cigarette manufacturers. CREF noted that certain colleges and universities had divested themselves of tobacco stocks years ago. "However, looked at as an investment issue, divestiture would conflict with the CREF trustees' responsibility to maximize CREF returns. Also, the stock portfolios would become less diverse and riskier."[101]

The Social Choice Account, created by CREF in 1990, does exclude tobacco stocks. It also precludes, among others, investments in companies that produce nuclear energy or whose activities might damage the natural environment. The brief history of that account, combined with the difficulty of finding appropriate models for comparison, makes it difficult to judge its long-term performance. A cursory balance sheet may, however, prove instructive. The account, from inception through December 1994, yielded an annual return of 9.73 percent. In 1994, a rocky year for the economy, the account had a return of -1.31 percent, from which it rebounded in the first quarter of 1995 to an annualized return of 7.56 percent.[102] The return on the unrestricted CREF Stock Account also slipped in 1994--to -0.12 percent. The strength of that account, however, lies in long-term performance. For the 10-year period ended December 31, 1994, it tallied a 14.27 percent annual return, nearly five points higher than the Social Choice Account's annual return in the four and a half years of its existence.[103]

A Modest Proposal

Individual investors have every right to direct their own investments through social choice accounts, 401(k) plans, 457 plans, or other defined contribution systems. If their choices garner subpar returns, in the main they and their dependents alone will suffer. The public sector, however, stands behind public employee retirement systems, hence the importance of curbing questionable investments by the public funds before the taxpayer is forced to bail them out. Pressure for reform has been building. One proposal has been to extend ERISA to the public funds. Indeed, after the passage of ERISA, Congress tossed around the idea of broadening its application, but the project died aborning. Legislators are sensitive to state and local concerns, and many governors and mayors appreciate a slush fund. The Department of Labor has never mustered much enthusiasm for the project. Given the outlook of the present secretary, the idea is unlikely to make much headway, for the well-articulated fiduciary responsibilities of ERISA would cut off ETIs at the pass. Broadening ERISA would also expand massively the liability of the PBGC. At current levels of funding, it may be that lawmakers are reluctant to countenance such a potential threat.

Organizational changes could, however, mitigate political pressures, whether federal, state, or local. Increasing the number of fund trustees elected by plan participants would increase the independence of fund boards. By identifying fund boards as the sole fiduciaries of pension funds, state constitutions could "create a firewall against legislative interference." Placing greater reliance on passive indexed investment strategies would reduce the opportunities to exert political pressure on fund managers. Despite those changes, however, "the possibility of political pressure on fund voting" would persist.[104]

A shift from defined benefit plans to defined contribution plans offers greater hope of fundamental change. As Romano explains in her analysis,

A more effective, albeit more drastic, structural reform would be for states to switch from defined benefit plans to defined contribution plans. The change would transfer pension assets from fund board to individual employee control. By eliminating the state's direct ownership of fund assets, the opportunity to apply damaging political pressure on decisions concerning those assets is diminished, if not eliminated.[105]

That switch is already under way, as the growth in 457 plans attests. Romano's analysis, however, points to a defect yet to be resolved. As the 457 plans are presently structured, they fail to meet the common law definition of trusts, for the state still owns the assets of the plans, making them vulnerable to creditors in case of default. A more likely scenario would be a raid on the assets by the state or by the fund itself under pressure to politicize investments. Only privatizing the plans, putting the funds under the direct control of the contributors, can remove that threat to their security.

Teachers' plans are predominantly of the defined benefit or nonportable variety, which keeps workers tied to their jobs and to their unions. As a result, the unionized educational establishment--the American Federation of Teachers and the various state educational associations--is strongly opposing the switch. As outlined above, opposition is traceable, in part, to fear of losing control over pension funds. In a larger context, opposition reflects a well-founded fear that the portability of assets under a defined contribution plan would make teachers more mobile, less dependent on particular unions, and harder to organize. Last year, despite the dogged resistance of the Michigan Education Association, Gov. John Engler succeeded in establishing a defined contribution system for all new teachers. Maine is phasing in a similar program.[106] At this point, it is unclear whether those systems will actually function as common law trusts. If the assets are segregated in a separate fund belonging to the teachers, they will; if the assets are commingled with state funds, belong to the state, and are vulnerable to creditors or to the next budget crunch, the teachers will have reason to be cautious.

Back to the Private Sector

In the private sector, the number of defined contribution plans has increased substantially. Such plans now cover more than a third of U.S. workers who have pension plans; in 1975 that figure was 13 percent. When workers have two pension plans, the second is almost always a defined contribution plan.[107] In other words, given a choice, workers will opt for at least one plan that they can control and take with them if they change jobs.

Defined contribution plans, at least in the private sector, are a form of private property. Contributions, whether made by employer or employee, belong to the employee. The employer has no further control; he cannot use the plan's assets to make up a budget deficit or a company shortfall. The employee generally makes the investment decisions and bears the risks. If he wishes to support social goals, however amorphous, he is free to do so, with his own money and with the knowledge of his financial exposure. On the other hand, since his personal security and that of his dependents are at stake, he is unlikely to sacrifice that security for the will-o-the-wisp of collateral benefits. Indeed, a number of studies have shown that people with defined contribution plans tend to be cautious.

In any case, the assets become part of the employee's estate, enabling him to bequeath them to his family or to his favorite charity. Neither the corpus of the investment nor the income stream disappears automatically upon his death, as is still too often the case with defined benefits.

Underfunding: Unpleasant Revelations

Privatizing investment also offers a solution to the troubling inadequacies of the current system, difficulties that are nearly as acute for defined benefit plans in the private as in the public sector. A recent analysis asserts that in 1993 total underfunding of private pension systems in the United States exceeded $51 billion.[108] In 1994 it jumped to $71 billion, an increase of 40 percent. In November 1993 the PBGC listed 49 companies whose total liability, in millions, ranged from $106 to $1,844, for Inland Steel. The underfunded liabilities ran from a high of 89 percent to a low of 9 percent.[109]

Despite increased underfunding, the balance sheet did improve significantly in 1994. Higher interest rates shrank the PBGC's deficit for single-employer plans by more than half, from $2.9 billion in 1993 to $1.2 billion in 1994. The account covering multiemployer pension plans, however, suffered its first loss, although it could still boast a $200 million surplus. Nevertheless, the agency's executive director, Martin Slate, predicted that improved funding, largely resulting from passage of the Retirement Protection Act of 1994, would enable his agency to convert a deficit into a surplus within 10 years. Over the next 15 years, the $71 billion shortfall, the gap between promised benefits and the money available to pay for them, should diminish by 70 percent.[110]

The news was far from uniformly positive. ERISA preserves the right of companies to terminate a plan at any point and pay only the benefits earned up to that point.[111] However, all participants are automatically vested regardless of the length of their participation. By the end of fiscal year 1993, the PBGC had handled nearly 2,000 plan terminations. In fact, terminations of underfunded plans had increased by 30 percent from the previous year.[112]

Despite the gains, underfunding continues to endanger the defined benefit plans, which promise to pay a certain sum monthly to workers upon retirement. The earnings of a defined benefit pension fund swing with the market, but the company incurs a fixed obligation to pay pensions. A downturn in business or a generous salaryplus-benefits labor contract with bountiful shutdown or early retirement agreements may compromise pension security. A troubled company is likely to decrease or even suspend its required contributions to the fund.[113] In the worst possible case, the pension fund of a company lacking funds to meet its obligations will collapse, perhaps dragging with it the sponsoring company.[114] Even if the company and the fund survive, COLAs, relatively rare in the private sector, are likely to vanish, leaving the participants prey to the worst enemy of the retired, inflation.

The PBGC, established by ERISA to pay the beneficiaries of failed plans, supplies a safety net; but the net itself has holes. Modeled on the Federal Deposit Insurance Cooperation, the PBGC shares with that agency a signal weakness or, as most insurers term it, a moral hazard: the existence of insurance may increase the chance that pension funds will take risks, knowing that the government will bail them out if necessary.[115] The PBGC now insures roughly $1 trillion of the private pension liabilities of defined benefit plans by collecting a premium from participating employers, a premium that is being adjusted upward but is still inadequate.

Moreover, the PBGC is far from allpowerful and must often do battle on several fronts at once. The Internal Revenue Service may contribute actively to its difficulties, since the IRS exerts its authority to hold down pension funding. Above a certain level, companies may not deduct contributions. In fact, virtually all underfunded companies on the PBGC's 1993 list had made their minimum contributions; many had made their tax-deductible maximum, indicating that a change in funding standards may be essential.[116]

Another major difficulty arises from the lack of reliable data. The PBGC may know of underfunded companies, but it has no way of determining the full extent of its own liability.[117] At the moment, it insures benefits up to $2,600 per month, increasing its payouts in rough lockstep with inflation. Should the number of failed pension plans increase dramatically, it might well find that its own resources were insufficient. The U.S. taxpayer would be called upon once again for a bailout.

Moreover, the PBGC lacks regulatory authority over the defined benefit pension funds and can do very little to modify risky practices, a weakness that became evident in the case of General Motors. Last March the Department of Labor sanctioned the company's questionable move to bolster its pension plan, the underfunded liability of which, $22.3 billion at the end of 1993, was the highest of any U.S. corporation. In December 1994 the company announced that it would pay $2.5 billion into its pension fund for the final quarter, bringing its 1994 total to $7.7 billion and cutting its unfunded liability to about $11 billion at the end of the year. Higher interest rates were also reducing its liability.[118] Despite ERISA's strictures on selfinvestment, that is, pension plan investments in employer securities, the Department of Labor then gave GM permission to further reduce its liability by contributing $6 billion in the Electronic Data Systems (Series E) version of GM stock. The contribution of employer stock diminished opportunities for diversification and could also be used to reduce required contributions.[119]

Even more important, the prohibited transaction exemption sanctioned by the Department of Labor relieved EDS, now a GM subsidiary, of responsibility for GM pension liabilities should EDS be sold to another company. In other words, the deal went only part of the way toward reducing the long- term pension liability of GM, but it increased the potential liability of the PBGC and escalated the potential risk for taxpayers. GM profited handsomely. Not only did it receive favorable publicity for cutting its pension liability, it also avoided paying capital gains tax on its investment in EDS, which it bought from Ross Perot in the 1980s for $2.5 billion. The Clinton administration's opposition to a cut in the capital gains tax and approval of a windfall for GM qualify as quixotic. The Department of Labor seems willing to sap the financial stability of relatively small pension funds by pressuring them to make ETIs, thus weakening their financial stability; the big guys receive corporate subsidies.

The Current Outlook on Reform

Given competing political and administrative interests, to say nothing of the risk to retirees and pensioners, it would seem that a clear-sighted review of a troubled system would be high on the agenda. In 1994 Secretary Reich and Martin Slate, executive director of the PBGC, did try to address chronic underfunding by seeking higher insurance premiums; but the initiative came to shipwreck on the shoal of health and welfare reform. The following year the administration's efforts to pay the costs of the unrelated General Agreement on Tariffs and Trade brought about the passage of "the most significant pension funding changes in 20 years."[120] The pension provisions were tacked on to the end of the bill and simply whizzed by the legislators, most of whom seem to have been unaware of their import. In reality, the raising of nearly $1 billion in new money to save GATT will have farreaching, some might say cataclysmic, consequences for U.S. workers and retirees.[121]

The combined bill did have benefits:

It mitigated the problem of the $70 billion under- funding of corporate pensions by stipulating that companies speed up plans for narrowing the gap between assets and obligations. Later negotiations resulted in an agreement to stretch out the payment schedule, but the administration nevertheless gained ground.

It strengthened the PBGC by removing the $53 cap on added insurance premiums that underfunded plans must pay the corporation.[122] The increased premiums gave the GAO reason to strike the PBGC from its highrisk list.[123]

The effort to offset GATT's $12 billion, fiveyear cost, traceable mainly to tariff cuts, through a mix of new revenues and spending cuts also had significant negatives:

* By allowing some companies to pay retirees smaller lumpsum distributions, it reduced corporate tax deductions, thereby increasing revenue for the government at the expense of retirees.

* By limiting taxdeferred employer and employee contributions to 401(k) retirement plans and stock ownership plans, it once more raised revenue, again at the expense of workers.

Although they received little press coverage, negotiations with the large companies most affected were bloody and protracted. The PBGC eventually prevailed in its efforts to force employers to adopt updated and standardized mortality tables, but the tables are to be phased in over five years.[124] Previously, companies had been able to use any "reasonable" tables, a concession that had allowed GM to lower its funding gap by estimating that its workers and retirees would die at twice the rate of Ford workers. Companies with overfunded plans, such as IBM, obtained the extension of a pension law provision allowing them to use excess funds to pay retirees' medical expenses. That provision also had the effect of increasing tax payments available to finance GATT.

Substantive gains in enforcement provisions for the PBGC went unheralded. The bill requires that notices be sent to workers whose plans have less than 90 percent of necessary funding, a provision that sent a number of companies scurrying to increase their contributions in order to avoid the disclosure. The legislation also stipulates that companies must keep a minimum of three years of benefit payments in their plans. In addition, the PBGC can now require privately held companies to inform it of their plans for mergers.

The administration desperately needed a victory on GATT, and large companies pushed hard to obtain concessions on funding requirements. Each time the government backed down on obligatory but tax-deductible contributions, the accommodation increased taxable revenues that would be available to cover potential losses from GATT. In the main, negotiations between government and business were successful. The necessary revenues were generated, and GATT passed. However, the nearly $1 billion produced to cover GATT's costs over five years cost many workers and potential retirees dearly.

To begin with, roughly onethird of large employers give their employees the option of receiving their pensions in a lump sum at retirement. Those lump-sum payments dropped drastically as a result of changes established by the legislation in the interest rates used to calculate the present value of future payments. The rate set currently by the PBGC and used by many employers is 6.25 percent, up from 4.5 percent in January 1995. The GATT legislation requires employers to use a rate based on the yield of 30year Treasury bonds, which, at the end of 1994, stood at 8.08 percent. The change leaves retirees who choose annuities virtually unaffected; higher interest rates counterbalance smaller investments, generating the same annuity. For those who choose lump-sum payments at retirement, however, allowing smaller lump-sum distributions to decrease corporate tax deductions and raise revenue has produced dramatic reductions. One analyst calculated a loss of about 7 percent in the lumpsum pension distribution for a 65yearold employee. Younger workers would fare even less well under the new rules: a 55yearold worker who took early retirement or switched jobs would lose about 25 percent; a 45-year-old would take a 50 percent cut.[125]

Workers who have suddenly learned of the shrinkage in their benefits are furious. They have some leverage since employers have the discretion of phasing in the new requirements over five years, giving some employees the option of choosing the most favorable time to retire. Others chose to retire immediately rather than wait until June 1995, when the requirements became effective.

Those depending in whole or in part on 40l(k) plans are equally disturbed. The GATT bill means that the ceiling on contributions will be rising more slowly. One couple discovered that the new formula would cost them about $600 this year.[126]

Ironically, the pain inflicted on individual workers appears to have been unnecessary. The reductions in lumpsum payments and in savings via 401(k) and employee stock ownership plans were the frosting on the cake. Other concessions made by the administration to employers scaling back pension outlays and thus increasing revenues raised the nearly $1 billion required to cover GATT's costs over five years.

Well-Founded Distrust

The behavior of Reich, Slate, and the rest of the current administration on the GATT legislation is on a par with the obfuscations presented by Reich and Berg in dealing with ETIs. In neither case have the underlying issues, whether statutory or economic, been presented honestly for open debate. The GATT legislation is the more easily remedied of the two: the penalties inflicted on unknowing workers should be repealed. They were unnecessary. GATT is now law; the administration, having won the victory, should move to remedy the harm done by the battle.

At the same time, the Department of Labor could move to salvage and strengthen the most positive requirement of the new legislation, that of disclosure. A simple statement of the percentage of underfunding, however, is likely to be woefully inadequate. The Department of Labor could protect employees by insisting not only on full but on more accessible disclosure of the financial status of defined benefit plans, whether public or private. At the moment, such information is generally hidden in the footnotes of annual reports or comes to light only after a long and tedious search. The employee who finally gets his hands on a Form 5500, a plan's annual financial disclosure statement showing assets, liabilities, investments, and service providers, will be rewarded by a government that charges him 15 cents a page to copy the report.[127]

To be fair, the Department of Labor attempted in December 1993 to broaden disclosure requirements when it asked for employers' comments on possible requirements for fuller disclosure of the financial status of defined benefit plans. Should employers notify workers when pension funds are underfunded or when employers apply for funding waivers? Should annual reports to workers disclose a projected benefit and note the extent to which the PBGC would ensure that benefit? Not surprisingly, employer trade associations reacted in the negative, declaring that workers would be "confused and worried needlessly," a reaction that calls to mind the patronizing response of the Public Pension Coordinating Council and the National Council on Teacher Retirement when confronted with the GAO's negative report.[128]

The GATT legislation has now mandated a floor on disclosure. It should be possible to capitalize on that rule to require companies to supply their employees with simple, easily accessible "report cards" on their pension funds.[129] Institutional history suggests, however, that we not hold our breath.

ETIs and the Future of Private Investment

The interpretive bulletin is more difficult because more insidious. It purports to be nothing more than a clarification of existing law while in fact it constitutes a sophisticated attempt at subversion. In its attempts to justify proposed intervention in the capital markets, the Department of Labor clings to the fusty rhetoric of "capital gaps," "market inefficiencies," and "creative financial engineering," concepts largely in disrepute with contemporary economic and financial analysts. Aided and abetted by HUD, the Department of Labor has chosen to embark on a campaign that will further undermine the often subpar investment performance of private defined benefit plans. Unwilling to accept the demonstrably disastrous consequences of social or divergent or economically targeted investing in the public sector, the two departments have chosen to deny the obvious and proceed on a path fraught with dangers for all who now depend on pensions for financial security or who will do so in the future.

Heeding the siren song of the current secretaries would make the pension funds prey to any incumbent administration. As Schotland noted over a decade ago, the issue of choice is of paramount importance. Assuming that divergent or social or economically targeted investing becomes an acceptable goal, who is to define the collateral benefits? The assumption underlying such investing, that everybody thinks alike and would make the same choices, is clearly false. Who then is to choose the favored projects? The current government? The trustees? On what principles are those who control the funds to base their decisions? Under such conditions, there can be no objective standards.

Despite disclaimers by Secretary Reich and Assistant Secretary Berg, the issue of coercion raises its head as well. Should the Department of Labor or HUD gain the power to establish and impose collateral considerations, the temptation to apply political pressure to companies and plans will prove irresistible. Investments will be diverted to the favored group capable of serving the political and social predilections of the party in power. Patronage and its attendant evil, corruption, will gain new strength as the political football is tossed back and forth. Ultimately, such a scheme will sap the economic strength of the pension plans, leaving a shaky structure bolstered by government IOUs and the taxpayers' promise to pay if all else fails.

Efforts to circumvent ERISA have not been lacking. In the waning days of the Bush administration, the Work Group on Pension Investments of the Department of Labor issued a report stating that the department "should preserve the current ERISA interpretation which allows pension plans to favor ETIs once such assets meet a prevailing rate test based strictly on their financial characteristics.

Without reference to a source, the report blithely assumed a "current ERISA interpretation," which actually undermined ERISA and which many would have hotly contested. The work group then went on to advocate establishing a "safe harbor" test for presuming a prevailing market rate. In addition, "for ETIs that do not meet the existing prevailing rate test," it was suggested that the department "consider designing a 'safe harbor' process for evaluating, bench- marking, and tracking performance . . . and specifying the plan structure for which such considerations may be suit- able." In other words, the Department of Labor would micro- manage pension fund investments on a grand scale.

In the opinion of the work group, such procedures would provide substantial benefits, allowing the Department of Labor "to help set standards for the process of considering criteria other than direct investment performance in selecting assets and to establish a more positive, operational dialogue with the industry." Evidently concerned that such interference would fall short of total control of the market, the work group recommended that the department "suggest guideline procedures for fiduciaries which will improve their understanding of performance tracking and their ability to select relevant performance benchmark indices." The underlying goal of "improving their understanding" can be paraphrased as brainwashing fiduciaries into disregarding their duty of exclusive loyalty to plan beneficiaries in order to adopt the "socially positive" perspective of those who advocate collateral benefits.[130]

Since Berg advertises herself as an ardent proponent of collateral or nonmonetary factors in the making of investment decisions, she might be expected to establish a procedure for considering nonmonetary factors in investment decisions by promulgating an official advisory letter, at which point the procedure would become law unless changed in a court. The Department of Labor and a court might well deem any pension trustee who followed the safe harbor procedure to have acted "prudently." The procedure would thus allay fears of breaching fiduciary duty, creating subtle pressure for private pension trustees to invest in ETIs.[131] That prospect should make all those involved in pension fund decisionmaking profoundly uneasy. For retiree, actual or potential, it is a nightmare.

Reform within Reach

Fortunately, the current Congress is moving to curtail drastically the powers of the Department of Labor and to buttress ERISA. On May 9, 1995, Representative Saxton introduced the Pension Protection Act of 1995 (H.R. 1594), which asserts that "economically targeted investments vio- late sections 403 and 404 of the Employee Retirement Income Security Act of 1974." Such investments are a breach of the fiduciary duty of undivided loyalty and are designed to "benefit persons other than plan participants and beneficiaries and to serve interests other than those of plan participants and beneficiaries" (section 1). In other words, the bill upholds ERISA's provisions that investments must be made solely in the interest of and in the exclusive interests of the workers contributing to the plan.

The bill essentially negates IB 94-1 by insisting that ERISA be applied regardless of that bulletin or any other official pronouncement that would have similar results (section 2). In a swipe at Berg, who has frequently spoken in favor of ETIs, the activities of the Department of Labor are restricted.

No officer or employee of the Department of Labor may travel, lecture, or otherwise expend resources available to such Department for the purpose of promoting . . . economically targeted investments (sec. 2[b]).

The third section of the legislation axes the clearinghouse by prohibiting federal agencies from "establishing or maintaining any clearinghouse of other database relating to economically targeted investments." Through the Department of Labor, taxpayers have already contributed $250,000 in start-up capital to that questionable operation, but section 3 would staunch the capital flow. Finally, contracts that have been entered into in violation of the act are to be terminated (section 4).

Provided that the legislation passes both houses of Congress speedily and without amendment, private pension fund investment managers will be able to breathe more easily. The Department of Labor will be unable to hassle them into making decisions based on collateral benefits. Even more important, contributors to pension funds and those already drawing benefits will sleep well, knowing that their hard-earned dollars have been protected. As was made clear by several people who testified at the hearing before the Joint Economic Committee on May 18, pension funds are indeed participants' money, and they are being respected as private property.[132] Private pension funds are not to become a pawn in the game of socioeconomic experimentation.

Disclosure should be pursued as a collateral remedy. Alerted by the GATT mandate, not only legislators but private consortia of present and future pensioners should force governmental entities--federal, state, and local--and private companies to disclose the status of their pension plans and publicize, if necessary, their resistance.

Precedent for such a tactic exists not only in the GATT legislation but in the GAO report and the Department of Labor initiative mentioned previously. It is a fair bet that requiring a report card on the funding status of their pension plans would rouse employees to scrutinize the investment policies of their employers, whether public or private, and to demand that decisions be made with their sole benefit in mind. It might also deter public officials from legislating by stealth.

There exists a lamentable tendency to underestimate the intelligence of the worker whose labor is supplying the pension plan with its funds. Given adequate information in an accessible format, he is quite capable of making rational decisions on the use of his money. It is, once again, his money. Disclosure would spur opposition to questionable investment policies, fury at underfunding, and outrage at secrecy. Economically targeted schemes, whether in the public or the private sector, can do nothing but depress the long-term prospects for a secure retirement. They would not long withstand such scrutiny. Awareness of the opposition that would be roused by disclosure probably explains the resistance to disclosure by companies as well as by governmental entities.

A twopronged response to the current assault on the pension funds seems advisable. Congress should act quickly to pass the Pension Protection Act of 1995, which reinforces ERISA and rejects both IB 94-1 and the clearinghouse. At the same time, organizations that supposedly have the welfare of retirees as their goal--TIAA/CREF and the AARP come to mind--should sound the alarm. Whatever protective measures evolve in the long term, it is imperative to shield private pension plans quickly from political pressures before the social prejudices of the current administration bring the entire structure of the pension universe crashing down on the heads of the taxpayers.

Notes

[1] Robert B. Reich, "A Moral Workout for Big Money," New York Times, September 11, 1994, sec. 3, p. 9.

[2] Jim Saxton, "A Raid on America's Pension Funds," Wall Street Journal, September 29, 1994, p. A14.

[3] Robert B. Reich, "Pension Fund 'Raid' Just Ain't So," letter to the editor, Wall Street Journal, October 26, 1994, p. A21.

[4] "HUD Unveils Plan for Pension Funds to Invest in Housing," Wall Street Journal, August 3, 1994, p. A2.

[5] Berg quoted in ibid. ERISA is found at 29 U.S.C. 1001 et seq. (1974).

[6] Those jointly established plans were originally governed by the Taft_Hartley Act, which provides that trust funds operate for the sole and exclusive benefit of employees and their families. Those plans are now covered by ERISA as well.

[7] "HUD Unveils Plan for Pension Funds to Invest in Housing."

[8] For a succinct definition of defined benefit and defined contribution plans, see Roberta Romano, "Getting Politics Out of Public Pension Funds and Out of Corporate Board Rooms," American Enterprise, November-December 1993,

p. 47. Romano outlines the policy advantages of defined contribution plans in "The Politics of Public Pension Funds," Public Interest, no. 119 (Spring 1995): 42_53.

[9] Within defined contribution plans, it is worthwhile to note the distinction among totally self_directed plans, such as Keoghs, or 401(k) plans, and nondirected retirement funds. The company that sets up the latter type of fund contributes jointly with the employee, but the investment manager or trustee, often a bank, makes all the investment decisions. There are also quasi-directed plans, the most notable being Teachers Insurance and Annuity Association/College Retirement Equity Fund for academics, in which the employee chooses among funds or allocates his contributions to particular types of assets.

[10] Ellen E. Schultz, "State Street Unit to Offer Public_Retiree_Plan CDs," Wall Street Journal, February 16, 1995, p. C1.

[11] Thomas G. Donlan, Don't Count on It (New York: Simon and Schuster, 1994), p. 26.

[12] James D. Hutchinson and Charles G. Cole, "Legal Standards Governing the Investment of Private Capital," in Should Pension Assets Be Managed for Social/Political Purposes? An EBRI Policy Forum, December 6, 1979, ed. Dallas L. Salisbury (Washington: Employee Benefit Research Institute, 1980), p. 44.

[13] "Prior to the enactment of ERISA, there were three principal sources of law relevant to investment decisions by an employee benefit plan." First were the principles of fiduciary duty contained in the common law. Second, the Internal Revenue Code stipulated that the employer's plan be maintained "for the exclusive benefit of employees or their beneficiaries," if the plan was to qualify for tax_exempt status. Third, the Taft_Hartley Act for plans established jointly by a union and one or more employers "requires that the trust fund be established 'for the sole and exclusive benefit of the employees and their families and dependents." Ibid., pp. 38-41.

[14] American Law Institute, Restatement of the Law, Third, Trusts (Prudent Investor Rule) (Philadelphia: American Law Institute, 1992).

[15] Roberta Romano, "Public Pension Fund Activism in Corporate Governance Reconsidered," Columbia Law Review 93, no. 4 (May 1993), reprinted by directors of the Columbia Law Review Associates, Inc., 1993, pp. 811-12, 812n. 63. Romano cites John H. Langbein and Richard A. Posner, "Social Investing and the Law of Trusts," Michigan Law Review 79 (1980) in support of the position that the common law of trusts and ERISA bar a trustee from adopting social investment criteria on his own initiative (p. 811n. 61).

[16] Edward A. Zelinsky, "Economically Targeted Investments, IB 94_1 and the Reincarnation of Industrial Policy," Berkeley Journal of Labor and Employment Law, forthcoming.

[17] U.S. Congress, Joint Economic Committee, Hearing on Targeted Pension Fund Investments for Economic Growth and Development, 103rd Cong. 2d sess., June 22, 1994, transcript, pp. 16, 18, 19.

[18] Ibid., p. 19.

[19] Ibid., pp. 24, 26.

[20] Ibid., pp. 33-34.

[21] Ibid., pp. 36-37.

[22] Ibid., pp. 44-45.

[23] Ibid., p. 59. See also M. Wayne Marr, John R. Nofsiger, and John L. Trimble, "Economically Targeted Investments: A New Threat to Private Pension Funds," prepared for the Institute for Chartered Financial Analysts, June 1994, pp. 94_95.

[24] U.S. Congress, Joint Economic Committee, p. 88.

[25] Ibid., p. 95.

[26] Loring: A Trustee's Handbook, 7th ed., rev. by Charles E. Rounds Jr. and Eric P. Hayes (Boston: Little Brown, 1994), pp. 110_11.

[27] During the hearings that preceded the passage of ERISA, Congress "found that the common law emphasis on the intent of the grantor, which permitted deviations from sound in vestment practices, was inappropriate for employee benefit plans." Hutchinson and Cole, p. 44.

[28] Loring, pp. 111-12.

[29] Langbein and Posner, p. 73.

[30] Loring, p. 121.

[31] Ibid., pp. 121-22

[32] Langbein and Posner, pp. 76, 88.

[33] Ibid., pp. 92-93.

[34] Ibid., p. 93.

[35] Ibid., pp. 94-95.

[36] Ibid., p. 96.

[37] Hutchinson and Cole, p. 35.

[38] Blankenship v. Boyle (1971) and Withers v. Teachers' Retirement System of the City of New York (1979), cited in ibid., pp. 57-60.

[39] Ibid., pp. 55, 61, 63.

[40] Ibid., p. 63.

[41] Ibid., p. 65.

[42] Ibid.

[43] During the June hearing, Representative Saxton raised the possibility of such equivalence that a decision could be made by flipping a coin. He also noted the difficulty, if not the impossibility, of finding such investments. [44] Hutchinson and Cole, p. 66.

[45] Ibid., p. 68.

[46] Ibid., p. 69.

[47] Ibid., p. 71.

[48] Roy A. Schotland, "The Opponent's Arguments: A Review and Comment,"in Should Pension Assets Be Managed for Social/Political Purposes? p. 115.

[49] Ibid., pp. 29-30.

[50] Ibid., p. 131.

[51] Ibid., pp. 136-37, 178.

[52] Ibid., pp. 145-46. Broader representation may have emotional appeal to equity, but it has little empirical support. Commenting on the performance of Taft_Hartley plans, administered jointly by labor and management representatives in equal numbers, Alicia H. Munnell finds that broader representation has had little effect on rates of return or overall portfolios. See Alicia H. Munnell, "Who Should Manage the Assets of Collectively Bargained Pension Plans?" New England Economic Review, July_August 1983, p. 28.

A more recent and more stringent critique finds that "yields in 1990 were about 2 percent lower if retiree representation on the public pension boards increased by 10 percent." The result, however, may be attributable only in part "to more conservative choices made by retiree board members," since assets "improperly selected" by appointed members may also depress asset yields. Caution is advisable before concluding that retiree participation is "necessarily deleterious." Olivia S. Mitchell and Ping Lung Hsin, "Public Pension Governance and Performance," Working Paper no. 9, Institute for Labor Market Policies, Cornell University, May 1993, pp. 14_15.

[53] Schotland, p. 159.

[54] Zelinsky, p. 2.

[55] Ibid., pp. 5, 9, 10.

[56] Ibid., pp. 9-10.

[57] Ibid., pp. 12-13.

[58] Technically, it should be noted that government plans are not covered by ERISA's fiduciary provisions; thus IB 94_1 does not govern them. It is clear, however, that a bulletin promulgated by the Department of Labor, the na- tion's chief interpreter of pension fiduciary law, must influence government plans profoundly. Zelinsky, p. 28n. 53.

[59] Ibid., pp. 14-15, 16, 17, 19.

[60] Ibid., pp. 26-27.

[61] Ibid., p. 32.

[62] Ibid., pp. 32-34.

[63] U.S. Congress, Joint Economic Committee, p. 29.

[64] Julie Bennett, "Pension Funds Hit New Targets," Planning 61, no. 2 (February 1995), electronic transmission. [65] Donlan, p. 53.

[66] Stephen Glass, "Teachers Face a Pension Deficit Disorder," Wall Street Journal, February 21, 1995, p. A26.

[67] Donlan, p. 54.

[68] State governments short of cash have occasionally issued vouchers, that is, promises to pay. Witness California in 1991-93.

[69] Schultz, p. C1.

[70] Alicia H. Munnell, testimony, in U.S. House of Representatives, Public Employee Pension Plans: Joint Hearing before the Subcommittee on Oversight of the Committee on Ways and Means and the Subcommittee on Labor-Management Relations of the Committee on Education and Labor, 98th Cong., 1st sess., November 15, 1983, pp. 68-

69.

[71] "The Ultimate Raid," Wall Street Journal, May 9, 1995, p. A20. See also Donald Lambro, "Risky Clinton Plan for Pension Funds," Washington Times, May 8, 1995, p. A22.

[72] Schotland, pp. 114-15.

[73] Marr et al., p. 94.

[74] Ibid.

[75] Ibid. In fact, Bennett, p. 5, gives the figure as $236 million lost between 1985 and 1991 by the thrift alone.

[76] Marr et al., p. 94. See also Paul Craig Roberts, "Confiscation by Decree," National Review, October 24, 1994, p. 49.

[77] Marr et al., pp. 94-95.

[78] The Colt fiasco is notable as well for the state trea- surer's pledge that Colt did not make assault weapons. Eventually, the state legislature concluded that manufactur- ing assault weapons was precisely the function of the compa- ny. Zelinsky, pp. 31-32, 32n. 60.

[79] Mitchell and Hsin, p. 2.

[80] Honor Thy Contract," Wall Street Journal, editorial, February 10, 1995, p. A8.

[81] The discussion of Prince George's County draws on the following reports from the Washington Post: Charles Babington and Robert E. Pierre, "Dispute Kills Glendening Honey moon," February 3, 1995, pp. C1, C3; Michael Abramowitz and Charles Babington, "Extent of Glendening's Involvement in Pension Decisions Still a Mystery," February 6, 1995, pp. B1, B6; David Montgomery and Robert E. Pierre, "Council Member Challenges P.G. Pension Plan,"February 9, 1995, pp. D1, D5; Charles Babington, "Glendening Battles to Save 2 Cabinet Picks," February 9, 1995, pp. B1, B4; and Michael Abramowitz, "P.G. Ethics Board Required Disclosure of Pension Interests," February 10, 1995, pp. C1, C4.

[82] Loring, pp. 112-13.

[83] On June 13, 1995, the Prince George's County Council revoked the provision of the pension plan under which Glendening and his aides had received their generous benefits. Robert E. Pierre and Terry M. Neal, "P.G. Ends Enhanced Severance," Washington Post, June 14, 1995, p. A1.

[84] Roberta Romano, "Public Pension Fund Activism in Corporate Governance Reconsidered," pp. 817-19.

[85] Donlan, p. 104.

[86] Bennett, p. 2.

[87] Ibid., p. 4.

[88] Donlan, p. 105.

[89] "Clinton's Bacon Grease," Wall Street Journal, April 11, 1995, p. A20.

[90] Frederick Rose, "Calpers Looks Close to Home as Place for New Investment," Wall Street Journal, March 2, 1995, p. A3; See also "CalPERS, Magic Eye Joint Venture," San Jose Mercury News, March 2, 1995, p. C2.

[91] Rose, p. A3.

[92] Mary Lynne Vellinga, "PERS, Smarting, Defends Its Fund," Sacramento Bee, April 20, 1993, p. C7; and Donlan, pp. 80-81.

[93] Bennett, p. 2.

[94] Ibid., p. 4.

[95] Quoted in ibid., p. 6.

[96] Romano, "Public Pension Fund Activities in Corporate Governance Reconsidered," p. 812.

[97] Ibid.

[98] Mitchell and Hsin, pp. 3, 16, 22.

[99] Kenneth N. Gilpin, "Big Investor Talked, Grace Listened," New York Times, April 10, 1995, p. D1.

[100] Quoted in ibid.

[101] "CREF Participants Vote Down Proposals," Participant, February 1995, p. 1.

[102] Information on the Social Choice Account from telephone conversation with CREF employee responding to the Contributor Information Line, June 13, 1995.

[103] "CREF Participants Vote Down Proposals," p. 20.

[104] Romano, "Public Pension Fund Activism in Corporate Governance Reconsidered," p. 852.

[105] Ibid., pp. 852_53.

[106] Glass, p. A26.

[107] Donlan, p. 62.

[108] Donlan, p. 16.

[109] Donlan, pp. 273-74.

[110] David Cay Johnston, "Top Pension Regulator Sees a Narrowing Benefits Gap," New York Times, March 31, 1995, p. D2.

[111] Donlan, p. 27.

[112] "PBGC's 20th Annual Report Cites Improved Financial Management, Lower Deficit, and Pension Reforms for 1994," PBGC News, no. 95_29 (March 30, 1995): 2.

[113] Donlan, p. 28.

[114] Ibid., pp. 14-15.

[115] Ibid., p. 126.

[116] Ibid., pp. 125-26.

[117] A recent working paper has provided more reliable evidence on the investment performance of large state and local pension systems, but an extensive study covering the small plans is lacking, as is an in_depth exploration of the

private defined benefit universe. The Government Accounting Standards Board of the United States has developed a standardized framework for reporting public pension plan liabilities and assets, which may prove helpful to fund managers. See Mitchell and Hsin, pp. 22_23.

[118] Robert L. Simison and Neal Templin, "GM Will Cut Pension Liability Further with $2.5 Billion Payment This Period," Wall Street Journal, December 22, 1995, p. B7.

[119] James M. Smalhout, "Labor's Wrong Call on GM Pensions," Wall Street Journal, March 14, 1995, p. A15. The following paragraph also draws on Smalhout's analysis.

[120] Albert E. Karr and Ellen E. Schultz, "Pension Rules Tacked Quietly on Trade Bill Portend Vast Changes," Wall Street Journal, March 15, 1995, pp. A1, A6.

[121] Ibid.

[122] David Cay Johnston, "Top Pension Regulator Sees a Nar- rowing Benefits Gap," New York Times, March 31, 1995, p. D2. The analysis of the pension changes draws heavily on Karr and Schultz and Johnston.

[123] Karr and Schultz, p. A1. The PBGC made a "fortuitous mistake" in deciding how the premiums should be figured, resulting in a $500 million, rather than a $150 million, increase in revenue. As a result, the piggyback became almost irresistible.

[124] Ellen E. Schultz, "Pension Cutbacks in GATT Legislation Scare Pre_Retirees and Bewilder Experts," Wall Street Jour- nal, December 13, 1994, p. C21. The special 1983 mortality table eventually adopted mitigates somewhat the effect of the interest rate assumption on lump_sum payments. By assuming a longer life expectancy than many employers use, it results in larger lump sums, thus partially offsetting the effect of higher interest rates.

[125] Ibid.

[126] Karr and Schultz, p. A6.

[127] Donlan, pp. 265-66.

[128] Ibid., p. 267.

[129] Ibid., pp. 267-68.

[130] U.S. Department of Labor, Advisory Council on Pension Welfare and Benefit Plans, Work Group on Pension Investments, "Economically Targeted Investments," November 1992, pp. 31-32.

[131] Marr et al., p. 95.

[132] Charles E. Rounds Jr., professor of law at Suffolk University, was particularly emphatic on that point.