JEC HOUSE STAFF REPORT

JIM SAXTON, VICE-CHAIRMAN SEPTEMBER 1995

The Economics of ETIs: Sacrificing Returns for Political Goals

Executive Summary

President Clinton's Labor Department has taken up the banner advocating Economically Targeted Investments (ETIs). Clinton and Labor Secretary Robert Reich would put the entire private pension system at risk by requiring pension plans to include social considerations when investing pension plan assets.

- Among state-level public pensions, where ETIs have been attempted, the evidence clearly demonstrates that ETIs reduce the rate of return on pension investments. Returns on such assets are crucial, since millions of hard working Americans depend on the investment income of pension assets to pay for their retirement benefits.

- Two independent studies were reviewed to see what effect ETIs have on investment returns. Using these findings, the JEC report estimates the financial consequences of engaging in ETIs on the national level.

- A 1983 paper by Alicia Munnell (recently nominated by Clinton to his Council of Economic Advisors) found that ETIs are associated with a 2 percentage point reduction in investment returns. Based on these findings, the JEC calculated that ETIs would cause pensions to be underfunded by $90 billion in just 10 years. After 30 years, ETIs would cause a pension funding shortfall of over $2.2 trillion.

- The second study, by Wayne Marr and John Nofsinger (1995), reviewed three sets of data to conclude that ETIs lower returns by 1.18 to 2.10 percentage points. The corresponding loss to the pension system based on these findings could reach $94 billion after 10 years, and over $2.3 trillion after 30 years.

- When broken down to the individual level, these losses appear truly staggering. Using Munnell's 2 percentage point reduction in investment returns, pension assets with ETIs would be worth $2,188 less than non-ETI investments after 10 years. After 30 years, the sacrificed value of pension assets would balloon to $43,298 per pension participant.

- The Clinton ETI plan is particularly threatening to the living standards of elderly Americans who rely on their pension benefits. Even as the Clinton Administration opposes the efforts of Republicans to save Medicare from insolvency, it is also threatening America's senior citizens by weakening the soundness of the private pension system in order to fund its liberal social spending agenda.

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Introduction

With the advent of a Republican-controlled Congress in January, 1995, the Clinton Administration has run into a brick wall in its attempt to implement a liberal social welfare agenda. In particular, the focus of Republicans on balancing the budget by slowing the growth rate of spending has put in jeopardy a number of expensive, big-government projects favored by the liberal wing of the Clinton Administration.

Recognizing the taxpayers' unwillingness to bear an even greater tax burden, and the Republicans' commitment to fighting another Clinton tax increase, the current administration has resorted to other methods of generating funds for its spending agenda. Perhaps the most insidious such approach involves the use of retirement pension plans to finance Economically Targeted Investments (ETIs).

ETIs are, quite simply, a type of what is commonly known as social investing, which are "socially desirable" projects that, under normal circumstances, would have a more difficult time receiving the necessary financing. The reason that these projects typically have difficulty obtaining financial backing is that they are riskier investments, yield lower returns on the investment, or both. Even the Department of Labor (DOL) has conceded that such investments are "less liquid, require more expertise to evaluate, and require a long time to generate significant returns."[1]

ETIs primarily fall under the jurisdiction of the Department of Labor, which is required by ERISA (the body of law governing the nation's pension system) to be the guardians of private pension funds. DOL Secretary Robert Reich apparently feels that sacrificing returns or financial soundness is an acceptable risk to pension plans in order to pursue a liberal social welfare agenda. In June of last year, Reich's Labor Department issued Interpretive Bulletin #94 (IB-94), which tried to define ETIs in such a manner that makes them appear legal.[2] This was necessary because most of the private pension investment community felt that ETIs violated the fiduciary duties set forth in ERISA.

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[1] U.S. Department of Labor, "Interpretive Bulletin Relating to the Employee Retirement Income Security Act of 1974," Interpretive Bulletin 94-1, June 23, 1994.

[2] Despite the Labor Department's claims in IB-94, ETIs are thoroughly inconsistent, in both moral and legal terms, with the standards set forth in ERISA. For a more complete discussion of other arguments against ETIs, see the JEC *Issue Summary* and *Talking Points* on "Economically Targeted Investments."

Unfortunately for proponents of ETIs, such semantic positioning fails to meet the standards set forth by ERISA. Although political appointees in the Labor Department espouse ETIs publicly, the Labor Department itself acknowledges that the traditional guidelines for America’s pensions are intrinsically inconsistent with ETIs. A recent Labor Department publication states:

> The primary responsibility of fiduciaries [the individuals who manage pension plans] is to run the plan solely in the interest of participants and beneficiaries and for the exclusive purpose of providing benefits and paying plan expenses. Fiduciaries must act prudently and must diversify the plan’s investments in order to minimize the risk of large losses.[3]

Clearly, the use of pension funds to promote social goals is not “solely in the interest of participants and beneficiaries,” and therefore violates ERISA. ETIs, by definition, are totally inconsistent with the legal and financial obligations of pension plans.

The Detrimental Effects on Pension Plans

Substantial evidence exists to support the contention that ETIs are harmful to pension plans. Among state and local government pension plans, where ETIs have been attempted, they have proven to lead to ETI disasters, including business ventures or public housing projects that went belly up, often costing pension plans tens of millions of dollars.

The experience of the Kansas Public Employees Retirement System (KPERS) is illustrative. After making ETIs in a savings and loan institution, a steel company and a technology firm, KPERS has already lost tens of millions of dollars on ETIs, and the total could reach between $138 million and $236 million. The State of Connecticut had a similar experience when it used a public pension fund to keep a local business afloat, only to have the business go bankrupt anyway. It is now unlikely that the pension fund will ever recoup any of its investment.

On the aggregate level, the evidence shows that pension plans engaging in ETIs yield significantly lower returns than non-ETI pension plans. Returns on pension assets are crucial for such plans, since pension plans depend on the investment income of their assets to pay out benefits in the future. By investing in ETIs, and consequently suffering below market returns, pension funds become underfunded by large amounts, requiring a reduction in benefits, increased payments by the plan sponsor, or both.

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[3] Pension and Welfare Benefits Administration, U.S. Department of Labor, “What You Should Know About Your Pension Rights,” Washington, DC: Government Printing Office, 1995, p. 40.

Although it has proven difficult to track closely the performance of ETIs, several researchers have produced estimates of the loss in investment returns attributable to ETIs. There are two independent analyses of ETI underperformance used in this study. A review of this work suggests a range of estimated loss in investment returns from a conservative 1.18 percentage points to a high of 2.10 percentage points.

One of the researchers reviewed is Alicia Munnell, recently nominated to President Clinton's Council of Economic Advisers. In 1983 Munnell wrote:

> [t]he answer to whether pension funds should sacrifice returns in their investments seems unambiguous, at least to these authors. The acceptance of a lower return on pension fund investments will eventually require either increased contributions or lower benefit payments to plan members.

This conclusion was based on her own research that found that investments designed to increase home-ownership caused pension plans to suffer significantly lower returns, on the order of 190 to 240 basis points, with 200 basis points being a conservative middle-ground. The table below displays a range of estimates quantifying these effects.

Table 1. *Underfunding of pension plans due to ETIs' lower rates of return.*

		Researchers	
	Munnell	Marr & Nofsinger- Low	Marr & Nofsinger- High
Return Reduction	200 basis points	118 basis points	210 basis points
Loss in Year 10	$90 billion	$55 billion	$94 billion
Loss in Year 20	$520 billion	$328 billion	$541 billion
Loss in Year 30	$2.25 trillion	$1.47 trillion	$2.33 trillion

Other researchers have found similar effects of ETIs on investment returns. Wayne Marr and John Nofsinger review three sets of data to find that ETI returns were 118 to 210 basis points lower, even after accounting for other factors.

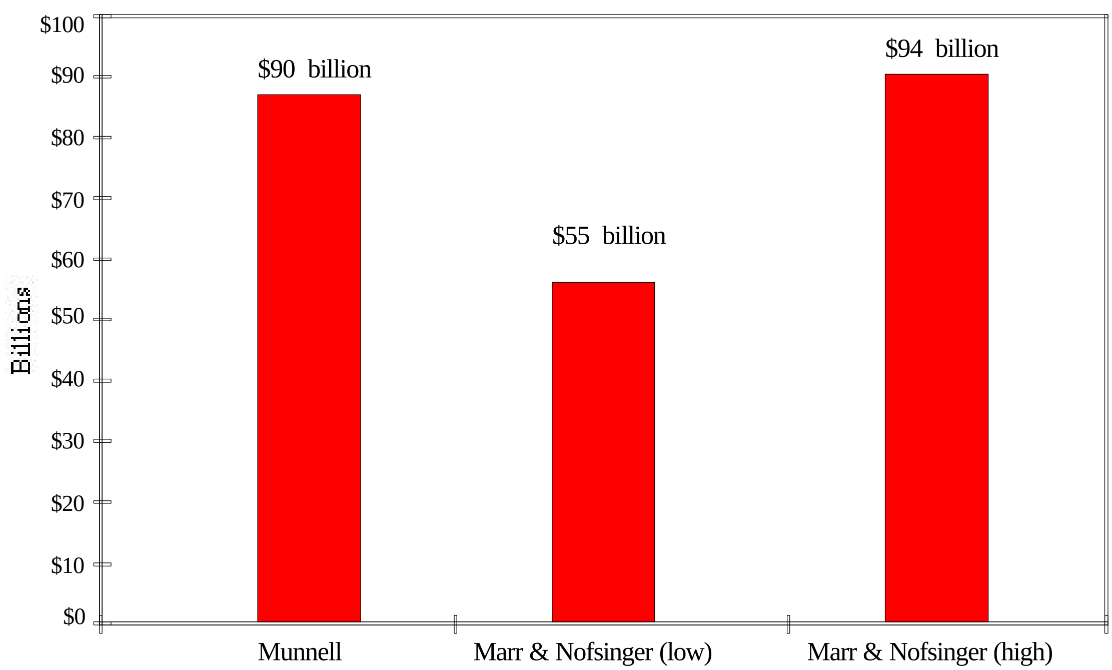
Although the 200 basis point reduction in returns may seem extreme, the relatively small scope of ETI investing thus far suggests that the potential reduction could be much larger. A 1993 study by the Institute for Fiduciary Education reports that only $19.8 billion has been invested in ETIs over their entire history. If past ETIs funded the best such social projects (even given their dismal performance), then the ramifications of flooding the market with an additional $175 billion in ETI pension funds would be extremely negative. The increase in ETIs would force more pension plans to turn to increasingly risky investments. Indeed, a 200 basis point reduction in returns would appear to be a conservative estimate.

Estimated Effects of Lower Returns on Pension Plans

To put these empirical findings on ETIs in perspective, consider the effect of lower rates of return on pension investments. President Clinton, as governor of Arkansas in the 1980s, supported a requirement that pension funds direct 5 percent to 10 percent of total pension assets to ETIs. On the national level, private pensions are currently worth approximately $3.5 trillion. If just 5 percent of all private pension assets were invested in ETIs (as advocated by many ETI supporters), it would amount to $175 billion. A comparison of private pension performance with estimates of ETI underperformance identified by two independent studies is the basis of the analysis below.

Pension Funding Shortfall Due to ETIs

Aggregate loss in pension fund assets in 10 years due to ETIs



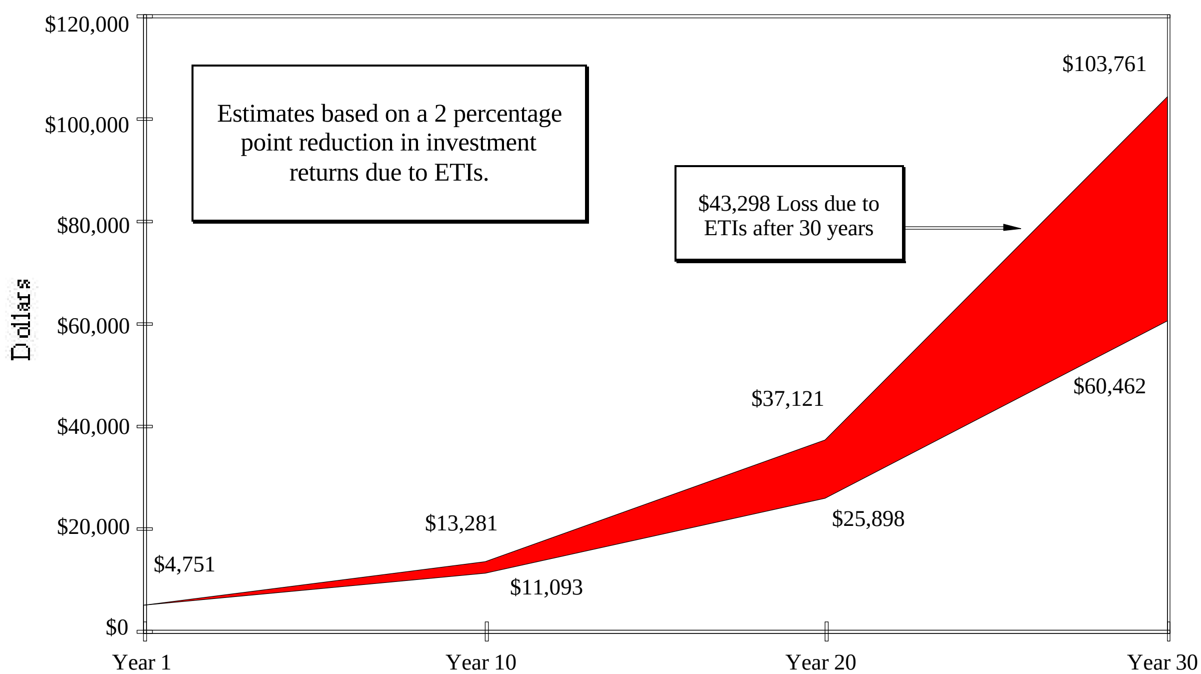
Source of estimated lower return due to ETIs

Using $175 billion as the pool of potential ETI pension assets, it is possible to quantify the consequence of lower returns due to ETIs. According to the Employee Benefit Research Institute, the average rate of return on private pension assets from 1990 to 1995 was 12.1 percent per year. If the $175 billion were invested normally and received average returns, the pension assets would be worth $548 billion after 10 years. After 30 years of average growth, the pool of pension assets in this example would be worth almost $5.4 trillion.

By comparison, if ETIs were to underperform non-ETIs by the 200 basis points estimated by Munnell, the total pool of potential ETI assets would be worth $90 billion less in 10 years, and over $2.2 trillion less in 30 years (Figure 1). This is consistent with the range of investment underperformance estimated by Marr and Nofsinger, whose research suggests that pension fund assets would be worth $55 billion to $94 billion less than what average market returns would produce in one decade. After 30 years, the value of assets sacrificed for ETIs would range from $1.47 trillion to $2.3 trillion. ETIs, therefore, could cause a potential crisis in America's pension system due to a $2.3 trillion shortfall.

These aggregate numbers translate to huge losses per pension plan participant (all individuals either contributing to or receiving benefits from a private pension plan). In the absence of ETIs, it is expected that a $175 billion pool of potential pension assets would be worth $13,281 per pension participant after 10 years, and $103,761 per participant after 30 years (Figure 2). Using the interest rate differential from Munnell, the 10 year sacrificed returns from ETIs would amount to $2,188 per private pension participant. After 30 years, the pension assets would be worth just $60,462, or a loss of $43,298 attributable to ETIs.

Per Participant Value of ETI Pension Assets:
With and Without ETIs



Based on the research by Marr and Nofsinger, the corresponding 10 year shortfall in pension funding under ETI investments would equal between $1,334 and $2,288 per participant. After 30 years, pension assets invested in ETIs would sacrifice nearly $45,000 per pension participant in order to meet the social welfare goals embodied in the concept of ETIs.

Conclusion

By forcing pension fund managers to invest in politically targeted investments, ETIs would cause the nation’s pension system to be underfunded by up to $2.3 trillion after 30 years. And as Munnell herself has stated, “To the extent that sacrificed returns result in higher taxes, the acceptance of a lower return is equivalent to an expenditure of taxpayers’ money.”

For public pension plans, the lower returns would require the state to make additional contributions, which of course would have to come from the pockets of the taxpayer. In the private sector, for direct contribution plans, it would be a direct loss to the pension beneficiary; and in the case of defined benefit plans, the employer would make additional pension contributions (which could come from lower salaries). With the potential losses due to ETIs in the trillion dollar range, there is a significant risk of some companies being unable to make the necessary increased contributions.

Given the potential for significant losses due to ETIs, it is no surprise that a 1993 study of ETIs found that one-third of all pension funds engaged in ETIs in 1989 had ceased to do so by 1993. Moreover, a 1994 survey of pension plans found that over 90 percent of all respondents wanted nothing to do with ETIs.

Although the evidence presented above has dangerous implications for America’s pension system, there are consequences beyond just pension plans. According to standard economic theory, optimal economic growth requires the efficient use of all resources, including capital. If capital is diverted to less productive uses, economic growth will be slower than it would be otherwise. ETIs are important in this respect because pension plans are a major source of financing capital investment. The potential for ETIs to harm the nation’s economic growth is considerable: by forcing pension funds to finance less productive investments, the whole economy will suffer. The long run slowdown of economic growth caused by the ETI-induced misallocation of capital will depress income growth and the standard of living.

Though ETIs are costly, the full extent of ETI losses are hard to see today. Consequently, the liberal spending wing of the Clinton Administration felt that it could force pension participants to fund their social welfare agenda without encountering too much opposition. As the data presented in this paper demonstrate, however, ETIs have consequences that are incredibly costly -- upwards of $90 billion after just ten years -- and dangerous for the millions of Americans who are counting on their current pension plans for their future retirement.

This analysis was prepared by Dan Miller, economist, and Joe Engelhard, counsel to the Vice-Chairman, with research assistance provided by Lewis Weinger.