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CHAPTER 22

Social Security Reform: An Analysis of the Ball/Altman Three-Point Plan

KATHRYN L. MOORE

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SYNOPSIS

§ 22.01 INTRODUCTION

In light of Social Security's long-term funding deficit,[1] Robert Ball, a long-serving former Commissioner of the Social Security Administration, has proposed a three part plan that would bring the Social Security system into close actuarial balance.[2] The first part of the plan consists of gradually increasing the maximum earnings base until it reaches 90 percent of earnings.[3] The second part of the plan calls for dedicating the estate tax to funding Social Security beginning in 2010,[4] and the third part of the plan consists of investing a portion of the Social Security trust fund in equities.[5] Nancy Altman, Chairman of the Board of Directors of the Pension Rights Center and assistant to Alan Greenspan when he served as Chairman of the bipartisan National Commission on Social Security Reform from 1981 to 1983, endorsed the plan in her recent book, The Battle for Social Security: From FDR's Vision to Bush's Gamble.[6]

This Article analyzes the costs and benefits of this three part plan.

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[1] The Social Security Trustees project that by 2017, the Social system will begin collecting less in contributions than it owes in benefits, and by 2040, the Trust Fund will be exhausted. Board of Trustees of Fed. Old Age and Survivors Ins. and Disa. Tr. Funds, 2006 Annual Report 2 [hereinafter 2006 Trustees' Report].

[2] Robert M. Ball, The Social Security Protection Plan: How we can cope — calmly — with the system's long-term shortfall (Jan. 2006). Close actuarial balance is defined as income within plus-or-minus 5 percent of outgo over the next 75 years. Nancy J. Altman, The Battle for Social Security: From FDR's Vision to Bush's Gamble (2005).

[3] Ball, *supra* note 2, at 2–3.

[4] Id. at 3–4.

[5] Id. at 4–6.

[6] Altman, *supra* note 2, at 297–306.

§ 22.02 INCREASING THE MAXIMUM EARNINGS BASE[7]

Current law imposes on both employees[8] and employers[9] a tax of 6.2 percent of wages, up to a maximum taxable wage base,[10] indexed to the increase in average wages nationwide and equal to $97,500 in 2007,[11] to finance Social Security benefits.[12] Under current law, the maximum taxable wage base also serves as a benefits base which establishes the maximum amount of earnings that are used to calculate benefits.[13] In 2007, the benefit for an individual who earned the maximum taxable wage for at least 35 years (the number of years on which benefits are based) and retired at the full retirement age (65 and 10 months for workers reaching age 65 in 2007), is equal to $2,116 per month or $25,392 per year.[14]

Robert Ball and Nancy Altman recommend that, in addition to the automatic annual increases in the maximum taxable wage under current law, the maximum taxable wage base (for purposes of both taxes and benefits) be gradually increased until the base covers 90 percent of all wages paid to covered employees.[15] (A wage base that covers 90 percent of wages would be about $150,000 in 2005.)[16] Specifically, they propose that the maximum taxable wage base be increased by 2 percent each year (in addition to the currently scheduled automatic increases due to the growth in average wages) until the base reaches 90 percent of taxable payroll.[17] Under their proposed approach, it would take about 40 years to reach the 90 percent level.[18]

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[7] This section is based on Section V.A. of Kathryn L. Moore, *Social Security Reform: Fundamental Restructuring or Incremental Change*, 11 Lewis & Clark L. Rev. (forthcoming 2007).

[8] 26 U.S.C. Sec. 3101(a).

[9] 26 U.S.C. Sec. 3111(a).

[10] 26 U.S.C. Sec. 3121(a)(1); 42 U.S.C. Sec. 430(a).

[11] Social Security Administration, Fact Sheet: 2007 Social Security Changes, available at http://www.ssa.gov/pressoffice/factsheets/colafacts2007.htm.

[12] The self-employed are required to pay similar taxes. 26 U.S.C. Sec. 1401(a).

[13] 42 U.S.C. Sec. 430.

[14] Social Security Administration, Fact Sheet: 2007 Social Security Changes, available at http://www.ssa.gov/pressoffice/factsheets/colafacts2007.htm.

[15] Ball, *supra* note 2, at 2; Altman, *supra* note 2, at 302 (describing and endorsing Ball proposal).

[16] Debra Whitman, *Social Security: Raising or Eliminating the Taxable Earnings Base*, CRS Report for Congress CRS-6 (May 2, 2005).

[17] Ball, *supra* note 2, at 2. Altman, *supra* note 2, at 302.

[18] Ball, *supra* note 2, at 2.

Ball notes that under current law, only about 83 percent of earnings are taxed today.[19] He asserts that Congress affirmed a goal of collecting Social Security tax on 90 percent of all covered earnings in 1983, and that the current law automatic adjustment in wages has not worked as planned, because wages for the higher paid have increased much more rapidly than average wages.[20] He proposes that the taxable wage base be gradually increased to "get [] back to the practice of collecting the Social Security tax on 90 percent of all covered earnings."[21] Ball recommends that the increase be gradual to minimize its impact on the workers subject to the higher wage base.[22] Specifically, he states that under his proposed gradual approach "deductions from earnings for the highest-paid 6 percent of workers would simply continue for a few days longer into the year . . . Such a gradual adjustment would be virtually painless."[23]

This section begins by providing a brief history of the Social Security maximum taxable wage base. It then discusses the costs and benefits of the proposed gradual increase in the maximum taxable wage base.

[1] History of Social Security Maximum Earnings Base

As originally drafted, the Roosevelt Administration's proposal did not include a maximum taxable wage base. Rather, in its original proposal, President Franklin Roosevelt's Committee on Economic Security excluded from coverage non-manual workers with monthly wages of $250 or more.[24] Presumably, the committee excluded these high wage workers because the program's drafters were focused on alleviating the poverty a large number of people faced at the time, and they were not concerned with high wage workers.[25]

The maximum taxable wage base first appeared in a bill reported by the House

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[19] Ball, *supra* note 2, at 2.

[20] Ball, *supra* note 2, at 2.

[21] Ball, *supra* note 2, at 2.

[22] Ball, *supra* note 2, at 2.

[23] Ball, *supra* note 2, at 2.

[24] Report to the President of the Committee on Economic Security, *reprinted in* Report of the Committee on Economic Security of 1935, and other Basic Documents Relating to the Development of the Social Security Act 25, 45 (50th Ann. ed. 1985).

[25] Whitman, *supra* note 16, at CRS-1. ("Being in the midst of the Depression, the Administration's attention was on the large number of aged people living in poverty. . . . Not concerned about high-income retirees, the Administration's proposal exempted non-manual workers earning $250 or more a month from coverage (i.e., $3,000 on an annual basis). Manual workers were to be covered regardless of their earnings, but few had earnings above this level.")

Ways and Means Committee.[26] The Committee replaced the exemption for high wage workers with a maximum taxable base, which it set at $3,000 per year (which equals $250 per month).[27] Although the Committee report did not provide a clear explanation for replacing the high wage exemption with a taxable wage base, Debra Whitman of the Congressional Research Service speculates that the Committee may have added the taxable wage base to promote administrative ease and tax equity.[28] Excluding high wage workers could have created administrative difficulties for workers whose earnings fluctuated above and below the $250 monthly threshold. In addition, low and average wage workers may have objected to paying taxes from which high wage workers were exempt.[29]

When the Social Security program was ultimately enacted in 1935, it included a maximum taxable wage base set at $3,000.[30] When the taxes were first collected in 1937, the $3,000 threshold taxed 92 percent of all wages in covered employment,[31] and 96.9 percent of covered workers were taxed on all of their wages;[32] that is, only 3.1 percent of covered workers had wages that exceeded the taxable wage base.

The maximum taxable wage base was increased on an ad hoc basis six times between 1935 and 1972.[33] Then, in 1972, Congress amended the Social Security program so that the benefit formula (including the taxable wage and benefit base) was indexed to adjust automatically to changes in the cost of living.[34]

In light of the rampant inflation at the time, the indexing formula turned out to

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[26] Id. at CRS-1.

[27] Id.

[28] Id.

[29] Id. at CRS-2. ("The committee's report and floor statements made at the time give no clear record as to the reasoning for the taxable limit, but concerns about tax equity and attaining as much program coverage of the workforce as possible were suggested as factors for rejecting the high-earner exemption. Not covering them meant that they would not pay the tax where lower wage earners would, and coverage would be erratic for workers whose earnings fluctuated above and below the $250 monthly threshold.)

[30] P. L. No. 74-271, Sec. 811(a) (1935)

[31] 2005 Annual Statistical Supplement, Table 4.B1, at 4.12.

[32] 2005 Annual Statistical Supplement, Table 4.B4, at 4.18.

[33] *See* 2006 Annual Report, *supra* note, at 125 (showing that contribution base was increased to $3,600 in 1951, $4,200 in 1955, $4,800 in 1959, $6,600 in 1966, $7,800 in 1968, $9,000 in 1972).

[34] Pub. L. No. 92-336, Sec. 202, 86 Stat. 412, 493–503 (1972).

be flawed,[35] and Congress amended the formula in 1977.[36] In addition, because the Social Security program faced both short-term and long-time financing difficulties at that time, Congress enacted four separate increases in the maximum taxable wage base to help address the system's deficit.[37] The increases were designed so that the taxable wage base would cover 90 percent of all wages by 1982.[38] The House Ways and Means Committee Report explains,

> Your committee' bill provides for increasing the contribution and benefit base — in four steps — to a level where about 90 percent of all payroll in covered employment would be taxable for social security purposes (and about 93 percent of all workers would have their full earnings credited for benefit purposes.) When the social security program began in 1937, about 92.5 percent of all payroll in covered employment was covered, and about 97 percent of the workers in covered employment had their full earnings counted for benefit purposes. Your committee believes that it would be desirable to move toward taxing a higher proportion of total payroll in covered employment than the 85 percent that is now taxable.[39]

Moreover, "[a]s a result of the automatic adjustment," it was expected that "the proportion of total payroll covered by the base [would] be eliminated at a constant level over the long run."[40] That prediction, however, has not turned out to be true. Due in large part to the fact that salaries for top earners grew faster than for lower wage workers,[41] the share of earnings subject to the tax has decreased from 90 percent of all earnings in 1982 to just under 85 percent in 2004,[42] and is expected to further decrease to 83 percent of all earnings by 2015[43] and remain stable

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[35] See Henry J. Aaron and Robert D. Reischauer, Countdown to Reform 83 (1998).

[36] P. L. No. 95-216, Sec. 201, 91 Stat. 1509, 1514 (1977).

[37] These changes were contained in Title I of the Act, entitled "Provisions relating to the Financing of the Old-Age, Survivors, and Disability Insurance Program." 91 Stat. 1509 & 1510.

[38] P.L. 95-216, § 103 (increasing the base to $17,700 in 1978, $22,900 in 1979, $25,900 in 1980, and $29,700 in 1981).

[39] Social Security Amendments of 1977, House Report No. 95-102, Part I 18, reprinted in 1977 U.S.C.C.A.N. 4155, 4175.

[40] Social Security Amendments of 1977, House Report No. 95-102, Part I 18, reprinted in 1977 U.S.C.C.A.N. 4155, 4175.

[41] Whitman, *supra* note 16, at CRS-3.

[42] Social Security Administration, 2005 Annual Statistical Supplement, Table 4.B1, at 4.12–4.13.

[43] See Virginia P. Reno and Joni Lavery, *Options to Balance Social Security Funds Over the Next 75 Years,* National Academy of Social Security Brief No.18, at 3 (Feb. 2005).

thereafter.[44] On the other hand, the share of workers who have income that exceeds the taxable wage base has remained at a relatively constant 5 or 6 percent since the 1980s.[45]

[2] Costs and Benefits of Increasing the Maximum Earnings Base

[a] Reducing the Long-Term Deficit

The most obvious benefit of the proposed increase in the taxable wage base is its potential to reduce Social Security's long-term deficit. According to Social Security Administration projections, the Ball/Altman proposal to gradually increase the taxable wage base over a forty year period would reduce the long-range actuarial deficit from its then level of 1.9 percent of payroll to 1.3 percent of payroll.[46] If the maximum taxable wage base were increased faster, it would reduce even more of the system's long-range actuarial deficit.[47]

Opponents of proposals to increase the taxable wage base do not deny that increasing the taxable wage base would reduce Social Security's long-term actuarial deficit. They contend, however, that reducing the system's long-term actuarial deficit is essentially meaningless[48] because adding money to Social Security's trust fund "does nothing to change Social Security's actual solvency."[49] Rather, they contend that "[a] far better measure of Social Security's finances and the impact of changes such as raising the tax cap is the annual cash-flow surplus or deficit, that is, the yearly gap between Social Security's revenues and expenditures."[50] If the taxable wage base were increased as Ball and Altman have

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[44] Whitman, *supra* note 16, at CRS-5.

[45] Whitman, *supra* note 16, at CRS-3.

[46] Ball, *supra* note 2, at 2; Social Security Administration Memorandum, Estimated OASDI Financial Effects for a Proposal With Six Provisions That Would Improve Social Security Financing (April 14, 2005).

[47] Ball, *supra* note 2, at 2 (noting that implementing the change over 10 years rather than 40 years would reduce the deficit by .1 percent of payroll rather than .6 percent of payroll).

[48] *See, e.g.,* Michael Tanner, Cato Inst., *Keep the Cap: Why a Tax Increase Will Not Save Social Security* 5 (June 8, 2005) ("[T]hose claims [that removing the wage cap would reduce Social Security's long-term deficit] are based on a fundamental fallacy: the assumption that Social Security surpluses accumulated today can be saved through the Social Security Trust Fund.")

[49] Id. at 6.

[50] Tanner, *supra* note 48, at 6. *See also Raising the Social Security Taxable Earnings Cap: Real Reform or Another Placebo?,* The Concord Coalition's Series on Social Security Reform Issue 9, at 5 (July 6, 2005) ("What matter most to the economy and budget is not the 75-year aggregate impact

proposed, the Social Security system would begin to run cash-flow deficits in 2021,[51] just four years after the system is projected to run cash-flow deficits under current law.[52] Opponents argue that increasing the taxable wage base would increase taxes with little offsetting benefit.[53]

[b] Addressing Earnings Inequality

As discussed above, Ball contends that gradually increasing the taxable wage base until it reaches 90 percent of taxable earnings would address the growing inequality of wages in the United States and restore the system to a goal Congress affirmed in 1983.[54] Opponents of increasing the taxable wage base do not dispute that over the last twenty years "earnings have risen most rapidly for workers at the top of the earnings distribution, that is, among those workers who were already receiving the highest earnings."[55] Instead, opponents of increasing the taxable wage base note that historically the share of earnings subject to the Social Security tax has varied widely, ranging from a low of 71.3 percent in 1965 to a high of 92.4 percent in 1940,[56] with the percentage below 85 percent more than half the years the Social Security tax has been in effect.[57] Critics of increasing the taxable wage base contend that there is no normatively appropriate level to set the maximum taxable wage base and thus the wage base need not be increased to address increasing earnings inequality.[58]

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on the trust funds of raising the tax cap but how much it would reduce Social Security's annual cash deficits as they emerge and grow over time.") Matt Moore, *Eliminating the Social Security Payroll Tax Cap: A Bad Idea*, National Center for Policy Analysis No. 470 (March 23, 2004).

[51] Tanner, *supra* note 48, at 7.

[52] See 2006 Annual Report, *supra* note, at 2.

[53] Tanner, *supra* note 48. Concord Coalition, *supra* note 50, at 5–6 ("As the table shows, even the most extreme of the three measures (eliminating the cap without crediting additional earnings) would not generate enough revenues to cover the future Social Security cash deficits."); Matt Moore, *supra* note 50, at 2 ("While eliminating the Social Security payroll tax cap would reduce the funding gap somewhat, it has only a marginal effect and comes with a huge economic cost.").

[54] Ball, *supra* note 2, at 2. See also Altman, *supra* note 2, at 301–02 (discussing history of taxable wage base).

[55] Peter A. Diamond and Peter R. Orszag, Saving Social Security: A Balanced Approach 64 (2004).

[56] Social Security Administration, 2005 Annual Statistical Supplement, Table 4.B1, at 4.12.

[57] Concord Coalition, *supra* note 50, at 3. *See also* Gareth G. Davis and D. Mark Wilson, The Impact of Removing Social Security's Tax Cap on Wages, A Report of the Heritage Center for Data Analysis, CDA99-01, at 3-4 (Jan. 19, 1999); Tanner, *supra* note 48, at 2.

[58] Concord Coalition, *supra* note 50, at 3. *See also* Tanner, *supra* note 48, at 2

[c] Impact on Workers and the Economy

Ball and Altman contend that their proposed increase in the taxable wage base would only affect the highest-paid 6 percent of workers, and if gradually phased in over time, could significantly reduce Social Security long-term deficit with little noticeable pain.[59] Under current law, employers are required to collect the employee's share of the Social Security tax from the employee's wages as and when the wages are paid.[60] For employees who earn less than the taxable wage base, Social Security taxes are collected throughout the year. For the 6 percent or so of workers whose wages exceed the taxable wage base, Social Security taxes are collected each pay period until wages reach the taxable wage base. For the remaining weeks or months of the year (depending on the employee's total wages), no Social Security taxes are collected from the employee's wages. Thus, under the Ball/Altman proposal to gradually increase the taxable wage base by 2 percent per year over the currently scheduled increases until the base reaches 90 percent of wages, "deductions from earnings for the highest-paid 6 percent of workers would simply continue a few days longer into the year. . . Such a gradual adjustment would be virtually painless. . ."[61]

Opponents of increasing the taxable wage base assert that "[i]n the end, proposals for changing the taxable wage cap are all pain and no gain."[62] Critics ignore the possibility of gradually increasing the wage base to 90 percent of covered wages as Ball and Altman have proposed. Instead, they focus on proposals to immediately eliminate the taxable wage base and decry such as a change as constituting "the largest tax increase in American history — some $461 billion over the first five years alone."[63]

Again, focusing solely on the possibility of immediately eliminating the wage

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[59] Ball, *supra* note 2, at 2.

[60] 26 C.F.R. Sec. 31.3102-1.

[61] Ball, *supra* note 2, at 2. Diamond and Orszag would also phase in their "reform over an extended period of time to allow workers time to adjust to the change." Diamond and Orszag, *supra* note 55, at 86.

[62] Tanner, *supra* note 48, at 1.

[63] *See* Matt Moore, *supra* note 50, at 2. *See also* Tanner, *supra* note 48, at 4 (claiming that elimination of wage cap would result in $472 billion tax increase); Concord Coalition, *supra* note 50, at 6 (asserting that elimination of wage cap would amount to more than $1.3 trillion in new taxes over next ten years); Davis and Wilson, *supra* note 57, at 5 ("Eliminating the Social Security taxable wage cap would result in the largest tax increase in U.S. — $425.2 billion over five years, or $367 billion in 1998 inflation-adjusted dollars.").

cap,[64] critics contend that such a change would harm the economy in at least two ways. First, they contend that eliminating the taxable wage base would reduce the incentive to work by increasing the marginal tax rate on labor.[65] "Should Social Security's tax cap be removed, many workers will immediately find that federal taxes alone consume almost 55 cents of every additional dollar they earn from employment."[66] In addition, critics contend that increasing the taxable wage base would reduce national savings because the tax increase would reduce the after-tax income of those workers who are most able to save.[67]

[3] Recommendation

I support the Ball/Altman proposal that the taxable wage base be gradually increased to 90 percent of taxable payroll. The first, and most important, reason for increasing the taxable wage base is that it would reduce Social Security's long-term actuarial deficit. While critics of increasing the taxable wage base are right that in many ways Social Security's annual cash-flow position is more important than its long-term deficit, reducing the long-term deficit is not meaningless.[68] Moreover, gradually increasing the taxable wage base would in fact improve the system's annual cash flow position by increasing tax receipts,

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[64] *Cf.* Rea S. Hederman, Jr., et al., *Keep the Social Security Wage Cap: Nearly a Million Jobs Hang in the Balance*, A Report for the Heritage Center for Data Analysis, CDA05-04, at 2 n.8 (April 20, 2005). ("The same number (and type) of workers would be affected by either an increase in or the outright elimination of the taxable wage cap. Only the magnitude of the tax increase and its impact on family budgets and the economy would suffer.")

[65] *See, e.g.,* Matt Moore, *supra* note 50, at 2 ("increasing the marginal tax rate will have adverse economic consequences."); John Kyl, *We Can't Tax Our Way Out of the Social Security Crisis* (Feb. 8, 2005) ("Moreover, increasing or eliminating the wage cap would stunt the growth of the entire national economy."); Davis and Wilson, *supra* note 57, at 5 ("An increase in the marginal tax rate on labor income would damage the economy by reducing the incentive to work.").

[66] Davis and Wilson, *supra* note 57, at 5.

[67] *See, e.g.*, Tanner, *supra* note 48, at 5; Davis and Wilson, *supra* note 57, at 8. Indeed, Davis and Wilson contend that increasing the taxable wage base would also reduce charitable contributions by reducing the after-tax income of the workers who contribute the most to charity. Davis and Wilson, *supra* note 57, at 8–9 ("removing the maximum taxable wage cap would reduce charitable contributions by $15.5 billion . . . from 2000 to 2004, or 1.9 percent of all charitable giving over the same period").

[68] *Cf.* Alicia H. Munnell, *Are the Social Security Trust Funds Meaningless*, Center for Retirement Research at Boston College Issue Brief No. 30 (May 2005) (explaining that accumulating a surplus in the Social Security trust funds is meaningful if it results in increased national savings).

particularly in later years when the system will be in the greatest need of increased revenues.

Second, increasing the taxable wage base makes sense in light of the growing inequality of wages in the United States. The legislative history of the taxable wage base shows that there is no single, normatively accurate level for the taxable wage.[69] Nevertheless, 90 percent of wages seems reasonable.

I agree with the critics that increasing the taxable wage base would not be entirely painless, particularly for the 6 percent or so of workers who would be required to pay increased taxes. That, however, does not mean that the proposal should be rejected. There is simply no entirely painless way to address Social Security's long-term deficit. Gradually increasing the base over a long period of time should help to minimize the pain for these individuals. Moreover, while it is possible that gradually increasing the taxable wage base and thus increasing the marginal tax rate on labor would decrease work effort, it is unlikely to have a very significant impact. Under the Ball/Altman proposal to gradually increase the taxable wage base, Social Security taxes would simply be collected, at most, for an additional week each year.[70] It is hard to imagine that such a variation in take home pay would have a significant impact on work effort. I do not believe that the risk of reduced labor supply outweighs the benefit of reducing Social Security's long-term deficit.

§ 22.03 DEDICATING THE ESTATE TAX[71]

Currently, the Social Security trust fund[72] is funded principally by dedicated payroll taxes.[73] Specifically, in 2005, net payroll taxes accounted for 84 percent

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[69] Congress explicitly selected 90 percent as the level in 1977, but it did not offer any normative justification for the 90 percent. *See* Social Security Amendments of 1977, House Report No. 95-102, Part I 18, reprinted in 1977 U.S.C.C.A.N. 4155, 4175.

[70] *See* Altman, *supra* note 2, at 302 ("Those earning at or above the maximum taxable wage base would have the same tax rate provided under present law deducted from wages a bit longer in the year - one additional week a year, at most.").

[71] This section is based on Section IV.B. of Kathryn L. Moore, *Social Security Reform: Fundamental Restructuring or Incremental Change*, 11 Lewis & Clark L. Rev. (forthcoming 2007).

[72] For these purposes, the term "Social Security Trust Fund" refers to the Old Age Survivors Insurance Trust Fund. The percentages for the Disability Insurance Trust Fund are similar though not identical.

[73] *See* 26 U.S.C. Secs. 1401(a), 3111(a), 3101,

of the Social Security trust fund's income.[74] Interest on the Social Security Trust Fund's surplus accounted for 14 percent of the trust fund's income,[75] and revenue from federal income tax imposed on certain Social Security benefits accounted for two percent of the trust fund's income.[76]

Under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA),[77] the estate tax exemption is scheduled to gradually increase from $1 million in 2002 to $3.5 million (or $7 million for a couple) in 2009, and be abolished in 2010.[78] EGTRRA, however, includes a "sunset" clause which causes the entire Act to expire in 2011.[79] Thus, under current law, the estate tax will be revived at its 2000 levels beginning in 2011.[80] President Bush, and many Republicans, call for the permanent abolition of the estate tax beginning no later than 2010.[81] In the second part of their three part plan, Ball and Altman advocate freezing the estate tax at the 2009 level and earmarking the proceeds for Social Security from 2010 on.[82]

This section outlines the costs and benefits of dedicating the estate tax to funding Social Security.

[1] Public Perception of Social Security as an "Earned Right"

The creators of the Social Security program chose to finance Social Security

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[74] 2006 Trustees' Report, *supra* note 1, at 4.

[75] 2006 Trustees' Report, *supra* note 1, at 4.

[76] 2006 Trustees' Report, *supra* note 1, at 5.

[77] Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38 (2001).

[78] Pub. L. No. 107-16, Secs. 501–521, 115 Stat. 38, 69–72 (2001).

[79] Pub. L. No. 107-16, Sec. 901(a); 115 Stat. 150 (2001).

[80] Pub. L. No. 107-16, Sec. 901(b); 115 Stat. 150 (2001). Virtually everyone expects some sort of change in the estate tax between now and 2011. The question is what form it will take. Cf. Diamond and Orszag, *supra* note 55, at 94.

[81] Leonard E. Burman, et al., *Options to Reform the Estate Tax*, 2005 TNT 61-17 (March 31, 2005) ("The president and many members of Congress would like to repeal the [estate] tax permanently, and many would like to do so before 2010.")

[82] *See* Ball, *supra* note 2, at 3; Altman, *supra* note 2, at 299–301 (endorsing Ball's proposal). Although not part of their three part plan, Peter Diamond and Peter Orszag also support using the estate tax to fund a portion of Social Security benefits. Diamond and Orszag, *supra* note 55, at 93–96.

benefits with "contributions" or payroll taxes[83] because they believed that payroll tax financing would give workers a "right" to benefits and garner long-term support for the system.[84] Indeed, President Franklin D. Roosevelt told a reporter:

> Those taxes were never a problem of economics. They are politics all the way through. We put those payroll contributions there so as to give the contributors a legal, moral, and political right to collect their pensions and their unemployment benefits. With those taxes in there, no damn politician can ever scrap my social security program.[85]

Arguably, earmarking estate tax revenues for Social Security could reduce public support for Social Security by weakening the public's perception of the program as an "earned right."[86] Earmarking estate tax revenues, however, need

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[83] Under the Social Security Act as originally enacted, Social Security benefits were not directly funded with payroll taxes. In order to avoid a constitutional challenge to the Social Security program,

> Title II of the Social Security Act created "an account in the Treasury of the United States to be known as the 'Old-Age Reserve Account.' " Title VIII of the Social Security Act imposed taxes on employers and employees. These taxes were paid into the general fund. But the legislation went on to authorize an annual appropriation from the general fund to the Old-Age Reserve Account in the exact amount of the proceeds from the Title VIII tax.

Altman, *supra* note 2, at 82–83. In 1939, however, the Social Security Act was amended to provide for direct funding of Social Security benefits with payroll contributions. See P. L. No. 76-379, Sec. 201, 53 Stat. 1360, 1362 (1939). See also 42 U.S.C. Sec. 201.

[84] See authorities cited in Moore, *Privatization of Social Security: Misguided Reform,* 71 Temple L. Rev. 131, 141 n. 63 (1998).

[85] See Moore, *supra* note 84, at 141 and authorities cited therein. *Cf.* Milton Friedman, Payroll Taxes, No; General Revenues, Yes, in The Crisis in Social Security 25, 28 (M. Boskin ed., 1977) ("The imaginative packaging has served a very important political function: it has made the public at large willing to pay much heavier taxes than they otherwise would have been willing to bear; it has made them willing to accept a capricious system of benefits and to support a mammoth bureaucracy that could never have arisen separately. The ultimate effect has been to foster the growth of government and, above all, of central government.").

[86] *Cf.* Testimony of Chairman Alan Greenspan before the Special Committee on Aging March 27, 2000), available at http://www.federalreserve.gov/boarddocs/testimony/2000/20000327.htm ("One argument was that using general revenues would blur the distinction between the social security system, which was viewed as a social insurance program, and other government spending programs."); Report of the 1994-1996 Advisory Council on Social Security, Vol. II: Reports of the Technical Panels on Trends and Issues in Retirement Savings, Technical Panel on Assumptions and Methods and Presentations to Council 83 ("On the other hand introducing general revenues to balance the system would substantially change the nature of Social Security, and it might also eventually erode public support. The additional use of general revenues would change the public's perception of Social Security benefits as earned rights, and might further politicize Social Security

not have such an effect.

Social Security's characterization as an earned right helps to distinguish it from public assistance.[87] Public assistance is based on "the right to a minimum standard of living based on membership in a civilized community."[88] Social Security, a form of social insurance, is based on participation in the labor market.[89] As Robert Ball has explained, Social Security's characterization as an earned right does not require "that the entire cost of the benefit be paid for by earmarked contributions or that the benefit amounts be in direct proportion to the worker's own contributions."[90]

Indeed, current Social Security benefits are not financed entirely by payroll taxes. Rather, as discussed above, interest on the Social Security trust fund's surplus accounts for 14 percent of the trust fund's income, and revenue from federal income tax imposed on certain Social Security benefits accounts for two percent of the trust fund's income. Based on the Social Security actuaries' projections, freezing the estate tax at the 2009 level would raise approximately $18 billion in 2010,[91] or about 2.5 percent of the OASDI's total income in 2005.[92] Such a relatively minor contribution to Social Security's income need not have a significant impact on the public's perception of and support for the program.

[2] Funding "Legacy Costs" with Estate Tax

One of the most significant, if not the most significant, reasons underlying Social Security's long-term deficit, is what Peter Diamond and Peter Orszag refer to as the system's "legacy cost" or "legacy debt."[93] This legacy cost arises from

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by drawing it explicitly into annual budget debates.").

[87] Insuring the Essentials: Bob Ball on Social Security: A Selection of Articles and Essays from 1942 through 2000 by Robert Ball 43–45 (Thomas N. Bethell, ed., 2000). For additional discussion of the distinction between social insurance and social assistance, see Altman, *supra* note 2, at 32–33.

[88] Id. at 43.

[89] Id.

[90] Id. at 44.

[91] Social Security Administration Memorandum, *supra* note 46, at Table 2d.

[92] Total income for the OASDI trust funds was $701.8 billion in 2005. 2006 Annual Report, at 4. Thus, estate tax revenues would only represent 18/701.8 or about 2.5 percent of the trust funds' income, a little more than the $14.9 billion currently received from the taxation of benefits. See id.

[93] Diamond and Orszag, *supra* note 55, at 6–7. *See also* Kathryn L. Moore, *President Bush's Personal Retirement Account: Saving or Dismantling Social Security,* N.Y.U. Rev. of Employee Benefits and Executive Compensation 5-1, 5-7-5-11 (2005) (discussing three factors that contribute

the fact that Social Security, like most social insurance systems, paid the first generations of retirees far more than their contributions to the system could finance.[94] As Robert Ball has explained:

> Financing the old-age survivors insurance program presents difficulties largely because persons retiring in the first 5, 10, 15, or even 20 years of the program cannot be expected to contribute at a high enough rate to accumulate a sum that would provide reasonably adequate benefits. Yet for sound social reasons we are not willing to postpone adequate payments under the social insurance program to the time when the amounts accumulated would cover the cost of such payments.[95]

According to calculations by economists John Geanakoplos, Olivia Mitchell, and Stephen Zeldes, as a group, the Social Security beneficiaries born before 1937 received about $10 trillion more in benefits than the economic value of their contributions to the system.[96]

The Ball/Altman proposal to earmark estate tax revenue to finance Social Security has intrinsic appeal. It requires some members of the earlier generations of Social Security beneficiaries to use some of their legacies to help pay for the "legacy debt" created for the benefit of their generations. Of course, it is not a perfect fit. First, many of the early retirees have already died and thus would not be required to use their legacies to pay for the legacy debt.[97] More importantly, the estate tax, whether it is frozen at the 2009 level (with a $3.5 million exemption for individuals or $7 million exemption for couples)[98] or returned to the 2000 level,

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significantly to Social Security's long-term deficit: (1) increasing life expectancy, (2) the fact that the baby boom generation is reaching retirement age and is followed by a much smaller generation, and (3) the legacy debt).

[94] See Insuring the Essentials, *supra* note 87, at 210 ("Most social insurance programs also give to the workers retiring in the early years of the program benefits that are much greater than can be bought by the contributions paid for their age group. This was true of the old-age benefit program under the original Social Security Act, passed in 1935; and in the 1939 amendments, older workers were given even larger benefits in relation to their contributions.").

[95] See Id. at 210.

[96] John Geanakoplos, et al., *Would a Privatized Social Security System Really Pay a Higher Rate of Return?, in* Framing the Social Security Debate: Values, Politics and Economics 137, 146 (R. Douglas Arnold et al. eds., 1998).

[97] Cf. Moore, *supra* note 93, at 5-9-5-10 (noting that Ida May Fuller, the first recipient of monthly Social Security benefits, died in 1975 at age 100).

[98] *Cf.* Gene Sperling et al., Repeal/Reform of the Estate Tax (June 30, 2005) (noting that by 2009, less than 0.3 percent of estates will owe any estate tax), available at http://

would only affect a tiny percentage of Social Security beneficiaries. Nevertheless, there is something appealing about using legacies to pay for a legacy debt.

[3] Advisability of Repealing the Estate Tax

The estate tax is a remarkably unpopular tax. Although it only affects a very small percentage of the population,[99] most Americans object to the tax.[100] Michael Graetz believes this anomaly may be due to the unflappable optimism of most Americans: most people must believe that they will be among the one to two percent richest in the nation when they die.[101] Yet, surprisingly, according to a survey by the U.S. Trust, more than half of the affluent (defined as Americans in the top one percent of income and thus most likely to be affected by the estate tax) believe that the federal estate tax should not be repealed, but that it should be continued at the rate of 18 percent.[102]

Whether the estate tax should be repealed has been the subject of major debate in recent years.[103] Indeed, as Richard Kaplan has noted, "entire forests have been

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www.americanprogress.org/site/pp.aspx?c=biJRJ8OVF&b=860671&printmode=1.

[99] *See* Diane Lim Rogers, *"Death Tax" Repeal Unfair to Those Who Owe "Birth Tax*," San Francisco Chronicle (May 31, 2006) (noting that according to the Urban-Brookings Tax Policy Center's estimates, in 2006, there will only be 12,600 taxable estates — thus a tax will be only be assessed on 1/2 of 1 percent of all deaths in 2006); Barry W. Johnson and Jacob M. Mikow, *Federal Estate Tax Returns, 1998-2000*, in IRS Statistics of Income Bulletin, Publication 1136, Spring 2002 (Rev. 5-02) (noting that an estimated 103,982 Federal estate tax returns were filed for individuals who died in 1998, that the returns represented 4.4 percent of all individuals who died that year, and less than half of the returns reported any tax liability); Barry W. Johnson and Martha Britton Eller, *Federal Taxation of Inheritance and Wealth Transfers* 19 Table 6 (March 2001) (showing percentage of adult deaths with taxable estate never exceeded 6 percent between 1934 and 1993, and in most years was less than 2 percent), paper prepared for 1997 American Statistical Association Conference and available at http://www.irs.gov/taxstats/article/0,,id=112193,00.html.

[100] *See, e.g.,* Michael J. Graetz, Erin N. Griswold Lecture Before the American College of tax Counsel: Erin Griswold's Tax Law — and Ours, 56 Tax Law. 173, 175 (2002) (noting that according to a Zogby poll, the public favored repeal of the estate tax by a 71-29% margin); Deborah Geier, *The Death of the "Death Tax"?: An Introduction*, 48 Clev. St. L. Rev. 653, 653 (2000) ("A June, 2000, Gallup poll, for example, indicated that 60% of those polled favored elimination of the estate tax 'even though only 17% [believed that] they would personally benefit.' "); Dennis J. Ventry, Jr., *Straight Talk about the 'Death' Tax: Politics, Economics, and Morality*, 89 Tax Notes 1159, 1159–60 (2000) ("In surveys conducted in late August and early September, the Pew Research Center reported that 71 percent of respondents favored 'eliminating the inheritance tax.' ").

[101] Graetz, *supra* note 100, at 175.

[102] Anonymous, *A few thoughts*, Beacon Hill Times 14 (July 18, 2006), 2006 WLNR 13326073.

[103] *See, e.g.,* Rethinking Estate and Gift Taxation (William G. Gale et al. eds. 2001); Edward J.

decimated in the process."[104] A comprehensive analysis of the estate tax[105] goes well beyond the scope of this article. I will simply try to highlight some of the principle arguments presented in the debate.

When Congress introduced the estate tax in 1916, it was said to have had two purposes: (1) to break up concentrations of wealth,[106] and (2) to produce revenue.[107] In recent years, a third goal or purpose has been attributed to the estate tax: adding progressivity to the federal tax system.[108]

Critics of the estate tax contend that it has done little to break up concentrations

McCaffery et al., *Should We End Life Support for Death Taxes?*, 88 Tax Notes 1373 (2000); *Symposium on Wealth Taxes Part I,* 53 Tax L. Rev. 257 (2000); *Symposium on Wealth Taexes Part II,* 53 Tax L. Rev. 499 (2000); Ventry, *supra* note 100; Charles Davenport & Jay A. Soled, *Enlivening the Death-Tax Death-Talk,* 84 Tax Notes 591 (1999); Edward J. McCaffery, *The Uneasy Case for Wealth Transfer Taxation,* 104 Yale L. J. 283 (1994); John E. Donaldson, *The Future of Transfer Taxation: Repeal, Restructuring and Refinement, or Replacement,* 50 Wash. & Lee L. Rev. 539, 541 (1993); Michael J. Graetz, *To Praise the Estate Tax, Not to Bury It,* 93 Yale L. J. 259 (1983)

104 Richard Kaplan, *Crowding Out: Estate Tax Reform and the Elder Law Policy Agenda,* 10 Elder L. J. 15, 20 (2002).

105 "Federal law imposes an integrated set of taxes on estates, gifts, and generation-skipping transfers." William G. Gale and Joel Slemrod, *Overview* in Rethinking Estate and Gift Taxation 1, 4 (William G. Gale et al. eds. 2001). Generally, when discussing the estate tax, most commentators address the gift tax or the entire transfer tax system together. This article will simply refer to the estate tax, but much of the discussion is applicable to the entire transfer tax system.

106 For an exhaustive discussion of why high concentrations of wealth should be broken up, see James R. Repetti, *Democracy, Taxes and Wealth,* 76 N.Y.U. L. Rev. 825, 828–50 (2001).

107 *See, e.g.,* Edward J. McCaffery & Linda R. Cohen, *Shakedown at Gucci Gulch: The New Logic of Collective Action*, 84 N.C. L. Rev. 1159, 1180 (2006) ("The tax was designed both to raise revenue and, in the progressive spirit of the times, to break up large concentrations of wealth."); Jay A. Soled, *Reassigning and Assessing the Role of the Gift Tax*, 83 B.U. L. Rev. 401, 402–403 (2003) ("There were two purposes that underlay the passage of this [estate] tax: to raise revenue and to impede the buildup of large wealth concentrations); Douglas A. Kahn & Jeffrey H. Kahn, *"GIFTS, GAFTS, AND GEFTS*" *The Income Tax Definition and the Tax Treatment of Private and Charitable "Gifts and a Principled Policy for the Exclusion of Gifts from Income*, 78 Notre Dame L. Rev. 441, 475 n. 125 (2003) ("A major reason for having estate taxes is to reduce large concentrations of wealth.").

108 Whether this is a recent claim or a long-standing defense is actually subject to debate. *Compare* Gale and Slemrod, *supra* note 105, at 29 ("Progressivity has long been a principal justification for the estate tax.") *with* Donaldson, *supra* note 103, at 541 ("More recently, the system has been 'justified' for its role or potential in adding an element of progressivity to the overall federal tax system.").

of wealth.[109] Some proponents of the tax concede that it has done little to break up the greatest concentrations of wealth[110] while other proponents assert that the tax does in fact decrease dynamic wealth concentration.[111] Other proponents of the tax assert that the failure of the tax to break up large concentrations of wealth is due to lack of political will, which is "hardly condemnatory of the tax."[112]

As for producing revenue, critics of the tax note that it only produces a tiny percentage of total federal tax revenue (about one percent)[113] and may even cost the federal government more to administer than it collects from the tax.[114] Critics label the tax "voluntary"[115] because so many methods have been developed to avoid it[116] and contend that the extraordinary amount of money devoted to avoiding the tax relative to the revenue collected causes the tax to impose an unacceptably high social cost.[117] Proponents of the estate tax concede that it produces a relatively small percentage of total tax revenue but contend that critics overstate the administrative costs associated with the tax.[118] Moreover, while the estate tax may produce a relatively small percentage of total tax revenue, it still

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[109] Barbara Redman, *Rethinking the Progressive Estate and Gift Tax,* 15 Akron Tax J. 35, 36 (2000); Donaldson, *supra* note 103, at 541.

[110] Graetz, *supra* note 103, at 271.

[111] *See, e.g.,* Repetti, *supra* note 106, at 856–59.

[112] Davenport and Soled, *supra* note 103, at 598.

[113] McCaffery, *supra* note 103, at 301.

[114] *See, e.g.,* Redman, *supra* note 109, at 36; McCaffery, *supra* note 103, at 300–04. For an overview of the debate regarding administrative issues, see Gale and Slemrod, *supra* note 105, at 37–43.

[115] George Cooper, A Voluntary Tax?: New Perspectives on Sophisticated Estate Tax Avoidance (1979).

[116] *See, e.g.,* Richard Schmalbeck, *Avoiding Federal Wealth Transfer Taxes in* Rethinking Estate and Gift Taxation 113, 120–44 (William G. Gale et al. eds., 2001) (describing methods for avoiding the estate tax and suggesting these devices may reduce the aggregate tax base by about one-third). It is worth noting that EGTRRA did not address the estate tax's many loopholes. *See* Diamond and Orszag, *supra* note 55, at 94.

[117] Johnson and Eller, *supra* note 99, at 20 ("The annual costs of estate tax avoidance schemes, including lawyer fees, accountant fees, costs of subscriptions to estate planning magazines, and opportunity costs of individuals involved in tax avoidance activities, have been shown to represent a large percentage of the annual receipts from estate and gift taxes."); Alicia H. Munnell, *Wealth Transfer Taxation: The Relative Role for Estate and Income Taxes,* New England Economic Review 3, 19 (1988) (asserting that tax avoidance costs approach billions of dollars each year which is "an inordinately high social cost for a tax that only yielded $7.7 billion in 1987.").

[118] *See, e.g.,* Davenport & Soled, *supra* note 103, at 618–625. *See also* Repetti, *supra* note 106, at 869–72 (stating that cost to IRS in administering tax appears to be proportional to revenues

raises sizeable dollars;[119] by one estimate, permanently repealing the estate tax would cost the nation $800 billion between 2011 and 2021[120] Indeed, earmarking the estate tax for Social Security would reduce about 20 percent of Social Security's seventy-five year actuarial deficit.[121]

To the extent that the estate tax is borne by decedents,[122] it is undoubtedly progressive.[123] At most, only about four percent of decedents must file an estate tax return, and only about half of those decedents pay any estate tax.[124] Thus, at most, only about the richest 2 percent of the nation's decedents have taxable estates.[125] Nevertheless, the desirability of progressive taxes in general,[126] and estate taxes in particular[127] has been the subject of considerable debate.

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generated and noting that with respect to compliance costs, it is difficult to distinguish between costs incurred to minimize estate taxes and those to provide for orderly succession of property).

[119] Graetz, *supra* note 100, at 175 ("In 1999, fewer than 50,000 taxable estates contributed $28 billion to finance the federal government. Estate tax receipts had been projected to grow to about $40 billion by 2008."); Repetti, *supra* note 106, at 852 (finding estate tax revenue significant relative to income tax revenue collected from low and moderate income individuals).

[120] William H. Gates, Sr. & Chuck Collins, *Tax the Wealthy: Why America Needs the Estate Tax*, 13 Am. Prospect 20 (Issue 11, June 17, 2002). *See also* Davenport and Soled, *supra* note 103, at 593 ("While not a large percentage of receipts, [transfer taxes] are sufficiently great that elimination or reduction of them would force some fiscal offset: other taxes would have to be raised; other taxes could not be cut; borrowing would be greater; or spending would have to be cut.").

[121] Diamond and Orszag, *supra* note 55, at 94–95. *See also* Ball, *supra* note 2, at 4. (stating that earmarking estate tax revenues would reduce Social Security's then long-term deficit of 1.9 percent of payroll (the level at the time of the calculation) to 1.4 percent of payroll).

[122] Even if the estate tax is borne by recipients, it may still be viewed as progressive. *See* Gale and Slemrod, *supra* note 105, at 28–29.

[123] *See* Geier, *supra* note 100, at 654–55 ("[I]t's undeniable that the estate tax is extremely progressive for the very reason that it collects tax from fewer than 2% of all decedents each year."). *But see* Donaldson, *supra* note 103, at 544 (arguing that "[t]he existing transfer tax system simply cannot be justified by reference to its contribution to progressivity [because it affects such a small percentage of the decedent population]").

[124] Gale and Slemrod, *supra* note 105, at 23.

[125] Gale and Slemrod, *supra* note 105, at 23. Indeed, under current law with much higher exemptions as few as one-half of one percent of decedents are expected to pay the estate tax. See authorities cited in note, *supra*.

[126] *Compare* Walter J. Blum, *Revisiting the Uneasy Case for Progressive Taxation*, 60 Taxes 16 (1982); Walter J. Blum and Harry Kalven, Jr., *The Uneasy Case for Progressive Taxation*, 19 U. Chi. L. Rev. 417 (1952) with Robert H. Frank & Philip J. Cook, The Winner-Take-All Society 20–21, 58, 121–23, 212–17 (1995).

[127] *Compare* Davenport and Soled, *supra* note 103, at 598 ("Because we believe in progressivity

Critics of the estate tax offer at least two other objections to the estate tax.[128] First, and perhaps foremost, critics of the estate tax argue that it has an adverse effect on savings and investment and thus on capital formation.[129] Proponents of the estate tax claim that the economic studies are equivocal and do not clearly establish that increased savings will result from the elimination or reduction of estate taxes.[130]

In addition, some critics contend that the estate tax hurts small farms and family-owned businesses.[131] "To pay the estate tax after the owner dies, the heirs

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we think that the contribution the estate tax makes to it is on the whole good); James R. Repetti, *The Case for the Estate and Gift Tax*, 86 Tax Notes 1493, 1500–03 (2000) (by increasing tax burden of the wealthy, estate tax contributes to progressivity of income tax); Graetz, *supra* note 103, at 272 (finding that about one-third of the progressivity in the federal tax system is due to the estate tax); Gates and Collins, *supra* note 120 (describing estate tax as one of most progressive taxes; "taxing dead mulitmillionaires is eminently more fair than taxing the no-so-rich living.") *with* Redman, *supra* note 103 (contending that to the extent that bequest or gift is recognition of and compensation for past services rendered, progressive taxation loses much of its logic); McCaffery, *supra* note 103 (favoring progressive consumption tax but not estate tax)

[128] For a response to a third argument against the estate tax, that it constitutes double taxation, see Ruth Carlitz and Joel Friedman, *Why the Estate Tax is not "Double Taxation*," Center on Budget and Policy Priorities (June 17, 2005).

[129] Graetz, *supra* note 103, at 278 ("The basic argument is quite straightforward. Our nation needs more savings if it is to enjoy economic growth. The estate tax is levied on savings, and taxing such savings will cause people to save less."); Johnson and Eller, *supra* note 99, at 3 ("Opponents claim that transfer taxation creates a disincentive to accumulate capital and, thus, is detrimental to the growth of national productivity."). For an overview of the debate regarding the estate tax's effects on saving and labor supply, see Gale and Slemrod, *supra* note 105, at 43–45.

[130] *See, e.g.,* Davenport and Soled, *supra* note 103, at ("Because of Slemrod's concern, we suggest an inquiry into whether taxing the very rich has a special effect on the economy. Short of that inquiry and results from it, no case has been made for the estate tax having much effect on savings or capital formation."); Repetti, *supra* note 106, at 858–66 (reviewing theory and empirical studies and finding that most empirical evidence suggests that estate tax does not decrease savings); Graetz, *supra* note 103, at 283 ("[o]n balance, . . . the economic evidence available to date simply fails to make a case for the elimination or reduction of estate and gift taxes on the grounds that increased savings will result.") *See also* Johnson and Eller, *supra* note 99, at 21 ("There are economists who also reject the postulate that moderate transfer taxes have an adverse effect on capital accumulation. Embracing an idea first proposed by the mid-19th century English economist J.R. McCulloch, they argue that transferors adjust their bequest plans when faced with transfer taxes.")

[131] Johnson and Eller, *supra* note 99, at 20 ("Federal transfer taxes are often cited as impediments to the livelihood of small businesses and farms."). For an overview of this debate, see Gale and Slemrod, *supra* note 105, at 45–50; Congressional Budget Office, Effects of the Federal Estate Tax on Farms and Small Businesses (July 2005).

face a stark choice: sell the machinery and go out of business, or make all the other kinds of cost-cutting decisions — layoffs, deferring new investment — that hurt the company's competitiveness."[132] Proponents of the estate tax respond that the estate tax should have a minimal impact on most small businesses because of a number of provisions in the estate tax law, including the exemption for small estates,[133] that are intended to provide relief to small business and farms.[134] Proponents concede that the law is complex and imperfect, but argue that the law should be reformed rather than repealed.[135]

[4] Recommendation

Overall, I find a great deal of merit in Ball/Altman proposal to earmark estate tax revenue for Social Security. The estate tax may be imperfect and in need of reform, but it should retained because of the role it plays in adding progressivity to the federal tax system. Moreover, in light of the progressive nature of the estate tax, and the fact that one of the reasons Social Security faces a long-term deficit is because the system redistributed income to the early generations of Social Security beneficiaries, it seems appropriate to use a highly progressive tax, rather than the regressive payroll tax, to fund this redistribution. Although an imperfect fit, using legacies to pay for a legacy debt is an appealing idea.

Of course, using estate tax revenue to fund some Social Security benefits would weaken the link between contributions and benefits and could erode public support for the program. Nevertheless, I believe the program is "mature enough to withstand an infusion of [estate tax] revenues without undermining its basic principles."[136]

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[132] John Engler, *Death tax' and folks who make things*, Akron Beacon J. B2, 2006 WLNR 9792763 (June 8, 2006).

[133] *See, e.g.,* Gale and Slemrod, *supra* note 105, at 47–49 (describing favorable treatment of family farms and businesses under pre-EGTRRA law); Repetti, *supra* note 106, at 866–68 (same).

[134] Some contend that the claim that the estate tax harms farms and small businesses is nothing more than a myth. *See* Geier, *supra* note 100, at 655 ("While commentators agree that there must surely be some farm or small business somewhere that was, indeed, sold to pay estate taxes, no one seems to have ever been able to find it."); McCaffery, et al., *supra* note 103, at 1374 ("While there are reports of businesses being sold to pay estate taxes, there is no work validating this. Some anecdotal information suggests the contrary.").

[135] *See, e.g.,* Graetz, *supra* note 100, at 175; Repetti, *supra* note 106, at 868–69; Ventry, *supra* note 100, at 1168–69.

[136] Munnell, *supra* note, 102, at 149.

§ 22.04 INVESTING A PORTION OF THE SOCIAL SECURITY TRUST FUND IN EQUITIES

Under current law, the assets of the Social Security trust fund must be invested in U.S. government bonds.[137] Over the last 75 years or so, the average annual total after inflation rate of return on large corporate stocks has been about 7%, compared to 2.3% on long-term government bonds.[138] In the third part of their three part plan, Ball and Altman propose that the law be amended to permit up to 20 percent of the assets of the Social Security trust fund to be invested in a broadly diversified, indexed equity fund or funds[139] to take advantage of this relatively higher rate of return. They propose that the investment in equities be implemented gradually, with one percent of assets invested in equities at the end of 2006, two percent of assets at the end of 2007, and increasing by one percent each year until 20 percent of assets are invested in equities at the end of 2025.[140] They propose a separate limitation on total trust fund investments equal to 15 percent of the total market value of all stocks.[141] The Social Security actuaries project that the Ball/Altman proposal to diversify the Trust Fund's investments would reduce the Social Security trust fund's long-term projected deficit by 0.37 percent of taxable payroll.[142]

At first blush, this proposal might appear to be a simple, costless fix to Social Security's long-term deficit. In fact, however, the proposal raises a number of important issues and concerns. This section identifies and analyzes some of the

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[137] 42 U.S.C. Sec. 401(d) ("Such investments may be made only in interest-bearing obligations of the United State or in obligations guaranteed as to both principal and interest by the United States.").

[138] Brian W. Cashell, *Investing Social Security Funds in the Stock Market: Some Economic Considerations*, CRS Report for Congress RL32848 CRS-2 (April 12, 2005); Alicia H. Munnell and Pierluigi Balduzzi, *Investing The Social Security Trust Fund in Equities*, AARP Public Policy Institute Paper No. 9802, at 5 (March 1998); P. Brett Hammond and Mark J. Warshawsky, *Investing Social Security Funds in Stocks*, Benefits Quarterly 52, 52 (3d Quarter 1997).

[139] Ball, *supra* note 2, at 4–5; Altman, *supra* note 2, at 303–04.

[140] Ball, *supra* note 2, at 4; Altman, *supra* note 2, at 303.

[141] Altman, *supra* note 2, at 303.

[142] Altman, *supra* note 2, at 303; *Cf.* Social Security Administration Memorandum, *supra* note 46, at 1–2 (noting that all three elements of Ball/Altman proposal would reduce deficit by 1.47 percent and attributing 0.61 percent reduction to increasing taxable wage base and 0.51 percent reduction to federal estate tax provision). *See also* Alicia H. Munnell and Steven A. Sass, Social Security and the Stock Market: How the Pursuit of Market Magic Shapes the System 5 (2006) (noting that "[t]he Social Security actuaries . . . credit equities with their expected rate of return" and do not adjust the return for risk when evaluating the financial impact of the proposed reform).

most significant issues raised by the proposal.[143]

[1] Greater Investment Risk

The fact that, over the long term, equity investments have provided a higher rate of return than have bonds is often referred to as the equity premium.[144] With the equity premium comes higher risk.[145] Specifically, investing a portion of the Social Security trust fund in equities would subject the trust fund to two forms of higher risk: (1) default risk, and (2) greater volatility around the mean.

Under current law, the assets of the Social Security trust fund must be invested in special Treasury securities.[146] Like marketable Treasury securities, special Treasury securities are backed by the full faith and credit of the U.S. government[147] and thus are virtually free from risk of default.[148] Equity investments, in contrast, are subject to default risk. One need only recall Enron to recognize that equity investments involve default risk.

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[143] For additional discussion of the issues raised by proposals to invest a portion of the Social Security trust fund in private equities, see, for example, Benjamin A. Templin, *Full Funding: The Future of Social Security*, 22 J. L. & Pol. 395 (2006) (arguing for full funding of Social Security system); General Accounting Office, *Social Security Financing: Implications of Government Stock Investing for the Trust Fund, the Federal Budget, and the Economy*, GAO/AIMD/HEHS-98-74 (April 1998) (identifying and analyzing host of issues); Alicia H. Munnell, *Investing the Social Security Trust Funds in Equities,* AARP Public Policy Institute Paper No. 9802 (March 1998) (identifying and analyzing 6 different issues); Lawrence J. White, *Investing the Assets of the Social Security Trust Funds in Equity Securities: An Analysis*, 2 Investment Company Institute Perspective (Number 4 May 1996) (identifying and briefly discussing 5 different issues); Report of the 1994-1996 Advisory Council on Social Security, Vol. II, Reports of the Technical Panel on Trends and Issues in Retirement Savings, Technical Panel on Assumptions and Methods, and Presentations to the Council 84-87 (identifying variety of issues).

[144] Cashell, *supra* note 138, at CRS-2 ("The difference between the yield on stocks and relatively less risky investments such as Treasury bonds is known as the equity premium.").

[145] Munnell and Balduzzi, *supra* note 138, at 6 ("Of course, the equity premium comes with higher risk, in the form of greater volatility around the mean. . .").

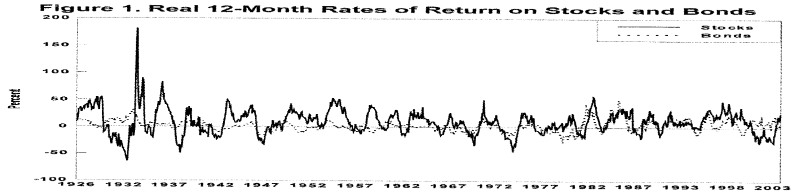
[146] The trust fund may invest in marketable Treasury and agency securities if the Managing Trustee (the Secretary of the Treasurer) determines that purchasing such securities is "in the public interest." 42 U.S.C. 401(d). Although the Trust Fund has invested in marketable securities in the past, such investments are rare. General Accounting Office, *supra* note 143, at 36 & n. 2 (April 1998) ("As of 1996, marketable Treasury securities represented only 0.009 percent of the trust fund's holdings.").

[147] 42 U.S.C. Sec. 402(d).

[148] General Accounting Office, *supra* note 143, at 36. Although they are free from default risk, they are subject to interest rate risk and inflation risk. Munnell and Balduzzi, *supra* note 138, at 6 n.10.

In addition, Treasury securities provide a much more predictable rate of return than do equity investments. Under current law, the interest rate on the special Treasury securities must be equal, at the time of issue, to the average market yield on outstanding marketable government securities not due or redeemable for at least four years.[149] The following figure, Figure 1,[150] shows the 12-month real rates of return on stocks and long-term government bonds, monthly from 1926 until 2003. It clearly illustrates the greater volatility of equity investments.

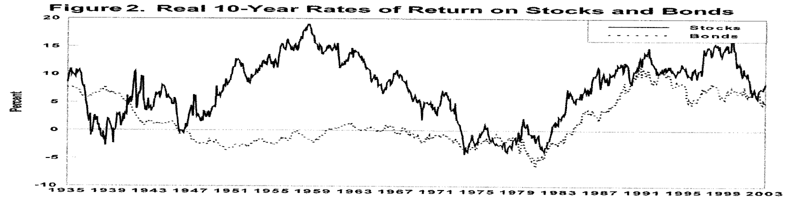
Figure 1. Real 12-Month Rates of Return on Stocks and Bonds



Source: Ibbotson Associates.

Short-term fluctuations, however, are generally not a significant concern for a long-term investor. Rather, long-term trends are more relevant, and historical evidence shows that as the holding period increases, the variation in the rates of return of equity investments decreases. Figures 2, 3, and 4 illustrate this phenomenon.[151]

Figure 2. Real 10-Year Rates of Return on Stocks and Bonds



Source: Ibbotson Associates.

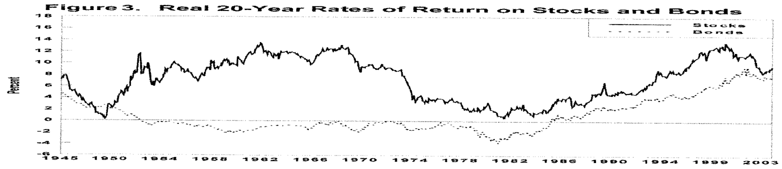
For an argument that the special Treasury securities are in fact subject to default risk, see Templin, *supra* note 143, at 413–14.

[149] 42 U.S.C. 402(d).

[150] This figure was originally published in Cashell, *supra* note 138, at CRS-3.

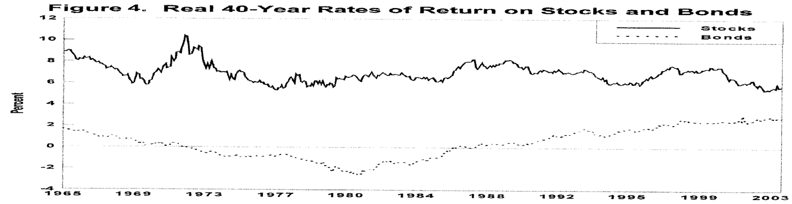
[151] Like figure 1, these figures were originally published in Cashell, *supra* note 138, at CRS-4-CRS-6, as figures 3, 4, and 6.

Figure 3. Real 20-Year Rates of Return on Stocks and Bonds



Source: Ibbotson Associates.

Figure 4. Real 40-Year Rates of Return on Stocks and Bonds



Source: Ibbotson Associates.

Thus, although the stock market is volatile in the short run, most commentators agree that past experience suggests that this volatility is not a significant risk for long-term investments,[152] like the Social Security trust fund's investment in equities would be.

[2] Who Should Bear the Investment Risk?

Although the volatility in the rates of return decreases over long holding periods, investing a portion of the Social Security trust fund in the private equities market undoubtedly involves some degree of risk.[153] This raises the question: who

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[152] See, e.g., Francis X. Cavanaugh, The Truth about the National Debt: Five Myths and One Reality 101 (1996) ("Although the stock market is volatile in the short run, the experience of the past fifty years shows that this volatility is not a serious risk for long-term investments, such as retirement funds."); General Accounting Office, *supra* note 143, at 40 ("Short-run fluctuations are generally less of a concern for a long-term investor who buys and holds investments.").

See also Thomas E. MaCurdy & John B. Shoven, Stocks, *Bonds, and Pension Wealth*, in Topics in the Economics of Aging 61 (David Wise, ed. 1992) (showing that all stocks portfolio has yielded a higher return than has an all bonds investment strategy for all careers exceeding twenty-five years); Templin, *supra* note 143, at 420–21 (discussing study by Jeremy Siegel of 200 years of financial data showing that a portfolio containing a broad based index of stocks had 80 percent chance of outperforming a bond only portfolio in a ten year period, a 90 percent chance over a 20 year period, and a 99 percent chance over a 30 year period); General Accounting Office, *supra* note 143, at 40 ("Given that from 1926 to 1996, there was no 20-year period in with a negative stock return, an investor might reasonably expect to earn a positive return over 20 years.").

[153] *See* Thomas E. MaCurdy & John B. Shoven, *Asset Allocation and Risk Allocation: Can*

should bear that risk. Some supporters of private accounts contend that it is inappropriate for the trust fund to bear the risk; although, it would be acceptable for individual workers to bear the risk through individual accounts. These supporters of individual accounts contend that if the trust fund were to invest in equities and the market were to experience a downturn, then all workers and/or retirees would be inappropriately forced to bear market risk. They contend that a system of individual accounts would be superior because only those workers who elect to invest in equities would be subject to market risk.[154]

Other commentators, in contrast, argue that some assets in the Social Security trust fund should be invested in equities precisely so that risk can be shared. They assert that the young bear no risk under the current system, and some assets should be invested in equities so that the young are forced to bear risk.[155]

[3] Effect on Stability of Market

Any proposal to invest a portion of the Social Security trust fund in private equities raises the question whether such an investment would overwhelm and destabilize the market.[156] The Ball/Altman proposal is designed to minimize any such concerns. First, it provides that equity investments would be gradually introduced with just one percent of trust fund assets being invested in equities each year for 20 years.[157] In addition, Ball and Altman propose a separate

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Social Security Improve Its Future Solvency Problem by Investing in Private Securities?, in Risk Aspects of Investment-Based Social Security Reform 11 (John Y. Campbell and Martin Feldstein, eds., 2001) (contending that switching from a policy of having the Social Security trust fund invest solely in special issue Treasury bonds to one in which the trust fund holds some private equities amounts to an asset swap and that exchanging ten or twenty year bonds for a stock portfolio would worsen Social Security's finances roughly 20 to 25 percent of the time); Martin L. Leibowitz and William S. Krasker, *The Persistence of Risk: Stocks versus Bonds Over the Long Term,* 44 Financial Analysts Journal 40–47 (Nov./Dec. 1988) (estimating that a stock portfolio has a 32 percent chance of underperforming a bond portfolio over a 10-year horizon and a 21 percent chance over a 30-year period).

[154] *See, e.g.,* Sylvester J. Schieber & John B. Shoven, Real Deal: The History and Future of Social Security 379 (1999); White, *supra* note 143, at 12–13 & n.17 (Number 4 1996).

[155] *See, e.g.,* Peter A. Diamond, *The Economics of Social Security Reform*, in Framing the Social Security Debate: Values, Politics, and Economics 38, 48–50 (R. Douglas Arnold, et al. eds. 1998) *See also* Munnell and Balduzzi, *supra* note 138, at 7; General Accounting Office, *supra* note 143, at 50–51 ("According to recent research, the increased risk of any shortfall if stock investing does not work as expected would be borne largely by future taxpayers.").

[156] Munnell and Balduzzi, *supra* note 138, at 8.

[157] Ball, *supra* note 2, at 4; Altman, *supra* note 2, at 303.

limitation on total trust fund investments equal to 15 percent of the total market value of all stocks.[158] In 1997, Brett Hammond and Mark Warshawsky studied the likely impact of the 1994-1996 Social Security Advisory Council's proposals on the equities market. They found that the Council's Maintain Benefits Plan's proposal to invest trust fund assets in equities, which was similar to the Ball/Altman plan but proposed more than twice the amount of equity investment,[159] would not overwhelm the equities market under most plausible circumstances.[160]

[4] Effect on Economy

Many commentators contend that investing a portion of the Social Security trust fund in private equities would have little to no effect on the economy.[161] They describe such proposals as asset swaps. For example, Alan Greenspan has said, "shifting social security trust funds to private securities, while likely increasing income in the social security system, will, to first approximation,

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[158] Altman, *supra* note 2, at 303.

[159] The Maintain Benefits Plan called for investing 2.67% of the trust funds assets in equities up to a limit of 40% of the total trust fund assets. Hammond and Warshawsky, *supra* note 138, at 54; Report of the 1994-1996 Advisory Council on Social Security, Vol. I: Findings and Recommendations 25–26 (1997)

[160] Hammond and Warshawsky, *supra* note 138, at 63.

[161] *See, e.g.*, Century Foundation Issue Brief 8, at 4 ("There is no reason why shifting a share of the trust fund reserves from Treasury securities into stocks would either increase or decrease economic growth. The change would not directly affect national saving, investment, capital stock, or production. It is possible that government borrowing rates might have to rise slightly to induce private investors to buy the securities that the trust funds would be eschewing for stocks. And private savers might earn slightly lower returns because their portfolios would contain fewer common stocks. And more government bonds — those that the trust funds no longer purchased. Still, most analysts believe that these effects would be almost undectable."); Robert Greenstein, *Should a Portion of Social Security Benefits be Invested in Equities?,* Center on Budget and Policy Priorities 10 (Feb. 23, 1999) ("the fact that the investment of trust-fund reserves in equities would not itself boost the economy is not relevant to weighing the advantages and disadvantages of trust-fund investment versus other Social Security proposals"); Munnell & Balduzzi, *supra* note 138, at 11 ("Investing the trust funds in equities should be viewed to a first approximation as a restructuring with little impact on aggregate savings, investment, or national income."); General Accounting Office, *supra* note 143, at 53 ("The economic effects of government stock investing would likely be minimal because stock investing by itself does not increase national saving."); White, *supra* note 143, at 8 ("If the equity purchases simply accomplish a swapping of assets between the OASDI Trust Funds and the general public . . . then there is a serious question as to whether there has been any net gain from the perspective of the overall economy.").

reduce non-social security retirement income to an offsetting degree."[162] Laurence S. Seidman wrote, "Portfolio diversification without fund accumulation would not raise the capital accumulation in the economy; if social security holds more corporate stock earning 6 percent and less government bonds earning 2 percent, then the public will hold less corporate stock earning 6 percent and more government bonds earning 2 percent."[163]

A few economists, however, have found that trust fund diversification could have real effects on the economy. They contend that once the heterogenity of current asset ownership is taken into account, determining the economic effect of investing a portion of the Social Security assets in equities becomes more complex. [164]

[5] Government Control of Private Companies

Arguably the most significant issue raised by the Ball/Altman proposal to invest a portion of the Social Security trust fund in private equities is the question whether such investment would be subject to inappropriate political influence. [165] Critics of proposals to invest a portion of the Social Security trust fund in private equities contend that direct trust fund investment could lead to inappropriate government influence over companies. [166] Critics cite two basic types of concerns:

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[162] Testimony of Chairman Alan Greenspan, *Social Security*, Before the Task Force on Social Security of the Committee on the Budget, U.S. Senate (Nov. 20, 1997). ("Without an increase in the savings flow, private pension and insurance funds, among other holders of private securities, presumably would be induced to sell higher-yielding stocks and private bonds to social security retirement funds in exchange for lower yielding U.S. treasuries. This could translate into higher premiums for life insurance and lower returns on other defined contribution retirement plans. This would not be an improvement to our overall retirement system.").

[163] Laurence S. Seidman, *Funding Social Security*, Tax Notes 241, 242 (Oct. 12, 1998).

[164] *See* Peter Diamond and John Geanakoplos, *Social Security Investment in Equities*, The American Economic Review 1047 (Sept. 2003). *See also* Michael Leidy, *Investing U.S. Social Security Trust Fund Assets in Private Securities*, IMF Working Paper WP/97/112 (Sept. 1997) (contending that investing trust fund assets in private securities could have an impact on aggregate savings and future output).

[165] Diamond and Orszag, *supra* note 55, at 215 ("One of the most commonly raised concerns about trust fund investment in stocks involves corporate governance.").

[166] *See, e.g.,* Testimony of Chairman Alan Greenspan, *Outlook for the federal budget and implications for fiscal policy,* Before the Committee on the Budget, U.S. Senate (Jan. 25, 2001) ("I believe, as I have noted in the past, that the federal government should eschew private asset accumulation because it would be exceptionally difficult to insulate the government's investment decisions from political pressures."), available at http://www.federalreserve.gov/BoadDocs/

(1) the fear that the Social Security trustees might engage in social investing and thus buy or sell the shares of stock of certain companies for political reasons rather than economic reasons, [167] and (2) the fear that the trustees would use stockholder voting power to try to exercise control over private companies. [168]

Testimony/2001/20010125/default.htm; Munnell & Balduzzi, *supra* note 138, at 13 ("The major opposition to investing the trust funds in equities, and a primary reason that part of the Advisory Council proposed Personal Security Accounts, centers on concerns about government interference with the allocation of capital in the economy and with corporate activity"); Report of the 1994-1996 Advisory Council on Social Security, Vol. II Reports of the Technical Panel on Trends and Issues in Retirement Savings, Technical Panel on Assumptions and Methods and Presentations to the Council 86 ("[S]ome critics argue that the proposal to have equities in the Trust Funds would expose people to additional political risk, in that government officials would have to select investment options and might not make these decisions purely on risk-return criteria."). *See also Should the Federal Government Invest Social Security Trust Funds*, National Center for Policy Analysis Brief No. 286 (March 22, 1999) (identifying political risks of government investing); White, *supra* note 143, at 15-19 (same).

[167] *See, e.g.,* Theodore J. Angelis, *Investing Public Money in Private Markets: What are the Right Questions,* in Framing the Social Security Debate 287, 290 (R. Douglas Arnold, et al., eds 1998) ("The most common concern is that officials would select to satisfy social or political goals rather than for their risk/return profiles"); Daniel J. Mitchell, *Why Government-Controlled Investment Would Undermine Retirement Security*, The Heritage Foundation Backgrounder No. 1248, at 1, 3 (Feb. 5, 1999) ("Government-controlled investing opens the door to corruption by allowing politicians to steer funds toward well-connected interest groups or campaign contributors." "Government-controlled investing invites "politically correct" decisions because politicians could forego sound investments in unpopular industries (such as tobacco) to steer money toward feel-good causes that are likely to lose money."); Michael Tanner, *The Perils of Government Investing*, CATO Institute Briefing Paper No. 43, at 4–5 (Dec. 1, 1998) ("Even if the government avoids directly using its equity ownership to influence corporate governance, there is likely to be an enormous temptation to allow political considerations to influence the type of investments that the government makes."); Krysztof M. Ostaszewski, *Privatizing the Social Security Trust Fund? Don't Let the Government Invest*, The Cato Project on Social Security Privatization No. 6 (Jan. 14, 1997) ("Even if the proposed Social Security investments in stocks are truly meant to be passive with respect to social policy, it is nearly impossible to imagine such a position being sustainable in the long run.").

[168] *See, e.g.,* Daniel J. Mitchell, *Why Government-Controlled Investment Would Undermine Retirement Security*, The Heritage Foundation Backgrounder No. 1248, at 3, 4 (Feb. 5, 1999) ("Government-controlled investing would mean partial nationalization of major businesses, which would allow politicians direct involvement in the economy." "Government-controlled investing invites crony capitalism — industrial policy that allows politicians to control the economy indirectly by attempting to pick winners and losers."); Tanner, *supra* note 168, at 4 ("Imagine the pressure faced by a congress if the government were to own a significant interest in a company that was threatening to close its plants and move overseas at the cost of thousands of jobs. Could politicians really remain passive in the face of such political pressure?); Krysztof M. Ostaszewski, *Privatizing the Social Security Trust Fund? Don't Let the Government Invest*, The Cato Project on Social Security Privatization No. 6 (Jan. 14, 1997) ("In essence, it is being proposed that the federal

[a] State and Local Government Pension Programs

The past experience of state and local government pension plans suggest that these objections are not wholly illusory. There is clear anecdotal evidence that state and local government pension programs have engaged in social investing. [169] For example, in the mid-1980s, many states passed laws that required state pension funds to divest holdings in South Africa. [170] Similarly, a number of state and local government pension plans have divested tobacco holdings due to political pressure, [171] and some state pension funds have disallowed investments in Iran, Cuba, and companies that comply with the Arab League's boycott of Israel. [172]

Similarly, there is clear anecdotal evidence that state and local government pension programs have used stockholder voting power to try to exercise control over private companies. [173] Indeed, the California Public Employees' Retirement System (CalPERS), the largest public pension fund in the United States, is well-known for its corporate governance reform. [174] CalPERS played a role in the

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government use tax money to pick corporate winners and losers.").

Critics may also raise a third objection, that is, such investments could create an inherent conflict of interest if the government is both the regulator of business and a shareholder. *See* Templin, *supra* note 143, at 431–32.

[169] For a leading study on public pension fund activism, see Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 Colum. L. Rev. 795 (1993).

[170] *See* Matthew Schaefer, *The "Grey Areas" and "Yellow Zones" of Split Sovereignty Exposed by Globalization: Choosing Among Strategies of Avoidance, Cooperation, and Intrusion to Escape an Era of Misguided "New Federalism,"* 24 Can.-U.S. L. J. 35, 63 (1998). *See, e.g., Board of Trustees of Employees' Retirement System of the City of Baltimore v. Mayor and City Council of Baltimore City*, 317 Md. 72 (1989) (upholding Baltimore city ordinances requiring city pension funds to divest their holdings in companies doing business in South Africa).

[171] Angelis, *supra* note 167, at 300.

[172] Angelis, *supra* note 167, at 290 n.7.

[173] Whether social investing and shareholder activism has actually affected the returns of public pensions, however, is less clear. *Compare* Templin, *supra* note 143, at 435 ("Both anecdotal and empirical data suggests that 'social investing may adversely affect fund performance.' ") *with* David Hess, *Protecting and Politicizing Public Pension Fund Assets: Empirical Evidence on the Effects of Governance Structures and Practices*, 39 U.C. Davis L. Rev. 187, 217 (2005) ("The political problems affecting public pension fund performance are not shareholder activism or social investing, as the critics of public funds suggest, but that governments are using pension assets as a safety valve against other budgetary problems.").

[174] Hess, *supra* note 173, at 188.

removal of Michael Eisner as Chair of Walt Disney [175] and was active in an attempt to remove the Chief Executive Officer of Safeway. [176]

Thus, the past experience of some state and local government pension funds lends credence to concerns regarding the ability of a public pension program to withstand political pressure when making investment decisions. Nevertheless, the experience of two other public pension systems, the Federal Thrift Savings Plan of the Federal Employees Retirement System and the Canadian Pension Plan, suggest that such pressures may not be insurmountable.

[b] Federal Thrift Savings Plan

In 1986, Congress authorized the Federal Thrift Savings Plan (TSP), a retirement and investment plan for federal employees. [177] The program was specifically designed to insulate its investment decisions from political pressures. [178] Three separate elements of the program were developed to protect against political influence: [179] (1) the program is administered by an independent and neutral investment board, the Federal Retirement Thrift Investment Board; [180] (2) the Board is subject to strict fiduciary duties; [181] and (3) investment choices are narrowly limited. [182]

Nominally, the Federal Retirement Thrift Investment Board falls within the executive branch, [183] but the Board determines its own budget and submits it directly to Congress. [184] The President appoints all five members of the Board and selects the chairman, but the House and Senate each recommend one Board member. [185] Once confirmed by the Senate, Board members cannot be removed during their four-year term. [186] The Board cannot prescribe particular invest-

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[175] *Id.* at 189.

[176] Id. at 206.

[177] Federal Employees' Retirement System Act of 1986, P. L. No. 99-335, Title I, Sec. 101(a), 100 Stat. 514, 541 (1986).

[178] Angelis, *supra* note 167, at 293.

[179] Angelis, *supra* note 167, at 293.

[180] 5 U.S.C. Sec. 8472.

[181] 5 U.S.C. Sec. 8477.

[182] 5 U.S.C. Sec. 8438.

[183] 5 U.S.C. Sec. 8472(a).

[184] Angelis, *supra* note 167, at 293.

[185] Angelis, *supra* note 167, at 293. 5 U.S.C. Sec. 8472(b).

[186] Angelis, *supra* note 167, at 293; 5 U.S.C. Sec. 8472(e)(1).

ments, but it does select an executive director to implement its guidelines. [187] The Board members serve on a part-time basis while the executive director manages the day-to-day operations on a full-time basis and in accordance with statutorily enumerated powers and policies established by the Board. [188]

The plan's fiduciaries are subject to fiduciary standards that are similar to ERISA's fiduciary standards. Fiduciaries are defined to include the members of the board, executive director, and any other person who exercises discretionary authority over the fund's assets or would otherwise qualify as a fiduciary under ERISA. [189] Like ERISA fiduciaries, TSP fiduciaries must discharge their duties "solely in the interest of the [TSP's] participants and beneficiaries." [190] In addition, the TSP incorporates ERISA's prudent investor rule. [191] The Secretary of Labor is authorized to enforce the fiduciary standards by filing a civil suit against any fiduciary except a member of the Board or the executive director. [192]

When Congress originally authorized the TSP, it established three separate TSP investment funds: (1) the Government Securities Investment Fund (G Fund), (2) the Common Stock Index Investment Fund (C Fund), and the Fixed Income Investment Fund (F Fund). [193] In 1996, Congress approved two additional stock index funds for the TSP: (1) an index of all companies, other than the Standard and Poor 500 companies, actively traded in the U.S. stock market, and (2) an index of major foreign corporations. [194] Members of the Board and TSP officials are prohibited from voting shares of stock; the Board's outside management votes the shares. [195]

Most analysts agree that, to date, the Federal Thrift Investment Board has not taken any action that has reflected political considerations. [196] Indeed, Francis

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[187] Angelis, *supra* note 167, at 293.

[188] Angelis, *supra* note 167, at 293–94.

[189] 5 U.S.C. Sec. 8477(a)(3).

[190] 5 U.S.C. Sec. 8372(b)(1).

[191] 5 U.S.C. Sec. 8477(b)(1)(C).

[192] Angelis, *supra* note 167, at 294; 5 U.S.C. Sec. 8477(e)(3).

[193] General Accounting Office, *supra* note 143, at 61.

[194] General Accounting Office, *supra* note 143, at 61.

[195] 5 U.S.C. Sec. 8438(f).

[196] *See, e.g.,* Karen C. Burket & Grayson M.P. McCouch, *Privatizing Social Security: Administration and Implementation*, 58 Wash. & Lee L. Rev. 1325, 1345 (2001); Angelis, *supra* note 167, at 293; *Investing the Social Security Trust Funds in Stocks*, The Century Foundation Issue Brief No. 8, at 3 (March 1, 1999); Tanner, *supra* note 168, at 7.

Cavanaugh, the executive director of the board from 1986 to 1994, has said,

> I encountered no significant problems as we selected an index (the S & P 500), obtained competitive bids from large index fund managers, and established a highly efficient stock fund with minimal administrative expenses. By 1996, 1 million federal employees had elected to invest $13 billion in the board's stock index fund. [197]

Based on his experience with the TSP, Cavanaugh has said that he "see[s] no reason why the Social Security trust fund should not have the same stock investment advantage as the Thrift Savings Plan." [198]

[c] Canada Pension Plan

In the late 20th century, Canada, like most industrialized nations, faced an aging population and its pay-as-you-go earnings-related public pension plan, the Canada Pension Plan (CPP), faced long-term solvency issues. [199] Canada decided to address those issues by pre-funding the CPP and investing a major portion of the accumulated assets in equities. [200] Thus, in 1997, the Canadian legislature created the Canadian Pension Plan Investment Board (CPPIB), a quasi-independent agency whose sole objective is to act in the best interest of plan participants, to manage the investments. [201] The legislation established an elaborate set of procedures to make the CPPIB as independent from the government as possible. [202] In addition, it instituted a set of internal and external review procedures to assure efficiency, transparency, and public accountability. [203] "Because of the explicit 'institutional investor' mandates included in the 1997 legislation and the elaborate governance and reporting structures, the CPPIB is widely viewed as

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[197] Cavanaugh, *supra* note 152, at 101.

[198] Cavanaugh, *supra* note 152, at 101.

[199] Steven A. Sass, *Reforming the Canadian Retirement System: Investing Social Security Assets in Equities,* Center for Retirement Research at Boston College Global Issue in Brief No. 5, at 1 (April 2006).

[200] Sass, *supra* note 199, at 5.

[201] For a more detailed discussion of the CPPIB, see, for example, Munnell and Sass, *supra* note 142, at 115- 24; Sass, *supra* note 199; R. Kent Weaver, *Whose Money Is It Anyhow?: Governance and Social Investment in Collective Investment Funds*, Center for Retirement Research at Boston College Working Paper 2003-007 (May 2003)

[202] Sass, *supra* note 199, at 6.

[203] Sass, *supra* note 199, at 6.

professional, independent, and accountable." [204]

[d] Safeguards in Ball/Altman Plan

In order to protect against inappropriate governmental interference in private sector decisions, [205] Ball and Altman propose that the trust fund private equity investments be done through a system with safeguards that are similar to those found in the Federal Retirement Thrift Investment Board and the CPPIB. For example, Ball and Altman would limit investments to a very broad index fund (such as the Wilshire 5000) that reflects virtually the entire American economy. [206] In addition, they propose that the investments be directed "by a board structured to ensure its impartiality and autonomy." [207] Specifically, they propose the creation of an independent agency, like the Federal Reserve Board, that would have long and staggered terms. This agency would be charged with "selecting the index fund, selecting the portfolio managers by bid from among experienced managers of index funds, and monitoring and reporting to the trustees and public on Social Security's investments." [208] Their proposal would prohibit Social Security from voting any stock or influencing the policies or practices of any company whose stock is held by the index. [209]

[6] Recommendation

I believe that the Ball/Altman proposal to invest a portion of the Social Security trust fund in private equities is far superior to proposals to invest Social Security assets in the equities market through individual accounts. First, private accounts entail much higher administrative costs than do investments through a single fund. [210] Second, I believe that the risks and rewards of equity investments should be

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[204] Id. at 8.

[205] Cf. Munnell and Balduzzi, *supra* note 138, at 13 ("Everyone involved in the debate recognizes that having the government in the business of picking winners and losers and voting on corporate proposals is undesirable. The issue therefore is not one of differing goals but whether effective mechanisms can be established to ensure that the government does not interfere in private sector decisions."); Greenstein, *supra* note 161, at 1 ("Virtually all parties to this debate concur that no Congressional or executive branch involvement should be allowed in investing Social Security reserves in equities.").

[206] Altman, *supra* note 2, at 303.

[207] Ball, *supra* note 2, at 4.

[208] Ball, *supra* note 2, at 4.

[209] Ball, *supra* note 2, at 4. *See also* Altman, *supra* note 2, at 303.

[210] Greenstein, *supra* note 161, at 7 (noting that administrative costs for a system of private

shared widely rather than borne on an individual by individual basis. [211] Finally, as I discussed at length in my 2005 contribution to this *Review*, I believe that individual accounts raise a host of other problems. [212] Thus, if any of Social Security's assets are to be invested in the equities market, I believe that the investment should be done through the trust fund rather than through individual accounts.

Whether any portion of the Social Security trust fund should be invested in private equities is a more difficult question. I believe that the proposal has distinct advantages. It offers the opportunity for higher returns, and ensures that those higher returns (and risks) would be shared widely. Nevertheless, it raises significant corporate governance issues. While past experience with state and local government pension plans shows how substantial the risks may be, past experience with the Federal Thrift Savings Plan [213] and the Canadian Pension Plan suggests that the risk of inappropriate interference in the private markets can be overcome. Accordingly, I believe the proposal merits serious consideration.

§ 22.05 CONCLUSION

The American Social Security system faces a long-term funding deficit, and reform of the system appears inevitable. Robert Ball has proposed, and Nancy Altman has endorsed, a three part plan that would bring the Social Security system into close actuarial balance. Although the plan is not costless, it merits serious consideration. There is simply no costless solution to Social Security's long-term funding deficit, and the benefits of the Ball/Altman plan (the most significant of which is bringing the Social Security system within close actuarial balance) outweigh its costs.

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accounts with free investment choice could average about 20 percent of the value of account balances compared to less than one percent for a system with central trust fund investments).

[211] Cf. Diamond and Orszag, *supra* note 55, at 215 ("[I]nvesting in stocks allows risk to be spread across generations. If the market should turn sharply down in some year, all generations could be made to bear some of the burden if the investments were undertaken through the trust fund. Under a system of individual accounts, some generations and individuals would bear the entire burden while others would bear none. The trust fund may therefore be a more effective means of absorbing risk than individual accounts.").

[212] Moore, *supra* note 93.

[213] For a discussion of how investing the Social Security trust fund in equities would differ from the TSP, see, e.g., Tanner, *supra* note 148, at 7–9; Angelis, *supra* note 167, at 296–99.