The politics of public pension funds

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In most large U.S. corporations, the owners are passive investors who do not run the business. This creates an agency problem, allowing the managers to operate the business for their own ends, not the shareholders’. In the 1980s, corporate takeovers tended to mitigate the agency problem. Poorly performing managers were threatened with replacement by new owners who were willing to pay the shareholders a premium to take control of the firm in the expectation of increasing profits. With the lull in takeover activity in the 1990s, commentators concerned about corporate performance have sought alternative mechanisms to discipline management; the most prominent strategy is to encourage institutional investors to be more active in corporate governance.

Institutional investors are the principal target of corporate-governance strategies because they hold larger blocks of stock than individual investors. By being able to spread the cost of active monitoring of managers over a larger number of shares,
corporate governance becomes more cost effective. Moreover, one group of institutional investors has been the focus of attention: public pension funds (state and local government employees' pension funds).

Public pension funds are typically considered the best candidates for corporate-governance activity because other financial institutions, particularly banks and insurance companies, are thought to have conflicts of interest. The conflict comes in monitoring managers of corporations whose stock they hold as a result of other business relationships they have with corporations, relationships which might be jeopardized if they opposed management on a matter of corporate governance. Corporate pension funds are suspect because they are run by corporate managers themselves.

When it comes to conflicting incentives to monitor corporate managers, however, there is no such clear-cut distinction between the public and private sector. Public pension funds are also confronted with conflicts of interest, though of a distinctive type. Namely, public fund managers are subject to political pressure to accommodate investment and voting policies to local considerations, such as increasing in-state employment. Just as certain private fund managers can be threatened with loss of business if they vote their shares against incumbent management, public funds can face economic losses if firms propose to close plants in states whose funds have not voted cooperatively or to not locate facilities in states whose funds are pro-management voters. Although these conflicts are geographically delimited compared to those involving private financial institutions, it is an open question whether one sector's decision making is more constrained than the other by its type of conflict.

While I have not attempted to measure the relative degree of conflict of interest in corporate-governance matters across private and public investors, I have investigated whether there are conflicts of interest in the public sector affecting fund decision making. There is ample anecdotal and statistical evidence to conclude that there is a significant problem and that it will increase if public funds intensify their monitoring activities. This severely limits the benefits from a strategy of encouraging public pension funds' activism in corporate gov-
Governance. Moreover, the best method of mitigating the conflict of interest that public pension funds face is to privatize the funds by shifting their organization from defined benefit plans to defined contribution plans, but such a transformation will eliminate their ability to engage in corporate governance. More about this later.

A tempting target

The percentage of corporate equity held by institutional investors generally, and by pension funds in particular, has increased exponentially over the past few decades. From holding less than 1 percent in 1950, pension funds held 26 percent of corporate equity by 1989. Public pension funds are approximately 30 percent of this sector, and their proportionate ownership of the stock market in the mid-1980s has been estimated at 6 percent to 8 percent. The book value of public funds rose over this 40-year period from $5.3 billion to over $600 billion. The phenomenal growth of assets under the control of pension funds, and of public pension funds in particular, is one of the reasons commentators have focused so much attention on them.

Another reason for the interest in public pension funds is that a small number of these funds has been far more active in corporate governance than other institutional investors. Funds like the California Public Employees' Retirement System (CalPERS) oppose management proposals and offer their own proposals at annual shareholder meetings, and they were among the successful advocates of the Securities and Exchange Commission's recent reform of its proxy-solicitation regulations, which facilitated communication among shareholders. Private financial institutions have not been as prominent as the public funds on any of these fronts.

Public pension funds are regulated by the states, as they are exempt from the Employee Retirement Income Security Act (ERISA), the federal statute regulating private-sector pension funds. Two features of the state regulatory regimes are of particular importance because they influence the sensitivity of fund managers to political pressure. First, states prescribe the investments public pension funds can make, either by specific approval on an itemized legal list, or by general authorization
subject to a fiduciary standard of prudential investment. Whether or not they follow the legal-list approach, numerous states also mandate or encourage local investments by public pension funds. For example, Arkansas requires its public pension funds to invest between 5 percent and 10 percent of their portfolios in Arkansas-related investments, and California permits its funds to invest 1 percent of book value in small-business venture capital, but a majority of such funds must go to California-based firms.

Such investments are often termed “social investments,” or “economically targeted investments.” The investments’ returns are typically not commensurate with the risk and, despite proponents’ claims, there is little evidence that the inability of particular projects to obtain private-sector financing is a function of capital market failure. This is recognized by those proponents of economically targeted investing who maintain that investment criteria should be expanded beyond the traditional financial returns to include non-financial returns, i.e., “social benefits.” However, it should be noted that, if market imperfections prevented important local projects from being financed by the private sector, it is problematic to place the risk of such investments on public employees rather than distribute the risk across the public at large by funding them directly through general revenues.

Second, state law designates the composition of public pension fund boards. Board members generally fall into one of three categories: gubernatorial appointees, individuals who serve by virtue of their office (such as the state comptroller or superintendent of schools), and plan participants (active or retired government employees) who are elected by the plan participants. The political affiliation of board members makes them especially vulnerable to influence by other state officials concerning local investment policy. Particularly in times of fiscal difficulties, pension fund assets have been an inviting target for state officials seeking new sources of financing for local projects.

The cost of social investing

There are numerous examples where political pressure was brought to bear on public pension funds, resulting in their
bailing out financially distressed governments and investing in very risky local projects. For example, in the mid-1970s, New York City pension funds were pressured to invest in city bonds to stave off the city's insolvency. In addition, under the threat of a decrease in the state's annual contribution, the New York State pension funds purchased the bonds of four state agencies involved in social investment activity that were on the verge of default. Moreover, in a 1982 survey of 18 state pension funds with social investment policies, officials of eight funds stated that they experienced political pressure to develop social (local) investment policies.

Public pension funds also make social investments without visible political pressure, and, in a number of cases, the results have been disastrous. This is particularly disturbing because not only have the number of such investments increased over time, but a federal commission and officials in the Clinton administration have endorsed such investing by pension funds. Yet, the full financial cost of aggressive social investing will not be known for a number of years.

The Kansas Public Employees Retirement System (KPERS), for instance, invested heavily in local businesses, including a steel mill and a savings and loan, and incurred a loss of over $100 million on this portion of its portfolio. In addition, the Connecticut pension fund provided $25 million for a leveraged buyout of a distressed local firm, Colt Industries, to maintain local employment. Its investment, which was intended as a bridge loan, turned into a longer-term investment equal to 47 percent of the corporation and is in jeopardy because Colt filed for bankruptcy.

Finally, a study of 10 state pension funds' investments in mortgage-backed pass-through securities to aid local housing markets from 1980 to 1982 found that, once the funds focused on social considerations, they failed to achieve appropriate returns from the investments, despite the existence of clear comparative benchmarks (federal agency pass-through mortgages) to price those investments. Since in most economically targeted investment contexts there are no readily available benchmarks, the problem of sacrificed returns is even greater.

Political pressure by proponents of social investments can even constrain public pension funds from undertaking what
are seen as thoroughly uncontroversial investment strategies by the professional investment community. When the Minnesota Investment Board, which handles the state pension funds' investments, hired an international equity manager to implement a decision to allocate 10 percent of its portfolio to international investments, organized labor protested. In response, the state adopted investment criteria for the international fund manager involving compliance with labor, human rights, and environmental standards. Such criteria are unrelated to maximizing portfolio value, the reason for diversifying into international investments in the first place. Private corporate pension plans have been holding international investments, without such interference, for years.

A more graphic example of local considerations trumping fund value maximization occurred in Illinois. The Illinois State Treasurer, a trustee of the state pension fund, threatened to withhold future investments from a leveraged buyout fund if the fund did not ensure that a financially distressed printing plant that it owned in Illinois would remain operating without any reduction in employment. The buyout fund operator thereupon agreed to terms of sale with the plant employees. The treasurer secured benefits for a small number of state residents (the printing-plant employees) without any apparent consideration of the impact on the return to the buyout fund (the plant owners), although the state pension fund was, of course, one of the owners. The Illinois treasurer's objective of maintaining in-state employment is not likely to coincide with the goals of the other investors in the leveraged buyout fund, Illinois taxpayers (who might well have to pay more taxes due to lower pension fund investment returns), or the public employees who are the Illinois pension fund's beneficiaries.

**Political interference in two states**

Pressure on direct investments of public pension funds is a problem for taxpayers and public employees; it is likely to reduce the returns to the funds' investments, requiring higher state contributions in the future and reducing the scope for providing pensioners with non-mandated cost-of-living increases in the future. Yet, it affects corporate governance only indirectly by directing resources to or from particular firms. There
are, however, some instances of funds having to follow policies that tie shareholder voting to local considerations. For example, the Iowa pension fund is required to temper its policy of voting against management proposals that make hostile takeovers more difficult with consideration of the company's in-state employment. More important, there have been two notable examples, in New York and California, where political pressure on state pension funds has more directly touched their corporate-governance activities.

After it was disclosed that the New York state pension fund had invested in a leveraged buyout fund that financed hostile takeovers, including the successful acquisition of RJR-Nabisco in a contest against a management-led bid, the governor created a task force to investigate pension fund investment policy. The New York State task-force report was critical of investor activities that opposed incumbent management and made several recommendations to prevent state funds from supporting hostile takeovers. It also proposed changing the fund's organization to reduce the comptroller's control over investment decisions. Not only was the comptroller a member of a different political party from the governor, he also supported active corporate governance to monitor corporate managers and opposed using pension assets for social investing, a policy favored by the governor. The split party control of the state legislature prevented the enactment of legislation implementing the task force's proposed organizational change.

A similar effort to put public pension funds under greater gubernatorial control occurred in California. Although the immediate reason was fiscal—the governor sought to reduce the state deficit by transferring pension funds into general revenues—commentators thought that the attempt was also related to the business community's dissatisfaction with CalPERS' corporate-governance activities. CalPERS had, for instance, criticized the management of several corporations for receiving excessive compensation, including that of major California employers, and had frequently introduced and supported shareholder proposals opposing management. The governor succeeded in transferring revenues but lost the organizational battle, again largely because of divided government.

One import of the New York State task force and Califor-
nia gubernatorial attempts to constrain fund officials is that, if public pension funds' activism in corporate governance accelerates, such efforts will also increase, as will the likelihood of legislative success. Indeed, political efforts at restraining public funds need not succeed to chill the funds' corporate-governance activities; it is possible that fund boards comprised of politically sensitive members will capitulate to local interests to forestall frontal attacks on fund organization and assets.

Shortly after the attack on its independence, CalPERS invested $375 million in local housing development, a social investment project favored by the governor. Moreover, after these two incidents, the New York fund and CalPERS cut back on more visible forms of corporate-governance activism, such as introducing shareholder proposals, and adopted what they termed a "quiet diplomacy" strategy of direct negotiations with management that was less confrontational than their prior approach.

**Finding a solution**

The available evidence suggests that political pressure on fund investment and voting decisions impairs pension fund performance. Public pension funds whose boards are more vulnerable to political pressure perform significantly worse than those whose boards are independent. This statistical relationship, the inverse correlation between fund performance and the politicization of fund boards, suggests two possible solutions: increase the independence of public pension fund boards or constitutionalize fund board independence from potential legislative and gubernatorial interference. However, in fiscally troubled times, even independent board members may be unable to resist political pressure, and constitutionalizing independence hardly prevents state officials from influencing politically sensitive board members.

Applying ERISA's fiduciary standard to state funds fails to solve the problem for the same reason, viz., the inherent susceptibility of individual fund managers to political pressure. Moreover, because permissible investments under ERISA are governed by Labor Department rulings, when Department officials favor economically targeted investments, as is true of the current administration, subjecting public funds to ERISA
will not eliminate political pressure on the funds.

Another possibility, mandating passive (i.e., indexed) investment strategies, would also fail to insulate public pension fund managers from public pressures. For one thing, investments in certain classes of assets necessary for maximizing portfolio diversification and value are not easily indexed. Moreover, since the shares in the indexed fund still need to be voted, the political pressure will simply be applied at this point. Although one might attempt to avoid this loophole by requiring outside management of public pension funds' indexed equity portfolio along with delegation of voting authority, this solution will not prevent the exertion of political pressure on the external managers through the threat of replacement.

The most promising mechanism for eradicating political pressure on public pension funds' decision making entails changing the organization of state pensions from defined benefit plans to defined contribution plans. A defined benefit plan guarantees a pension according to a formula depending on final salary and years of service that is independent of the value of the assets in the plan. A defined contribution plan, by contrast, consists of the financial assets that accrue in employees' individual accounts from contributions by the employer and employee over their working lives. Since employers are responsible for paying the pension in a defined benefit plan (thus bearing the risk of poor investments that do not cover the promised payouts), they justifiably expect to exercise control over investment decisions. In the defined contribution plan, the employee bears the investment risk and therefore he, and not the employer, makes the investment decisions. This proposal thus solves the problem of political pressure by privatizing public pension plans; investments are put in the control of the beneficiaries.

The typical choices provided private-sector employees in defined contribution plans are bond and stock index funds managed by reputable, typically national, mutual funds and guaranteed insurance contracts (GICs) that are sold by life insurance companies and promise a specified return. As long as public plans follow the predominant private-sector approach and do not manage their defined contribution plans' invest-
ment options, political pressure will not be a factor because the fund board does not control any assets, and hence has no voting responsibilities.

Although public pension fund boards will choose which financial institutions can manage beneficiaries' accounts, it is improbable that they will be able to exert much political pressure in this arrangement through the power of appointment. This is because national mutual fund managers are less likely to be pressured to temper their investment and voting decisions with any particular locality's employment concerns than public fund managers, as the threat of loss of any one state's business is not likely to pose a severe economic threat to such a firm.

More importantly, employees have far greater incentives to monitor fund board behavior in a defined contribution plan. They will insist on maintaining the best performing mutual fund regardless of the manager's support for social investments, for it is now their own money at stake. The employee's clearer appreciation of, and hence greater interest in, investment performance will reduce further the likelihood of the exercise of political influence on many managers by fund boards or other state officials.

**Additional policy advantages**

The choice of pension fund organization implicates a broad set of public-policy considerations toward pensions quite apart from the problem of corporate governance. As corporate-governance concerns should not exclusively drive pension policy, a brief overview of the broader considerations is in order and it indicates that there is much to recommend the proposed shift in plan type.

Defined contribution plans offer several important advantages over defined benefit plans besides their alleviation of political pressure on fund asset usage. They are:

1. *Defined contribution plans safeguard pension assets from raids by fiscally troubled states.* States cannot transfer pension assets to general revenues in a defined contribution plan because there are no surplus earnings to raid. All payments by the state immediately enter individual employee accounts and are therefore no longer the fund's property.
(2) Pensions are also more secure because states cannot underfund such a plan. Many state defined benefit plans are underfunded (in 1991, for example, 20 state funds were less than 75 percent funded), since ERISA’s funding requirements are inapplicable, and the states need only meet current retirees’ benefit payments in their annual contributions to the pension funds. In addition, annual contribution levels do not depend on actuarial assumptions that states can manipulate to reduce their annual payments to the plan. The significance of the problem of underfunding depends on workforce demographics as it enables the state to shift current expenses to future taxpayers and thus engage in an intergenerational wealth transfer.

(3) Defined contribution plan pensions are fully portable if the employee changes jobs, whereas in a defined benefit plan, payments are maximized only by remaining with the firm. The individual can therefore seek the best employment opportunity without being penalized by suffering a pension reduction.

(4) Individuals obtain greater choice and control over their pensions since they make the investment decisions concerning their retirement accounts. This feature of defined contribution plans encourages individuals to plan for retirement. Indeed, in the private sector, the number of options available to employees in defined contribution plans has continually increased due to employee demand for greater choice.

Though there are some drawbacks to defined contribution plans, these are readily addressed. First, employees, not employers, bear the risk of an inadequate accumulation upon retirement. The danger that individuals may therefore invest too cautiously is being rectified by a new breed of consultants who offer investment advice to participants in defined contribution plans. Secondly, the advantage to employees of portability is unwelcome to employers who want to use pension policy to reduce work-force turnover. However, to the extent that the employees who are most valued by the employers are savers, this problem can be solved by paying selectively higher wages to these individuals in the way of matching contributions. These employees will disproportionately value the match and consequently stay with the firm. Finally, the claim that defined benefit plans provide an incentive to retire early be-
cause, unlike a defined contribution plan, the total payout of a defined benefit plan decreases the later an employee retires, is not supported by data. Studies instead indicate that the differential effect on retirement choices of defined benefit plans compared to defined contribution plans is trivial; only the availability of Social Security seems to affect the retirement decision.

Though defined contribution plans are not a perfect policy tool, they have decisive advantages, then, over defined benefit plans. Such pensions are portable and secure and they eliminate state officials’ opportunities to conscript pension assets for social investment projects, whether by direct investment or share voting decisions. Instead, the choice is left to the individual. If public employees want to invest their pensions in economically targeted investments, we can expect funds specializing in such investments to emerge as an option for defined contributions, just as socially responsible funds have been introduced in the private sector. These benefits are far greater than any of the potential costs associated with the pensions, such as employee-borne investment risk, increases in employee turnover, and reduced retirement incentives.

The successful severing of public pension fund decisions from political influence by privatizing public pensions effectively eliminates their role in corporate governance. Public funds will no longer directly control any equity assets. The key players from the perspective of corporate governance in such a pension arrangement will be mutual fund managers, who make the investment and voting decisions for the shares their funds hold. Whether financial intermediaries, such as mutual funds in whose investment vehicles public employees place their contributions, would assume a more active role in corporate governance is an open question. However, it is also an open question whether such activity would be for the better of the fund shareholders. At the very least, such a reform will protect public employees’ pension assets at the same time it ensures that political influence on corporate governance will be minimized. This is a benefit to us all.