1993

The Prospects of Pension Fund Socialism

William H. Simon
*Columbia Law School*, wsimon@law.columbia.edu

Follow this and additional works at: [https://scholarship.law.columbia.edu/faculty_scholarship](https://scholarship.law.columbia.edu/faculty_scholarship)

Part of the Labor and Employment Law Commons, Law and Economics Commons, and the Law and Politics Commons

**Recommended Citation**


This Article is brought to you for free and open access by the Faculty Publications at Scholarship Archive. It has been accepted for inclusion in Faculty Scholarship by an authorized administrator of Scholarship Archive. For more information, please contact cls2184@columbia.edu.
The Prospects of Pension Fund Socialism

William H. Simon†

A substantial portion of corporate shareholdings in the United States is held by pension funds that secure retirement benefits for broad segments of the workforce. A number of commentators have argued that the assets secured by these pension funds should be used to promote the creation of a more democratic and egalitarian economy. Specifically, pension assets could be invested in projects that are deemed socially worthwhile, wielded in strategic "corporate campaigns" against companies resisting unionization, or directed toward allowing workers to obtain control over their own companies. This program of employing pension assets in the pursuit of a more democratic economy—referred to by the author as "pension fund socialism"—is hindered by a number of obstacles arising both from within the structure of pension funds and from the larger legal, economic and political landscape. For instance, there are legitimate reasons to limit the risk pension funds carry, thus narrowing the range of investment opportunities open to the funds. Also restricting the potential of pension fund socialism are the conflicting interests among different sectors of the workforce, such as those existing between current employees and retirees. The author's thesis is that the prospects of pension fund socialism are substantial but not as bright as many proponents have suggested.

I. Risk .......................................................... 254
   A. Defined Benefit Versus Defined Contribution .......... 255
   B. Concentration Versus Diversification .................... 256
   C. Background Investment Risk ........................... 258

II. Conflicts of Interest .................................... 259
   A. Retirees Versus Current Employees .................... 260
   B. Senior Versus Junior Workers .......................... 261
   C. Managers Versus Rank-And-File Employees .......... 262
   D. Division of Labor ...................................... 264

III. Control .................................................... 265

† Professor of Law, Stanford University. I am grateful for advice and assistance to Greg Alexander, Ian Ayres, Joe Bankman, Barbara Fried, Deborah Weiss and participants at seminars sponsored by the University of California, Davis, Department of Economics, the University of Warwick (U.K.) School of Law and the Law and Society Association.

Classical political economy portrayed the function of the capitalist class as saving and investing. This is an undeniably important role, and it seemed implausible to the classicists that, in a capitalist society, the great masses of people with minimal financial assets and barely enough income for current needs could participate in these activities. The fact that the performance of this socially valuable role entailed a socially regrettable distribution of wealth and income was viewed either as a necessary evil or as a reason to reject the entire capitalist framework of private ownership and market allocation of capital.¹

Recent developments in economic theory, reflecting on contemporary realities, have provided us with a different vision of the institutionalization of the savings and investment role. This vision locates savings and investment not in the class structure, but in the life cycle.² In early adulthood, people tend to save negatively (borrow) to finance education and set up households. As their careers proceed, they save positively, paying back their loans and accruing assets in anticipation of retirement. In retirement, they draw down their savings. This vision has considerably more benign distributive connotations than the classical one. The privileges and responsibilities of saving are distributed throughout the population. And there is no exploitation of savers by non-savers, since the two roles are performed by the same people at appropriate phases of their lives.

If you had to choose between the class vision and the lifecycle one as a description of the contemporary western economies, you should choose the class vision. But post-World War II policies encouraging pension savings have added some credence to the lifecycle vision. A substantial portion of capital claims in advanced economies is held by public and private funds that secure retirement benefits for broad segments of their workforces. For example, nearly one-third of the value of equity securities of American business is held by pension funds.³ This fraction is likely to increase in the future.⁴

¹. E.g., John Stuart Mill, Principles of Political Economy, bk. II, chs. 11-16 (1848).
². See generally Milton Friedman, A Theory of the Consumption Function (1957).
Moreover, the lifecycle vision has served as an inspiration for reform. It has occurred to some that the road to socialism, or some substantial socialization of the investment process, might lie in an expanded, publicly regulated system of pension finance.\(^5\) In the United States such notions have surfaced occasionally in debates over the "social investment" of pension funds or over "employee stock ownership" pension plans ("ESOPs").\(^6\) In Europe during the 1970s and 1980s, quite ambitious plans for "wage-earner funds" (not necessarily, but sometimes tied to pension finance) were debated vigorously.\(^7\) Recently, some proposals for the privatization of formerly communist East European economies have included provisions for state transfer of responsibilities to fund retirement benefits and assets to private pension plans.\(^8\)

"Pension fund socialism" probably is not the term best calculated to evoke broad enthusiasm for measures of this sort, and it is potentially misleading to the extent that it suggests that these plans are uniformly radical. But the term seems appropriate since, at the most general level, the plans are animated by the traditional socialist ideal of a more egalitarian and democratic economy; and they pursue this goal in a manner long associated with socialism—placing capital ownership in the hands of the working and middle classes. Moreover, the work of the politically centrist management theorist Peter Drucker in popularizing the term may have eroded its more radical connotations.\(^9\)

On a more concrete level, some of the discussions on this issue in America and Western Europe were prompted by the economic dislocations of the past two decades. In America, large, unanticipated employment and wage losses—associated with deindustrialization in the manufacturing sector and deregulation in the transportation and communications sectors—made established methods of ensuring job and wage security through employment contracts and collective bargaining agreements seem inadequate.\(^10\) Forms of worker ownership, facilitated by tax subsidies via the pension system, struck some as a promising response to these inadequacies, since worker-owners would be more careful and less

---

9. See Drucker, supra note 5.
10. See, e.g., Deborah Groban Olson, Union Experiences With Worker Ownership: Legal and Practical Issues Raised by ESOPs, TRASOPs, Stock Purchases, and Co-operatives, 1982 Wis. L. Rev. 729, 732-35.
opportunistic about laying off their fellows than would investor-owners.\footnote{11}

The debates over “wage-earner funds” in West Germany and Sweden focused on a distinct set of problems. One problem was the difficulty that the powerful national labor confederations in these countries with centralized union structures experienced in developing a strategy to maintain productivity-based wage growth without causing job losses or inflation or crippling investment incentives. High wage demands risked inflation or unemployment (or both), but wage restraint might allow capitalists to capture most of the benefits of price stability through higher profits. The state or the labor movement might try to recapture these benefits through exactions on the higher profits, but such exactions risked an undesirable reduction in investment. The wage-earner fund idea would combine wage restraint with profit exactions, but would reinvest exactions on a long-term basis on behalf of the workers. In theory, this would offset any reduction in investment by capitalists due to the exactions.\footnote{12}

In this paper, I will consider the principal constraints on the fulfillment of the egalitarian and democratic aspirations of socialism through pension reform, especially in the United States. Part I discusses the issues of investment risk that particularly concern pension plans. Part II identifies and analyzes conflicts of interest that may develop among pension plan beneficiaries. Part III examines the limits of worker control over their pension assets. Part IV explores the redistributive potential of pension fund socialism. Part V identifies background economic factors that influence the viability of pension fund socialism. I conclude that the promise of pension fund socialism is significant, but more modest than many proponents suggest.

\section*{I}
\section*{Risk}

In conventional capitalist theory, both the control and the financial return associated with ownership are functions of risk. Owners exercise control over their capital to limit the risks to their interests. The return they receive is in substantial part compensation for the risk they bear. Although classical socialism was quite hostile to this idea both descriptively and normatively, most discussions of pension fund socialism seem to accept it.\footnote{13} Pension fund socialism is a form of market socialism, and market socialism seems committed to allocating, in accordance with ownership, at least some of the risks that markets create.

The most fundamental issues of risk in pension plan design revolve

\footnotesize
\begin{itemize}
\item \textbf{11. } See id.
\item \textbf{12. } See SWENSON, supra note 7, at 129-223.
\item \textbf{13. } See DRUCKER, supra note 5, at 166.
\end{itemize}
around the problems of how much risk should be tolerated and how risk should be allocated among pension plan beneficiaries.

A. Defined Benefit Versus Defined Contribution

A defined benefit plan promises a specified benefit on retirement—for example, an annual payment during retirement equal to one percent of average salary during a worker's last three years multiplied by total years of service with her company. By contrast, a defined contribution plan simply promises a specified pension fund contribution and guarantees the worker accumulated contributions and earnings (or losses) on them.

Under a defined benefit plan the worker does not bear any investment risk associated with the fund. The promised benefits are insured by the employer, an insurance company and/or a government agency. If the fund's investment performance is not adequate to pay promised benefits, the insurer pays them. Under such a plan, the economic premise of worker control—worker investment risk—is absent. Here the insurer bears the residual risk (and is entitled to any assets above those necessary to fund benefits) and according to conventional premises, should control how the funds are invested. It is thus significant to any ambitious project of pension fund socialism that industrial unions have tended to bargain for defined benefit plans and have pushed for federal insurance of such plans. Apparently, they have preferred security to control.

But there is a strong case to be made—apart from the goal of giving employees control over their pension assets—that defined contribution plans would be a socially preferable structure for a pension system with broad coverage. First, workers pay for the security associated with defined benefit plans with lower expected benefit levels. An employer should be willing to make larger current pension contributions where, as in a defined contribution plan, she bears no continuing investment risk (and is not required to pay some other insurer to bear this risk).

Second, and far more important, the egalitarian goals of the socialist vision are ultimately more compatible with defined contribution plans. Society as a whole cannot escape investment risk. If some are to be im-

---

15. Id. at 105.
16. Id. at 112.
17. This is so, at least, to the extent that benefits are completely and effectively insured. So long as workers' benefits are implicitly conditioned on the solvency of the firm or insurance company, workers bear some risk. However, in the United States the Pension Benefit Guaranty Corporation [PBGC] insurance system covers about 80% of benefits in most private employer-defined benefit plans and, while there remains some risk that it will be unable to pay all insured claims, the system surely alleviates worker concern about employer solvency. See Richard Ippolito, The Economics of Pension Insurance 37-38, 65-69 (1989).
munized from it, others must be saddled with it. If capitalists bear the risk, they will demand compensation for it. Of course, a system limited to defined contribution plans still would produce inequality; less successful funds would have lower returns than more successful ones. But in such a system the high returns would be less socially concentrated and less correlated with other dimensions of social status (such as non-pension wealth, class background and occupational prestige) than they would be in a system where a small class assumes primary responsibility for investment risk.

Moreover, public insurance arrangements for defined benefit plans are prone to unfair cross-subsidization of different classes of workers. Cross-subsidization among the beneficiaries of different defined benefit plans may occur because of the political or administrative difficulty of calibrating insurance premiums to risk. This seems to have been the case with the Pension Benefit Guarantee Corporation system, under which a large majority of claims to date have come from auto and steel workers, at the expense of workers in other industries. Cross-subsidization of defined benefit beneficiaries as a class by the rest of the population also may occur if insurance funds prove insolvent and governments feel compelled to bail them out with general revenues; many fear that this will happen in the case of the PBGC, which is insolvent by some estimates. By contrast, defined contribution plans have the advantage that they do not encourage arbitrary cross-subsidization.

On the other hand, paternalistic and social welfare concerns weigh against excessive risk-bearing, and defined contribution plans subject beneficiaries to greater risk than do defined benefit plans. Some fraction of a retired worker's income should include relatively riskless benefits of the sort that Social Security and defined benefit plans now provide. Hence, only a portion of the typical worker's estate should be invested in the type of claims that involve the risk associated with ownership.

B. Concentration Versus Diversification

The second major risk issue concerns the diversification of funds that secure workers' pension claims. Funds that invest in a representative variety of businesses are less risky than those that invest in a single business or a single industry. Other things being equal, the economic returns to diversified funds will have less variance than returns to undiversified ones. Concentrated funds, on the other hand, will expose ben-

18. *Id.* at 41-45.
19. *Id.* at 41-48.
20. Of course, there is no such thing as a completely riskless claim. For example, the security of these benefits depends on the performance of the economy.
eficiaries to large losses and will produce more inequality among beneficiaries. Moreover, since workers already are subject to financial risks of wage or job loss in the event their employer enterprise or industry performs poorly, employees would be taking an additional—and potentially substantial—risk if they invested their pension assets in their own firm or industry. The diversification norm suggests that they invest their pension assets elsewhere.

On the other hand, investment diversification dilutes control in a way that strains the democratic goal of pension fund socialism. From the democratic perspective, beneficiary investment and hence control should be focused on the institutions that most affect beneficiaries. This suggests funds should be concentrated in the enterprises where beneficiaries work, as do ESOPs. But such investments would be riskier and would produce more inequality (i.e., there would be more variance in their returns) than would more diversified ones. On the other hand, to the extent that the fund seeks to reduce risk by diversifying, it fragments its holdings in a way that gives it relatively little control over individual investments. A sufficiently large fund might achieve both diversification and significant control over individual investments, but a fund so large would have a large number of beneficiaries spread among many enterprises, and it would hence be difficult to achieve meaningful democratic control of the fund itself.

The point that efficient allocation of risk creates a tradeoff between economic democracy and worker financial welfare must be qualified, however. There are important economic reasons why it may be desirable for workers to bear the risks associated with investments concentrated in their own firms. First, only investments focused in his own enterprise are likely to enhance a worker’s productivity incentives. In addition, more concentrated investments increase both the incentive and the ability of investors (whether trustees or the workers themselves) to monitor managers; and if such monitoring leads to improved firm performance, the returns may compensate for the added risk. Third, even while they increase an employee’s investment risk, concentrated investments may mitigate another economic risk—job loss. A fixed wage employment contract generally leads to larger and quicker layoffs in the event of product market downturn than does a contract that makes wages contingent on profits. Thus, it may make sense for workers to trade fixed wages for profit shares. Enterprise-focused funds may be good vehicles for doing so.

Two key variables that affect the viability of enterprise-focused funds are the capital intensity of the firm and the age composition of its workforce. The more capital intensive the firm, the less likely worker savings can play a major role in financing it. Still, even in the more extreme cases of capital intensity, there often will be some role for worker investment. One might have thought that the steel industry would be one of the worst candidates for worker finance. That industry always has been capital intensive; and recent technological changes have increased capital needs while reducing workforce size. Despite this, Weirton Steel was an outstanding example of a sizeable, 100% employee-owned industrial firm. In fact, as of November 1990, approximately 50,000 members of the United Steelworkers union participated in employee stock ownership plans. This may, however, be a transitional phenomenon related to the traumatic circumstances of the steel industry of recent years. In Weirton Steel's case, after re-achieving profitability, the company sold a substantial minority interest to the public. In the long term, the less capital intensive firms seem to be the more plausible candidates for the more ambitious worker ownership plans.

Older workforces are less plausible candidates for worker ownership than younger or middle-aged ones. Workers typically will want to cash in their shares on (or before) retirement, and under the Employee Retirement Income Security Act [ERISA], an ESOP must allow them to do so. Unless there are enough junior workers to buy out the retirees, their shares will have to be sold to outsiders.

C. Background Investment Risk

The extent to which investments expose workers to risk depends in part on the nature of a country's business environment. Notably, business risk is partly a function of government policy and industrial structure. Government policies that promote or tolerate price and currency exchange rate volatility and unrestricted foreign competition tend to create more business risk than policies aimed at monetary stability and cushioning competitive pressures. Industrial structures in which volatile, impersonal capital markets play the major monitoring role, and in which seriously troubled firms are left to a costly, traumatic bankruptcy process, involve more risk than structures in which firms linked in consortia monitor one another and provide some mutual insurance against the more traumatic effects of restructuring. In the United States, government policies and industrial structure tolerate a relatively high degree of

To the extent that the United States adopts economic policies that moderate business risk in general, policies encouraging enterprise- or industry-focused investment of retirement funds might become more plausible. However, policies that constrain economic instability may produce great inefficiencies, as the experiences of the former East European communist economies show. Yet, Japan's example suggests that this is not inevitable.

II
CONFLICTS OF INTEREST

The relative roles of democratic and paternalistic principles in American pension law currently are disputed. Proponents of economic democracy believe that the control associated with pension equity should be exercised through beneficiary vote. However, most funds are structured so that trustees exercise control according to their own judgments of beneficiary interests. The Department of Labor, which enforces fiduciary duties under ERISA, insists that even where plans purport to bind a trustee to the beneficiaries' instructions, ERISA sometimes may require the trustee or investment manager to substitute his own paternalistic judgment. This perspective presupposes a high degree of unity of interest among beneficiaries; it does not contemplate separate analysis and action with respect to each beneficiary's interest, but a single collective judgment and response.

Although voting permits differential responses among pension fund beneficiaries, the democracy perspective still requires a substantial degree of shared interests. Workers cannot constitute a viable political community without a significant degree of shared interests. Conflicting interests

27. See generally Aoki, supra note 26.
28. The Department of Labor concedes that, in general, defined contribution plan provisions binding a trustee to the beneficiaries' instructions on voting and tendering are permissible, but it insists that there are some situations in which a trustee cannot rely on instructions, for example where the instructions appear to be influenced by employer pressure or where they concern "unallocated" shares in leveraged ESOPs. Moreover, in the common situation where trustees appoint an investment manager for the fund, the Department interprets ERISA to preclude binding beneficiary instructions to the manager on voting. The Department also maintains that ERISA precludes plan provisions requiring trustees to vote shares for which no instructions are received in proportion to the votes on shares for which instructions are received. Department of Labor, Opinion Letter on Tender Offers (Polaroid), 16 Pens. Rep. (BNA) 390 (1989); Department of Labor, Opinion Letter on Profit Sharing Retirement Income Plan for the Employees of Carter Hawley Hale Stores, 11 Pens. Rep. (BNA) 391 (1988) [hereinafter "Carter Hawley Hale letter"].

For a treatment of these and related control issues from an economic democracy perspective, see Gregory S. Alexander, PENSIONS and PASSIVITY, 56 LAW & CONTEMP. PROBS. 111 (1993).
can lead to costly squabbling and paralysis. And conflicting interests may lead some worker beneficiaries to defect and ally themselves with other constituencies such as nonworker investors or creditors in ways that subvert worker control and/or inhibit the formation of a distinctively worker-oriented investment policy.

The more important potential conflicts grow out of the diverging interests possessed by workers in different positions within the firm and in varying stages of employment.29

A. Retirees Versus Current Employees

The assets of a defined benefit plan typically secure the claims of both retired workers receiving benefits and current employees who will not receive benefits until retirement. The potential for conflict arises from the fact that the typical retiree will be interested exclusively in the value of the shares in the fund, while the typical employee will be interested in a variety of enterprise policies that affect employment. Thus, if wage cuts and layoffs will improve profitability, the retiree has an interest in implementing them, while the interest of employees in profitability often will be outweighed by wage and employment considerations.30

The potential for conflicts of interest between current employees and retirees was illustrated in the 1950s, when John L. Lewis had the United Mineworkers pension fund purchase shares in Northeastern utilities, intending to influence them to purchase union-mined coal, which arguably would have benefitted current employees. The District Court for the District of Columbia held that this was a breach of the trustees' common law fiduciary duty, presumably toward retirees.31 In the mid-1970s, New York City's public employee pension plan purchased large amounts of low-rated bonds from the financially distressed City. In Withers v. Teachers' Retirement System,32 retirees charged a breach of fiduciary duty, arguing that the purchases were motivated by a desire to obviate employee layoffs.33 The court conceded that such a motive would have been improper, but rejected the challenge, finding that the purchase was justified by the fear that, if the bonds were not sold, the City would become bankrupt and default on payments to the fund, thus harming retirees and employees (future retirees) alike.34

Some Labor Department officials believe that ERISA's fiduciary norms codify the premise of these non-ERISA cases: the trustee's duties

30. Id. at 1120-21.
33. Id. at 1254.
34. Id. at 1256.
are to the interest of all beneficiaries in the soundness of the funds; benefits to working beneficiaries through their employment are not legitimate concerns, at least if they require a trade-off in terms of returns to the fund.\textsuperscript{35}

This conclusion seems at the least debatable. Proponents argue that the statute is concerned exclusively with retirement security. However, the statute does not interfere with the ability of employers and workers to trade off retirement benefits for current economic welfare in setting the terms of compensation. True, once the terms are set, the statute largely precludes workers from using pension accumulations for current consumption. But it seems unlikely that this provision reflects a legislative judgment that retirement interests always should trump current economic interests. Legislative concern about worker short-sightedness or self-indulgence might be weaker where the worker wants to trade retirement security for job security than where he wants to trade it for current consumption. Moreover, one might generalize a point in the Withers case and deny any clean trade-off between job and retirement security, since a job is a pre-requisite for continued retirement savings, as well as for current consumption.\textsuperscript{36} At the very least, where a large gain in job-related benefits for some workers could be achieved at a small cost to the fund as a whole, it seems unreasonable to require that such a gain be foregone.

Nevertheless, it is undeniable that a fund designed to exploit the full possibilities of control in the interest of active workers is likely to create severe conflicts with retirees. There is, however, a solution to this problem. The interests of workers can be severed from the fund on retirement. This is now typically done under defined contribution plans. A retiring beneficiary may take her stock and become an individual shareholder, or she may receive an annuity equal to the value of her interest, or a lump sum cash payment. She thus ceases to have an interest in the fund, and the possibility of conflicts with employee interests is avoided. Though defined benefit plan beneficiaries typically remain dependent on the plan after retirement, these plans could in principle be restructured to allow separation on retirement as well.

B. Senior Versus Junior Workers

A related conflict arises between senior and junior workers. In a mature plan, senior workers will tend to have stakes and perspectives


\textsuperscript{36} Withers, 447 F. Supp. at 1259 (concluding that bond purchases that increased risk to fund assets but reduced risk of employer bankruptcy and hence lost future contributions were consistent with purpose of fund to secure beneficiaries' retirement interests).
different from junior ones. Senior workers will be more intensely concerned about preserving and enhancing retirement benefits; they will be less concerned about the long-term prospects of the firm, and they will be less fearful of layoffs (both because seniority protects them and because the value of continued employment is lower to them as their expected tenure is shorter). Their views on issues such as layoffs that increase profitability will be much closer to those of retirees than to those of junior workers.

Moreover, depending on how a plan is structured, senior workers often will have accumulated far larger shareholdings than junior workers. This may create problems regarding the distribution of control in enterprise-focus funds. If control is distributed in proportion to financial stake, senior workers will have much more than juniors. But if control is distributed on a one-person-one-vote basis, there is a risk that junior workers will disrespect seniors' investment preferences (for example, by voting for excessive wages or expansion projects that might generate jobs while posing a high risk of capital loss).

One response to these problems would be to try to smooth differences in shareholdings in the employing enterprise by permitting or requiring senior employees to diversify their holdings. The ERISA requirements for ESOPs give workers the option of diversifying after ten years of employment or upon reaching age 55, whichever occurs first. During the first five years after this milestone, beneficiaries can instruct the trustee to invest twenty-five percent of their accounts outside their own companies; in the sixth year, they can raise this portion to fifty percent. This diversification serves two purposes: it responds to the relatively greater risk aversion of the senior employees, and it limits employee inequality in shareholdings in the employer company.

C. Managers Versus Rank-And-File Employees

A third axis of potential conflict of interest is between highly paid employees and senior managers on the one hand and rank-and-file workers on the other. High earners are more inclined (and better able) to save and invest than are low earners. This general tendency is intensified by the American tax system's practice of subsidizing pension savings through tax deductions, which are more valuable to taxpayers in higher brackets. Thus, high earners will favor larger pension benefits than low earners, and even if contributions are made at uniform percentages of workers' earnings, high earners will acquire larger stakes in pension funds.

Because of this tendency, managers have vastly disproportionate fi-
nancial interests in many nominally employee-owned firms, and sometimes complete control over those enterprises. In such situations, rank-and-file workers tend to experience no difference in their role in the firm following transition to employee ownership, and labor disputes indistinguishable from those in investor-owned firms frequently have arisen.\textsuperscript{39}

The best publicized recent ESOP adoptions in large public corporations were initiated by management as takeover defenses.\textsuperscript{40} The democratic potential of ESOPs often is subverted under these circumstances. Managers count on employees to support them in takeover contests, relying on workers' fears that new owners will initiate wage or job cuts. Such considerations are often legitimate employee concerns, but it is disturbing that ESOPs, while inhibiting assumption of control by outsiders, typically do not effectively reduce management's own ability to initiate wage and job cuts. And while they limit the ability of outside investors to discipline managerial incompetence or self-indulgence, they typically do not give employee-shareholders the ability to do so.

I will address below issues concerning the connection between ownership and control, but a separate set of problems arises from the concentration of ownership among the workplace elite. The tax code attempts to respond to this problem with constraints on inequality in pension contributions known as "nondiscrimination" and "top heavy" rules.\textsuperscript{41} For example, under the latter a plan must provide no more than 60 percent of its benefits to defined "key" elite workers or must meet specified alternative standards designed to constrain inequality.\textsuperscript{42} The law also sets caps on tax-subsidized amounts which can be contributed on behalf of any one employee.\textsuperscript{43}

However, these rules constrain inequality only very loosely. They permit the wholesale exclusion from participation in pension plans of part-time workers, newly hired workers, workers under twenty-one and workers covered by collective bargaining agreements.\textsuperscript{44} Thus, many ESOPs exclude entirely more than half the relevant workforce. For those included, contributions proportional to salary are not considered discriminatory.\textsuperscript{45} In fact, many plans take advantage of the option afforded by the rules on "integration" of pension and Social Security benefits to make contributions on the basis of larger fractions of salary for higher


\textsuperscript{40} E.g., NCR Corp. v. AT & T, 761 F. Supp. 475 (S.D. Ohio 1991); Shamrock Holdings, Inc. v. Polaroid Corp., 559 A.2d 257 (Del. Ch. 1989).


\textsuperscript{42} 26 U.S.C.A. § 416(g)(1).

\textsuperscript{43} 26 U.S.C.A. § 415(b) (West Supp. 1993).


\textsuperscript{45} See Blasi, \textit{supra} note 6, at 47.
paid employees than for lower paid ones.\textsuperscript{46}

Tightening such rules could mitigate the inequality problem. Changing the tax benefit\textsuperscript{47} from a deduction from taxable income to a credit against the tax payment would tend to equalize its value to high and low earners. The inclusion of all non-probationary workers could be required, as could contributions at uniform fractions of salary, perhaps with a fixed dollar maximum based on the relevant fraction of the median worker's salary. However, inequality constraints can have the disadvantage that they make affected benefits available to an individual worker turn on the wages of the people with whom she works; for example, low-wage employees in workforces with many high-wage workers often end up with higher contributions than they might like and would get in a workforce where they represented a larger fraction.\textsuperscript{48} Obviously, the more equal the underlying wage distribution, the less severe this problem. In addition, the more effectively control arrangements allow workers with diverse preferences to articulate them and have them considered in determining the design of compensation arrangements, the less severe tax distortions will be.

\textbf{D. Division of Labor}

Finally, we should note conflicts arising from the division of labor. The more rigid and extensive the division of labor, the greater the potential for conflicts arising from different work roles. With a rigid, stratified division of labor comes a relatively strong potential for conflict over such issues as relative compensation, technological changes that enhance productivity but eliminate certain work roles or product choice (where only certain workers are able to work on certain products). Henry Hansmann argues that the extent of the division of labor is the most important determinant of the viability of worker control.\textsuperscript{49}

This point may be overstated. The same conflict that Hansmann sees as widely impeding effective worker ownership would seem equally to impede effective union collective bargaining. While the American

\textsuperscript{46} \textit{Id.} at 39-52.

\textsuperscript{47} "Qualified" pension plans—those that comply with the various statutory conditions—receive three basic benefits: (a) The employer secures a current tax deduction for the contribution, 26 U.S.C.A. § 404(a)(1)-(3) (West Supp. 1993); (b) the employee is not taxed on contributions or fund earnings until distribution, 26 U.S.C.A. § 402(a)(1); and (c) the fund is exempt from tax on its investment income, 26 U.S.C.A. § 404(a)(9). "Leveraged" ESOPs, which purchase stock with employer-guaranteed loans, receive additional benefits, including employer deductibility of loan repayments (both principal and interest). If the ESOP owns more than half the outstanding stock, the lender may exclude 50% of the interest payments from its income. 26 U.S.C.A. § 133.


economy may not have experienced much successful worker ownership, it has in some periods seen a great deal of effective collective bargaining.

Nevertheless, it seems plausible that worker ownership is compatible with the kind of work organization that trains workers in diverse, general skills and either narrows the range of positions or rotates workers through the fullest feasible range of occupations. We do not know, however, to what extent this type of work organization is technologically plausible. Both theory and experience recently have challenged many deep-rooted assumptions on this point and suggest that the range of possible tasks is broader than previously thought.  

While there are plausible mitigating responses to the retiree/employee, senior worker/junior worker and manager/rank-and-file worker conflicts, these responses—severing retiree interests, diversifying funds, and limiting contributions on behalf of high-wage workers—all tend to reduce the pool of savings available for concentrated industry- or enterprise-focused funds.

III

CONTROL

The economic democracy norm contemplates worker control, but pension fund beneficiaries are not necessarily full-fledged owners, and even full-fledged ownership rights to capital often carry very limited control rights.

A. Scope Of Control Rights

As noted above, according to the Labor Department’s interpretation of ERISA, the statute imposes broad paternalistic duties on ESOP trustees which limit their ability to respect beneficiary instructions. Scandalously, the ESOP tax legislation permits privately held companies to appoint plan trustees (often managers themselves) who can exercise voting power without consulting beneficiaries, except with respect to major “organic” changes (for example, mergers, sales-of-all-assets, stock exchanges, recapitalizations and liquidations). Thus, ESOP beneficiaries in privately held companies can be denied the basic shareholder right of voting for the enterprise’s directors.

51. See supra note 28.
53. One important benefit to leveraged ESOPs—plans in which the stock is purchased with borrowed money—requires that all voting rights be passed through to beneficiaries in private, as well as in public companies. 26 U.S.C.A. § 133(b)(7). However, in leveraged ESOPs, voting is passed through only to the extent that the loan has been repaid. See Department of Labor, Carter Hawley Hale letter, supra note 28.
Moreover, while shareholder rights may be adequate to protect the interests of outside investors, the possession of these rights—even if fully passed through to beneficiaries—is insufficient to attain the goals of any ambitious conception of worker control. Shareholders can elect the directors and approve “organic” changes, but typically that is the extent of their power. Thus, if workers are to be given control over shop floor issues or over any strategic decisions with respect to their companies (e.g., investment, marketing, workforce level) other than the basic “organic” ones, they must be entitled to forms of participation other than those routinely accorded shareholders.

B. Initiation and Termination

A failing in some respects more serious than the limited participation afforded by ESOPs themselves, is the complete absence of participation afforded employees in connection with the adoption and termination of plans. Unless a workforce is unionized, employers unilaterally can institute ESOPs on their own terms, and unless the ESOPs give employees more control than is typically the case, employers unilaterally can terminate them as well.

One approach to remedying these defects would be to condition tax subsidies on the creation of participatory structures which are more meaningful than those associated with conventional stock ownership. Since labor law provides one example of such a structure, one might make the subsidy available only to unionized workplaces. Such a measure would have some affinity with “corporatist” labor law models in which unionization is encouraged and strengthened by conditioning benefits on unionization and giving unions a role in administering them. However, this approach is probably not politically viable in the United States, at least not in the near future.

A more modest measure would provide that the inauguration or termination of a tax-subsidized ESOP could be accomplished only with the consent of a majority of the employees in a vote that met stipulated procedural requirements. The very process of coming together to consider the initiation of the plan might generate employee relations and organization that would persist after its inauguration. Alternatively, the tax code could define and mandate some such organization in terms less ambitious than those defining unions, perhaps an elected workers’ council charged with coordinating the exercise of share voting rights.

Another set of issues concerns the allocation of voting power in relation to shareholdings. Presumably, each share carries an equal vote, so the more unequally shares are distributed, the more unequal their voting power. But economic democracy norms suggest that, even where unequal financial returns are justified, unequal voting is not. Union voting structures traditionally are organized on a one-person/one-vote basis (federal labor law requires this). In unionized settings, an ESOP with unequal voting power would violate the principle of equal voting rights (though not any legal requirements, since the labor law equality requirement applies only to internal union procedures). It also would channel the shareholders’ control process outside the union structure.

A further concern is whether workers should vote individually or collectively. If there are outside shareholders, or management has large holdings, or workers are divided into recognizable constituencies, individual voting may lead workers to divide their votes in ways that generally are counter-productive to their group interests. Even if all workers fare best when they vote their shares as a unit, individual workers occasionally may see an interest in short-term alliances with other constituencies, and once ranks are broken in this fashion, the cohesion needed for effective voting may be lost permanently.

Voting trusts have been used to respond to concerns about both equal voting and vote splitting in a few union-led ESOPs. For example, the trustee can be instructed to vote all the shares as directed by the union pursuant to a majority vote on a one-per-person basis. Whether ERISA will be construed to permit such arrangements remains to be seen.

D. Control in Diversified Plans

So far, I have assumed that the pension plans discussed focused on the workers’ own enterprise, as do ESOPs. Control possibilities also exist for diversified plans. Some large diversified plans have beneficiary-elected trustees, including two enormous ones: the California Public Employees’ Retirement System and TIAA-CREF, the private teachers’ fund. Experience so far, however, does not suggest that beneficiary participation is very meaningful in these cases. Voter participation rates are low, elections are not contested, and candidates do not run on sub-

56. See Olson, supra note 10, at 753-60 (discussing the case of Rath Meatpacking).
57. Id. at 757-58.
stantive platforms. The investment decisions of these plans seem generally comparable to those without participant voting.

One problem relates to a consequence of diversification: holdings are spread among a wide variety of enterprises and represent only a small fraction of the equity of each. The issues that will arise in such plans will be more remote to the worker, and the plans' influence over those issues will be less than in the case of the typical issue in an ESOP.

There appear to be two ways of responding to the problem of control dispersion in diversified plans. One would be to narrow the diversification of the fund and focus investments on projects or enterprises that are related to those of the workers. For example, investments could focus on the workers' own region. Other possibilities include concentrating on local housing investments (a practice that has attracted several public employee funds), on housing loans for union members (to mention a program of a Florida local of the Operating Engineers Union that survived an ERISA challenge), or on construction projects that employ union labor. Alternatively, a union plan might choose to form a venture capital fund targeting experimental enterprises with exceptional potential for job creation or worker participation, with a view toward selling off its interests once they become successful.

All of these efforts would entail additional risk. On the other hand, plan fiduciaries might have informational advantages over conventional lenders in areas of local interest which would mitigate or offset the effects of lost diversification. The investments also might generate补偿性 externalities in the form of worker training, or demonstration effects that would inspire private investors to emulate successful projects, thereby creating attractive jobs. To the extent that these practices involve additional risk, it is not clear whether ERISA permits them.

An alternative approach to the problem of beneficiary alienation would be to link the funds to national institutions engaged in broad eco-

59. ERISA mandates diversification for defined benefit plans. 29 U.S.C.A. § 1104(a)(1)(C) (1988). Many believe that ERISA encourages over-diversification; they argue that the financial benefits of diversification can be attained with considerably fewer investments than plans typically hold. Nevertheless, even with considerably less diversification, only the largest plans could ever attain more than a tiny toehold in large companies. See Mark Roe, The Modern Corporation and Private Pensions, 41 UCLA L. Rev. (forthcoming 1993).

60. Brock v. Walton, 794 F.2d 596 (11th Cir. 1986). This plan ran into financial trouble when Florida real estate values plummeted. See Joel Chernoff, Ego Leads to Dennis Walton's Downfall, PENSIONS & INVESTMENTS, Jul. 8, 1991, at 1.

The Taft-Hartley Amendments to the NLRA require joint employer-union control of employer-funded, union-sponsored plans. 29 U.S.C.A. § 186(c)(5)(B) (1988). However, since the employer has no responsibility to guarantee any particular benefit level in a defined contribution plan, it should be open to responsible 'social' investments that have strong worker support.

61. If the fund itself were diversified among a variety of start-ups and were only a small part of a much larger, more extensively diversified pension fund, the high risk associated with new enterprises might be permissible.
onomic and political functions, such as labor confederations and electoral parties. The labor federations of Sweden and West Germany and the social democratic parties allied with them are examples of such institutions. The "wage-earner fund" proposals in those countries seem to have contemplated that the participatory mechanisms of the union would spill over into the decisions of the wage-earner funds. The funds were to be managed by trustees appointed by the state and the unions jointly. Nevertheless, the mechanisms of worker influence on the fund and the modes of decisionmaking contemplated are quite vague in the plans. Moreover, impressive as the Swedish and West German labor federations are, it is questionable how effectively participatory they are. Thus, we really do not have a detailed model of how participation would work in a diversified fund.

The history of the Swedish supplementary ATP pension funding mechanism provides a sobering suggestion that unions strong enough to coordinate worker pension control rights in order to achieve nonfinancial goals may not wish to do so. The ATP program provided for wage-related pensions supplementing the basic flat grant pension provided under the original Swedish social security program. Unlike the flat grant program, under which current program claims were financed by current program income, the supplemental one was to be funded—that is, funds would be set aside and accumulated in anticipation of future claims. The supplemental program was to be financed by employment taxes paid into four funds managed by boards composed equally of labor, management and public representatives. Inaugurated in 1959, these funds have become major players in the Swedish capital markets. During the 1960s, they accounted for between a quarter and a third of new long-term investment and credit. This fraction has declined as the need to pay retiring beneficiaries has caused the funds to cash out increasing portions of their holdings.

Notably, neither unions nor labor representatives on the fund boards have shown any interest in incorporating nonfinancial criteria into fund investment decisions. Indeed, during the 1960s when the Swedish government sought to marshall credit on favorable terms to housing as part of a massive social program of housing expansion, the funds resisted on the ground that they could obtain higher financial returns elsewhere. The labor movement seems to have believed that "social investment" could best be accomplished through the state, rather than itself, and independent of the system of retirement finance.

In America, the "corporate campaigns" of some unions, including,

---

62. See, e.g., Swenson, supra note 7, at 156-72, 185-216.
notably, the textile and mine workers, provide one illustration of how pension fund socialism might be linked to traditional union functions. In a corporate campaign, the union seeks to increase pressure on an enterprise whose workers it is organizing or on behalf of whom it is bargaining by using its status as a creditor, shareholder or customer of either the target enterprise or some institution that is a creditor, shareholder, or customer of the target enterprise. The prospect that worker pension holdings might be employed in this manner on a broad scale has excited some visionaries.\textsuperscript{64} But, given diversified funds, such strategies would be practical only if coordinated by labor federations with strong central control and broad coverage. Such institutions do not exist in the United States.

More modestly, one might consider establishing for employee groups coordinating institutions along the lines proposed by Ronald Gilson and Reinier Kraakman for mainstream institutional investors.\textsuperscript{65} A group of diversified funds might sponsor an independent nonprofit corporation to research companies, recommend votes on contested shareholder voting issues, and field candidates for boards. The sponsoring funds presumably would follow the lead of the nonprofit and, when their holdings were aggregated, might achieve considerable influence.\textsuperscript{66}

Again, the lack of interest among the stronger European labor movements in using retirement finance to gain leverage in organizing and bargaining is sobering. The most obvious reason for their lack of interest is lack of need. These organizations are strong enough to obtain their organizing and bargaining goals without putting their members' retirement capital at risk. This makes the "corporate campaign" type of pension fund socialism seem more like a provisional and tactical response to circumstances of weak union organization and an unsupportive state than a model for the ultimate socialization of the investment process.

Of course, there exist serious paternalistic and social welfare issues regarding the extent to which workers should be encouraged to politicize investment decisions in retirement programs. Moreover, if there is to be politics, it should take the form of general principles legislated by beneficiaries but implemented by disinterested fiduciaries. The funds should not become either slush funds for union leaders or charitable trusts in

\textsuperscript{64} See generally Rifkin & Barber, supra note 6.


\textsuperscript{66} Id. Since federal law permits unions to control member pension funds only through boards on which employers are equally represented, 29 U.S.C.A. § 186(c)(5)(B), such strategies would require the acquiescence of employer representatives. Such acquiescence hardly could be routinely presumed, but as Rifkin & Barber point out, the interests of unionized employers and employees would coincide on some important issues. Unionized employers are generally sympathetic to efforts to organize and improve working conditions for their competitors' employees. Rifkin & Barber, supra note 6, at 222-23.
which claims of sentiment routinely trump interests of fiscal soundness and reasonable return on investment.  

IV  
REDISTRIBUTION  

America apparently owes its ESOP tax subsidy to the influence of the theories of the maverick financier Louis Kelso on Senator Russell Long, chairman of the Senate Finance Committee at the time the subsidy was enacted. Like his father Huey, Russell Long was an exponent of a peculiar brand of populism that attacked large corporations in the name of the toiling masses but sometimes performed its most effective services for wealthy “independent” businessmen. (Among Russell Long’s other legacies is a set of oil production tax subsidies for the likes of J.R. Ewing.) Kelso suggested that ESOPs could accomplish a massive redistribution, turning the country from a nation of plutocratic absentee investors to one of yeoman worker-owners.  

This seems implausible. Of course, workers pay for ESOP shares and other pension benefits through lower wages, higher taxes (the tax subsidy is largely regressive) and/or lower employment rates. This trade-off does not itself make workers richer except to the extent it creates incentives for greater productivity, and even in that case labor does not necessarily capture a greater portion of the increased wealth than lenders, outside shareholders, or managers. Pension policy might encourage a more egalitarian distribution in the long run if it induced the nonrich to save more than the rich. But, as I noted above, the thrust of American pension policy is generally in the opposite direction. The trend toward pension fund socialism has not been accompanied by any marked equalization in the distribution of capital ownership.  

Thus, an ambitiously redistributive pension program will have to look outside American pension programs for models, and here the European social democratic “wage-earner fund” plans, notably the one formulated by Rudolf Meidner, chief economist of the Swedish blue collar labor federation (the LO), are of interest. Meidner proposed financing his wage-earner funds through a profits tax, rather than through wage-based contributions. He argued that this approach had the virtues of avoiding the employment disincentive effects of high wage-based benefits, avoiding driving marginal firms out of business, and enabling labor to  

67. See RALPH C. JAMES & ESTELLE DINERSTEIN JAMES, HOFFA AND THE TEAMSTERS 213-317 (1965) (chronicling the misuse of Teamster pension savings during the Hoffa era for both cronyism and ill-conceived “social investment”).  
69. RUDOLF MEIDNER, EMPLOYEE INVESTMENT FUNDS: AN APPROACH TO COLLECTIVE CAPITAL FORMATION (1978).
capture a substantial portion of the rents of more successful firms without abandoning "solidaristic" wage policies designed to limit inequality in compensation across firms.\textsuperscript{70}

The Meidner plan was designed to gradually socialize Swedish capital. It proposed a twenty percent profits tax on firms above a minimum size. The tax was to be paid in the form of shares held by diversified union-managed funds. The scheme contemplated that eventually the funds would acquire control of all the large private enterprises in the economy. The pace of socialization would depend on the profitability of the firms. In a firm earning five percent a year on its capital, the funds would acquire a controlling interest in seventy-five years; in a firm earning a fifteen percent annual return, the funds would acquire control within thirty-five years. Eventually, the funds would own all large enterprises entirely.\textsuperscript{71}

In effect, the plan socializes investment through a combination of radically differential taxes on capitalist and worker investment (the tax rate on profits is uniform, but the share contribution to the funds rebates the tax on worker investment) and forced savings by workers. In the programmatic repertory of socialism, the Meidner plan is distinctive in its combination of radicalism of goal and gradualism of implementation.

The Meidner plan was not proposed as a form of pension fund socialism. The returns to the funds were to be used for collective consumption, worker training, unemployment benefits, and union organizing expenses. The plan's proponents may have been influenced by the rejection of social investment in the supplementary pension (ATP) plan. Nevertheless the proposed targeting of investment proceeds in the plan seems odd. If the plan ever proceeded to the ultimate conclusion Meidner envisioned, it would hold a far larger fraction of social wealth than would be rational to devote to these purposes.

The broader versions of the plan met with political defeat; only a shrunken version was enacted, with little prospect of having significant systemic impact on investment practices. Nevertheless, the plan seems far more plausible than the Kelso/Long approach as an engine of redistributive transformation.

V

BACKGROUND ECONOMIC AND POLITICAL FACTORS

The viability of pension fund socialist projects depends in substan-
tial part on a variety of background economic factors. Unfortunately, some of these factors, as they occur in the American economy, make the United States a relatively unfavorable setting for the more ambitious of such undertakings.\footnote{72. See generally Aoki, supra note 26; Joel Rogers, Divide and Conquer: Further “Reflections on the Distinctive Character of American Labor Laws”, 1990 Wis. L. Rev. 1.}

**Investment risk.** As noted above, investment tends to be riskier in the United States than elsewhere. For that reason, pension fund socialism would require American workers to assume greater risks with their retirement savings here than elsewhere and thus will seem less attractive.

**Social insurance.** The less generous social insurance programs are, the less investment risk workers can afford to take with their private savings (though more generous social insurance programs are likely to require taxation that will leave workers with less income for private savings). American social insurance programs are relatively meager.

**Wage inequality.** The more wage inequality, the harder it is to design programs that preserve the socialist equality goal. Either fund contributions must be subjected to progressively more restrictive limits for higher income workers (thus limiting the available investment pool) or control and/or income rights must be detached from wages/contributions (thus limiting the incentive effects of wage differentials). The United States has a relatively high degree of income inequality.

**Political infrastructure.** Where there is a strong union/party structure with wide coverage with which pension fund control procedures can be integrated, the problem of effectively democratizing control measures is less severe. The United States has a relatively weak union/party structure from which much of the population is alienated and excluded.

**VI**

**Conclusion**

The more ambitious forms of pension fund socialism promise workers a tolerable risk on their investment, a voice in decisions about the enterprises in which their funds own an equity interest, and a more equitable share of the economy’s capital income. Unfortunately, there are numerous political, legal and economic obstacles standing in the way of pension fund socialism. In this article, I have identified those obstacles which seem most intractable. At the level of large, diversified funds, the prospects of pension fund socialism are hampered by the difficulty of providing meaningful avenues of democratic participation to large, dispersed constituencies. In many industries, enterprise- or industry-focused funds probably could achieve some of the goals of pension fund socialism, such as extending worker control over the workplace. However, except in the
most stable and skilled labor-intensive industries, such funds are unlikely to attain anything approaching majority control of enterprises. While we should not abandon the pursuit of pension fund socialism, it is unlikely that pension reform will obviate the need for other means of worker ownership and protection.