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VII Concluding Observations

WE HAVE SEEN that the economic aspects of pensions are as broad as the flows of income, consumption and saving, and the network of public and private arrangements which characterize an urban industrial society. We have reviewed the creation and development of a mammoth pension structure and have attempted to preview its future growth and progress in attaining maturity. In the process of looking at these several segments of the whole, we have been at pains to remind the reader that pensions are not a separate structure but a part of the warp and woof of the fabric of our economy. The purpose of this chapter is to reflect briefly on some of the implications of this study of economic aspects of public and private pensions.

IMPLICATIONS FOR SAVING AND ECONOMIC GROWTH

The social security and other pension programs of the federal government, we have seen, act to sustain consumption and to depress the ability of individuals to save. The present system of payroll taxes to finance the OASDI system is less powerful in this direction than the financing of noncontributory programs through general revenues. It is simply not possible to lift living standards of the aged without the redistribution of income which these and other fiscal activities involve. The size and especially the prospective growth of these redistributive arrangements should, however, be taken into account in any appraisal of the influence of the total federal tax structure on economic growth.

The pension plans covering employees of state and local governments and individuals in private employment, to the extent that they are systematically funded, generate saving which is substantially a net addition to total saving in the economy. This is especially significant because the saving permits investment in business capital and housing. The flow of funds to finance business plant and equipment, inventories, research and development, and trade credit plays an increasing role in enlarging and improving the efficiency of productive capacity.

On the basis of our projections, the net flows into the markets for corporate securities and mortgages from both state and local government and private pension plans will increase from $10.4 billion a year in 1965 to more than $12 billion by 1975 and over $14 billion by 1980. These figures for net flows ignore the funds also provided in the form of corporate retained earnings of portfolio equity securities. To that extent, the projections represent an understatement of the volume of business capital financed. In any event, unless there is a major change in the trends presently indicated, it is clear that while these funds will finance a growing amount, they will contribute a diminishing share to the growth of capital assets in the business sector. This may or may not be disturbing to our expectations for economic growth, depending upon how we anticipate developments in other influences on the saving and investment process.

The projections, of course, are only an expression of the probable net effects of many influences. The realization of substantially higher returns can depress the level of contributions and of pension savings. An acceleration in the pace of the extension of coverage, in the trend toward more liberal vesting provisions, and in the rate of funding can continue to increase the rate of pension saving for another span of years. Our analysis of the working of the pension structure is, therefore, more illustrative than predictive.

Our exploration of the question of the burdensomeness of pension arrangements suggests that there is no precisely determinable

level of what the economy can afford without sacrificing some of its vitality and potential for growth. The size of the net burden attributable to the structure of benefit programs is apparently not great, especially if the plans for employees of state and local governments and private organizations continue to carry an important share of the provision of benefits.

The need for improved data and techniques for the measurement of the gain-loss patterns involved in huge transfers of income has been demonstrated by our analysis. The fruitfulness of further investigation and research in this area is evident for the informed evaluation of the economic consequences of alternative courses of action.

To set tax-supported pension programs apart from all of the other fiscal operations of government and to attempt to assess their influence on incentives and productivity gains is to create an artificial and unreal framework of analysis. Rather, the issue of what we can afford in the way of old-age income provision must be considered together with the whole range of public policies which affect the returns to different factors of production. Indeed, the interrelation between these and other public welfare objectives must be examined and constantly re-examined in a changing economic environment.[1] It is idle to appraise the influence of pension commitments running far into the future apart from the whole range of commitments being made in other areas. What we can afford, in some meaningful sense, is the total share of real output that can be diverted from the factors of production which provide it without impairing the incentives and motivations for continued expansion and growth.

Implications for Economic Stability

Pension and disability benefits clearly operate as contracyclical influences in the direction of economic stability. Retirements tend

[1] See this writer's "The Future of Private Pensions: Some Economic Aspects," *Journal of Risk and Insurance*, March 1967, pp. 27–32.

to increase when employment opportunities wane. The level of contributions, especially in private plans for the funding of past service liabilities and in profit-sharing plans, is sensitive to changes in corporate profits. Income maintenance is aided by rising benefits in periods of slack employment, and pension saving declines slightly in periods of less active demand for business capital investment.

In any case, the regularity of benefit payments is another of the built-in stabilizers in the economy.[2] Public and private pension programs will continue to provide a growing share of the income payments not susceptible to cyclical variations in aggregate economic activity.

The question has been raised as to whether pension saving is not too stable in times of deficient aggregate demand for consumer goods and services. As a consequence, it is argued, the cyclical changes in saving rates which contribute to stability are muted by the regularity of pension saving.[3] One answer is that the limits on the variability of pension saving are not entirely indigenous to the pension structure. In the case of private plans, indeed, corporate managements have preferred to use variable contributions as a method of averaging income. Public regulation to assure the fulfillment of pension promises seeks to regularize contributions and so does the Internal Revenue Code. Financial analysts and the public accounting profession seek regular recognition of pension costs as they are incurred and not when flexible contributions are actually made to the fund.[4] Also, variability in employer contributions is not feasible under the budgeting practices of state and local governments.

Essentially, however, the reality is that pension systems are not well designed to provide variability in saving flows. The long-term

[2] Cf. Arthur F. Burns, "Progress Towards Economic Stability," *American Economic Review*, March 1960.

[3] Nelson D. McClung, *Old Age Income Assurance: An Outline of Issues and Alternatives*, U.S. Congress, Joint Economic Committee, November 1966, p. 18.

[4] Ernest L. Hicks, *Accounting for the Cost of Pension Plans*, Accounting Research Study No. 8, American Institute of Certified Public Accountants, 1965.

nature of their contracts calls for regularity in provisions to meet them. Finally, equity investment is a major outlet for the saving flow, and there is some presumption that rates of return will prove higher on investments made during periods of slack economic activity. The stabilizing influence of pension fund investing on the secondary market for equity securities would diminish if pension saving flows were permitted to be highly variable.

One of the most important aspects of economic stability is the question of inflation. We have repeatedly observed that inflation can erode the value of pension promises and warned that, unless the burden of income transfers is willingly borne by the working members of society, they will acquiesce in policies which lighten the burden by inflation. This unfortunate outcome of the pension movement is not now in sight. But neither has the full burden been felt. The volume of claims to be presented has only well begun its long rise. Capital formation at a high level has spurred real output. Pension saving in the future may contribute less to this progress if, in fact, saving is the limiting factor on economic growth.

As we move into the period of substantial rise in benefit payments and witness the diminishing pace of pension saving, it will be necessary to adjust fiscal policy to the changing situation. Again, the availability of more precise measures of possible future effects of income redistribution through pension programs will be required to judge the adjustments most appropriate to the emerging situation.

Implications for the Capital Markets

The stability of net fund flows makes pension systems almost unique among the major suppliers of funds to the capital markets. Apart from the mild cyclical fluctuations mentioned above, no unpredictable changes in inflows need be anticipated by the portfolio manager. Another unique characteristic is the absence of valuation problems. There is no requirement, as with a deposit-type financial institution or a life insurance company, to demonstrate on a certain day an

excess of assets over liabilities on the basis of some prescribed or conventional valuation of assets.

These two salient characteristics, the absence of both liquidity and published statement requirements, impart different dimensions to the portfolio management decision to be made in relation to the long-time horizon of pension commitments. Despite competitive pressures to show good performance, the outcome of decisions is still to be judged over an extended period of time. If the illiquidity of a financial asset carries a premium in yield, pension funds are in about the best position to capture it. Hence the evolution of portfolio management has been steadily in the direction of holding less liquid assets, even in state and local government retirement systems.

The stability of lending and investing in the capital market obscures some variability in the pace of forward commitments for directly placed corporate obligations and mortgage loans. The tendency to enlarge forward commitments in periods of strong demand for funds may have the effect of contributing to a situation in which idle balances are being activated and velocity is rising. However, there can be no important shift into claims on pension funds and pension fund managers have little capacity or inclination to supply liquid assets, such as government securities, to holders of idle balances.[5] The important role of these funds, therefore, is as a rather neutral financial intermediary between savers and investors, with little impact on income velocity or the money markets.

We have observed that both state and local government and private plans, as suppliers of loanable funds, have shown a strong preference for corporate securities. Our projections for the future show a continuation of the growth of participation in the area of real estate finance. Slow but steady progress has been made in

[5] For a full discussion of these points, see Victor L. Andrews, "Noninsured Corporate and State and Local Government Retirement Funds in the Financial Structure," *Private Capital Markets,* Englewood Cliffs, N.J., 1964, especially pp. 465–481.

solving the administrative and expense problems of handling mortgages. It is now possible for a pension fund to secure most of the services normally encompassed in home-office administration from organizations which economically perform these functions. A mortgage portfolio can be handled with almost the ease and economy of a bond portfolio. If net yields after allocated expenses are competitive, risk factors considered, there will undoubtedly be a substantial growth in pension fund mortgage lending across the nation in conventional as well as FHA-insured and VA-guaranteed loans. By the late 1970's, the volume could easily be comparable to the average net acquisitions of mutual savings banks in recent years.

The ownership of real estate equities would appear to be a natural avenue of investment. Sale and leaseback financing has been, in fact, a growing outlet. The tax-exempt status of a private pension plan, however, can be impaired by engaging in an unrelated business. The operation of income-producing property, especially if the purchase is financed with borrowed funds and only an equity position is retained, is susceptible to being considered such an unrelated business. The tax benefits from accelerated depreciation to a real estate operator, and his ability to introduce substantial financial leverage, usually justify his paying a higher price for property than a pension fund is prepared to pay without these possibilities. Hence, pension fund ownership of true real estate equities is not likely to grow rapidly in the years ahead.

Corporate equity securities, we have seen, are likely to continue to occupy a major position in privately organized pension programs and to become increasingly important in state and local government retirement systems. Common stocks have historically produced a higher total yield than bonds or mortgages for the holder in a position to accept price volatility and irregularity in the realization of long-term rates of return. Pension funds are particularly well situated to accept these disadvantages of corporate equity securities. The principal limitation on their role is the need to support guaranteed annuity contracts and the problems with stocks as an invest-

ment medium for employee contributions subject to withdrawal and borrowing privileges.

In the accumulation of pension fund assets for the provision of future benefits of indeterminate amount, common stocks have especially desirable characteristics. The recent changes in life insurance operations to provide for separate accounts for corporate stocks should stimulate the rate of accumulation over the immediate future. Whether the benefits of equity investment will be more widely shared with present and future pensioners by use of the variable annuity contract is less certain. The fifteen-year record of the College Retirement Equities Fund in providing variable benefits for educators is persuasive of the merits of this approach, but many employee groups are not anxious to trade off the certainty and stability of retirement income for the possibility of a materially higher but fluctuating average level of benefits. There are also communication problems involved, and CREF's experience may not be readily transferable to other situations. Nevertheless, a trend toward the greater use of variable annuity arrangements is the most important single factor which might affect our projected capital market flows.

Our projections show modest purchases of U.S. government securities at some point in the future and an early cessation of net liquidation. This reflects the assumption that in the course of an orderly approach to public debt management the 4¼ per cent interest rate ceiling on long-term bonds will be removed and that the Treasury will find occasions to offer securities which are attractive in comparison with alternative investments in terms of yield, freedom from an early call provision, and marketability. There is always room for marketable securities, especially as the concentration in direct placements, mortgages, and common stocks limits flexibility in portfolio management at times.

Fund management has been criticized both for being too cautious and for accepting too great risks.[6] Equating the proportion in com-

[6] See, for example, *Old Age Income Assurance*, pp. 19–20.

mon stocks with high risk ignores what we know of the role of diversification—i.e., the right combination of high-risk equities, with a minimum of covariance between them, can comprise a portfolio with very limited risk. The investment of pension funds in unseasoned, marginal enterprises, on the other hand, clearly raises questions as to whether the trustees are observing the long-established standards of the prudent-man rule.

There has not been any visible pattern of relating the aversion to risk in the pension fund portfolio to the risk characteristics associated with the enterprises which contribute to it. If there were, we should expect to find the highest acceptance of risk among pension funds for state and local government employees or public utilities. Conversely, the greatest aversion to risk should be characteristic of plans for employees in highly cyclical or chronically unstable activities. Actually, almost the reverse is true. This may be a result of transferring to fund investment management decision-making the attitudes and outlook most frequently applied to the organization's internal investment decision-making.

Generalizations about the cautiousness of fund managements are, therefore, difficult to make. All kinds of portfolio policies are emerging and being followed. The spectrum of policies is nearly as broad as the range of investment opportunities. Over time, the funds will flow to the areas of the best returns, the allowance for risk being taken into account not perfectly but at least rationally.

Within the framework of recognized standards of fiduciary responsibility, then, the flow of pension saving will continue to spread through most segments of the capital markets. It is not material if these funds acquire predominantly seasoned equity securities, for example, because those who sell to pension funds may be in a position to reinvest in companies with greater risk exposure. In an aggregate flow-of-funds view of the capital markets, the significant factors are aggregate sources and uses, the absence of compartmentalization of markets, and a market structure which permits prompt responses to changing demands.

The growth of insured and noninsured pension plans for individuals in private employment, because of their flexibility in the allocation of saving flows, has probably done more than any other single development to improve the breadth and responsiveness of the capital markets to changing patterns of demand. They provided a major remedy to the shortage of equity capital in the period immediately following World War II, as evidenced by the subsequent recovery in the value of corporate earning power to previous levels. They have contributed to a closing of the yield differential between directly placed and publicly offered corporate bonds in the upper-quality ranges. They may have aided the responsiveness of certain classes of mortgage yields to bond yields.[7]

The picture which emerges is of an additional source of funds for the capital markets with a minimum of permanent commitments to any particular sector of those markets. In the years ahead, we can anticipate somewhat greater flexibility in the allocation of fund flows and greater responsiveness to yield differentials which express the comparative intensity of demands for funds. Our projections are illustrative of possible patterns of response, but what actually takes place will be a function of the changing pressures in the market place. On balance, these public and private pension accumulations have made a major contribution to the efficiency of the capital markets in channeling funds to the most productive areas of investments.

Implications for Financial Institutions

The increasing readiness of noninsured private pension trusts and state and local government retirement systems to participate in the mortgage market on a much larger scale suggests that life insurance companies, savings and loan associations, mutual savings banks, and commercial banks will find new competition for loans. Some of

[7] More definitive conclusions on these points will emerge from the National Bureau's interest rate study. See Joseph W. Conard, *The Behavior of Interest Rates: A Progress Report,* New York, NBER, 1966.

these institutions have already been working to establish relationships and to provide essential services to fund administrators. Mortgage bankers are also active in tailoring their facilities to these new markets. Such arrangements and correspondent services will undoubtedly develop further.

Efforts to develop a secondary market for mortgages seem unlikely to engage the interest of pension fund portfolio managers. The possibility of resale is well down on the list of desired objectives. Greater uniformity of mortgage terms and characteristics would, however, be an attractive feature of mortgage market developments.

Unless there is a major change in the saving habits and motivation observed in our study, other financial institutions will have good markets for financial services which either supplement or complement pension saving. Mutual fund plan accounts, efficient financing of household capital, additional life insurance protection, and variable savings accounts are a few of the possible areas of growth which may be stimulated by the extension of pension coverage.

Implications for Public Policy

The Cabinet Committee appointed by President Kennedy chose as the title of its report "Public Policy and Private Pension Programs." Major sections of that report dealt with economic aspects of pension growth and the public interest in private pensions. Although it is not within our province to make or endorse policy recommendations, certain of our findings are relevant to the Committee's analysis.

The Committee recognized that it is essential to the operation of public and private pension programs that the highest standards of fiducial responsibility be maintained. More complete disclosures of portfolios and changes in them were recommended. Also, the Committee advocated strengthening statutory provisions for enforcing recognized standards of fiducial responsibility in preference to the

application of regulations or formulas which would reduce the flexibility of asset management.

Our analysis of portfolio management indicates that diversity and flexibility of investment decisions account for much of the contributions of these funds to the more efficient functioning of the capital markets. At the same time, we have found no reason to conclude that more complete disclosure to participants would hamper portfolio management.

Another relevant issue of public policy is the question of concentration of economic and financial power. Limitations on the purchase of employer securities in private funds have long been recognized on the grounds that collateralizing a promise with the promisor's evidence of debt or a share in its equity is no security at all. At the same time, this type of limitation seeks to prevent use of the pension fund for purposes of control, support of the market for employer securities, facilitating acquisitions or control of other companies, and in other ways transforming the fund into an agency for purposes other than its intended one, the funding of pension commitments. In this report we have accepted the view that the governing considerations in portfolio management decisions will be comparative yield expectations and not the search for control or opportunities to exert influence on portfolio companies.

Certain safeguards are already operative. The most important is the established requirement that a trustee show undivided loyalty to his trust. Conflicts of interest must be avoided. The record of life insurance companies and bank trustees is excellent in this respect. Economic pressures are equally powerful in the same direction. Increasing emphasis on the quality of investment management to reduce the cost of pension benefits has strengthened the competitive forces at work. As large employers have divided their funds among a number of bank trustees or placed different funds under the management of different trustees, the measurement and appraisal of results have emerged as a practical prohibition against any course other than strict attention to the business of investing.

It is true, of course, that some very large concentrations of assets are emerging, particularly in the case of state-administered public employee retirement systems. Despite a few lapses from undivided loyalty to their participants, public fund administrators also have an excellent record of probity. Examinations in many cases by state insurance departments reinforce the system of internal controls. The trustees of these systems have their good names, and often public office, at stake in the administration of the retirement systems.

Admittedly, it is not feasible for a state retirement system to split its assets among several trustees as industrial corporations have frequently done. But concern is more properly with the lethargy and lack of flexibility in asset management which may affect these large pools of capital, especially when governmental units show reluctance to employ qualified staffs to deal with financial management responsibilities of these proportions.

Our study suggests, therefore, that competitive factors and greater disclosure are exercising strong pressures against the abuse of economic and financial power. It is clearly appropriate, however, that these issues in the realm of public policy should be examined and debated. In a relatively short span of years, public and private efforts have brought major new financial institutions into being. Mass coverage of the contingency of loss of income because of age or disability has been extraordinarily successful and shows promise of even further development. It is only prudent that we should take stock of both the economic and public policy issues which emerge, in this case, from the realization of accomplishments beyond our expectations. We can only hope that this kind of review will take place again and again, each time with better grounds for reaching judgments. We can also expect that it will become common knowledge that the validity of pension promises ultimately rests on the capacity of our economy to grow in productivity and to achieve higher standards of living for citizens of all ages.