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Volume Author/Editor: Roger F. Murray

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Chapter Author: Roger F. Murray

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Economic Aspects of Pensions

A Summary Report

I The Principal Questions

THE EMERGENCE of a new structure of fiscal operations, financial institutions, and capital market participants inevitably raises a host of questions about its implications for the American economy and, in particular, the saving and investment process. Despite the fact that the original federal legislation for the Old-Age and Survivors Insurance program dates back to 1935 and pioneer arrangements by private industry to provide retirement income are fifty years old and more, the present structure is properly described as new in the sense of only now becoming of genuine economic significance. Now it is possible to visualize the impact of public and private pensions on such basic economic processes as saving and capital formation.

Retirement Saving in an Industrial Society

How can a well-developed industrial society like the United States save for the purpose of providing retirement income? As fewer individuals directly own the means of producing those goods and services which they wish to use in retirement, it is evident that fewer of them can store tangible assets for future consumption. In the New Testament parable, the rich farmer could build new barns to store grain and other goods for years of future ease.[1] His present-day counterpart, however, would hire a larger safe deposit box to store financial claims and equities.

The point is simply that rising living standards are achieved through the development of an economy which relies upon the ex-

[1] Luke 12:16–19.

changing of claims to goods and services rather than the satisfaction of wants from the individual's own current output or a bartering of consumption goods. The individual members of our twentieth-century society, therefore, cannot and do not save for their own retirement needs in real terms. It is true that an individual can provide for some of his future needs by acquiring outright ownership of his home. But, in physical terms, he cannot store up future property taxes, insurance premiums, maintenance expenses, and the cost of cutting the grass.

That only a small fraction of saving for retirement can take the form of accumulations of tangible goods, whether we think of individual cases or of society as a whole, means that the process of saving and investment, the exchanging of financial claims, must develop and grow to accommodate an additional type of transaction. Furthermore, as arrangements are made to handle these transactions outside the family unit, the claims and financial assets entering into the money and capital markets are multiplied. The simplest illustration is the case of the son who used to support his parents from current income, but now supports them only as a member of the working population while they live on OASI benefits, a supplemental private pension, life insurance benefits, a savings account, and dividends from common stocks.[2]

This shifting to public and private organizations on a group basis and the adoption of insurance-type arrangements are significant developments in themselves and account for the historical record of a high growth rate for savings in this form. But these secular trends were jolted out of their regular pattern by a shift in the preferences of the American people. In the long history of employment in manufacturing, workers have accepted a substantial portion of productivity gains in the form of a shorter workweek to enjoy more

[2] The growth of financial institutions for such transactions has been explored in depth by Raymond W. Goldsmith in *Financial Intermediaries in the American Economy Since 1900,* Princeton University Press for National Bureau of Economic Research, 1958, and *The Flow of Capital Funds in the Postwar Economy,* New York, NBER, 1965.

leisure time. From 1950 to 1965, on the other hand, there was no reduction in the average number of hours worked. (Paid holidays and vacations were increased, to be sure.)

The same period witnessed a spectacular growth in pension coverage for manufacturing industries. Workers did, in fact, receive a substantial portion of their real gains in the form of future retirement benefits, along with other income maintenance programs, during the post-war years. Also, this lasted long enough to be called a trend. It is reasonable to conclude, therefore, that employee preferences have shifted, to some extent, from the desire for more leisure during their working years to a greater degree of financial independence during retirement or to earlier retirement.

The main threads of the story, then, are as follows: (1) the long shift in our society from agriculture and a degree of self-sufficiency in the family unit to an industrial, urban society; (2) the increase in life expectancy, the widespread application of fixed retirement ages, provisions for early retirement, and the resulting spectacular growth in man-years of living in retirement; (3) a preference for a degree of independence in old age as compared with other benefits during active employment; (4) the growth in institutional arrangements for attaining goals on a group, rather than individual, basis through the employment of insurance principles.

Basic to all of these developments has been a change in the attitude of the American people toward their old people, now sometimes known as "senior citizens." Dependency on public or private charity based on a means test is more widely recognized as destructive of human dignity and the full potential for self-realization that lies in every individual. Concurrently has come the widespread acceptance of social insurance as a normal institutional arrangement in our industrial society.

The economic aspects of pensions develop, then, from basic forces at work in our society. We can be confident that the structure of arrangements will not be dismantled, nor will it fall into disuse in another generation. Rather, it will grow and develop, spread and become more inclusive, and become an increasingly dynamic force in economic processes. For these reasons, too, we must look ahead, not dwell upon history, to detect the most important questions and issues of public policy and private action.

The Shape of Things to Come

Obviously, the pension structure will evolve over the next decade and more in response to many factors: the economic environment, rates of growth in different sectors, employee preferences, and public policy decisions. Nevertheless, it is possible to identify the basic forces at work and to rely upon them in projecting the probable course of flows of income and capital funds. Thus, one of the basic components of our study has been a projection of the magnitudes of such determinants of future economic influences as coverage, contributions, beneficiaries, benefit payments, and fund earnings and accumulations.[3]

The questions which arise in making these projections are discussed at length in Holland's study. The extrapolation of past trends has a certain validity because of the long time span of pension commitments. Moreover, most of the pensioners in the year 1975 will already have qualified for a large share of their prospective benefits. The costs have been incurred and may have actually been funded in whole or in part through insurance contracts or trust funds. Despite revisions in employee benefit plans from time to time and the increasing fulfillment of pension promises, the basic framework of pensions for this group is not likely to change materially.

Hence, it is possible to make helpful estimates not only of today's fund flows but also of the transfer payments and capital market flows of 1970, 1975, and 1980. Such estimates enable us to contrast with present and past influences on income and expendi-

[3] Daniel M. Holland, *Private Pension Funds: Projected Growth*, New York, NBER, 1966, deals with these variables in projecting the fund flows through industrial pension plans and the retirement systems of state and local governments. This study will be referred to as Holland's projections throughout this volume.

tures those transactions which will be generated in the future. What differences will they make? How will recipients of benefits respond to the creation and realization of their equities in pension programs? Who pays the cost of these benefits? How are the costs distributed over time?

The answers to these questions may be different at various stages in the evolution of the pension structure. It becomes essential, therefore, to look at the system from several vantage points: in its early stages, in its rapid growth phase, and in approaching maturity. In Chapter II, we have attempted this view of the structure of retirement income arrangements from 1940 to 1980.

The purpose of this view is, first, to appraise the redistribution of income brought about by the emerging pension structure. Chapter III explores this process of income transfers. The incidence of costs and the distribution of benefits are familiar problems of analysis in other contexts. Our inability to produce precise answers should not deter us from exploring the issues. We should even venture to face that old question: Is there some limit to the pensions we can afford? Is this a meaningful question and is there any quantitative answer to it? What might be the result in the distant future of the maturing of pension commitments?

In addition to the direct influence of transfer payments on incomes, spending, and saving, we should trace the impact of fund accumulations under pension arrangements. How do they affect aggregate saving? Our discussion of this major question in Chapter IV is based largely upon Phillip Cagan's perceptive analysis.[4] This thorny question also has its time dimension, and the pattern of saving reactions over future years becomes of great interest in the formulation of economic policy.

Entirely apart from these questions about the impact of the pension structure on aggregate saving, however, we face a range of

[4] Phillip Cagan, *The Effect of Pension Plans on Aggregate Saving: Evidence from a Sample Survey*, New York, NBER, 1965. This study will be referred to as Cagan's paper on saving throughout this volume.

questions relating to the influence on the capital markets of directing the flow of funds through financial intermediaries known as pension trusts, life insurance companies, and governmental retirement systems.[5] The assets acquired and held by these institutions are influenced, of course, by the nature of their liabilities. Our projections of the fund flows should, therefore, be a guide to the influences which we can expect to see investment managers exert on the capital markets. For private pension programs, these possibilities are discussed in Chapter V, and the operations of state and local government retirement systems are analyzed in Chapter VI.

In Chapter VII, the findings of the study are pulled together in the form of some conclusions, an identification of some of the implications for public policy, and a recognition of the gaps in our knowledge about certain aspects of the subject.

The Questions in Perspective

When viewed in their totality, the questions relating to the economic effects of the development of public and private pensions are as all-inclusive as a study of the American economy as a whole. Some narrowing of the field of investigation was inevitable, therefore, to make the project manageable. For example, we have not undertaken to study the impact of pensions on labor mobility, a matter of great importance in these days of rapid technological change. Nor have we been especially concerned with the tax treatment of pensions and the aged. The role of pensions in contributing to economic stability is treated by implication, but this has not been treated as a major topic.

Otherwise, we have attempted to respond to most of the issues outlined in the National Bureau's exploratory survey, published in 1957 as *Suggestions for Research in the Economics of Pensions.*

[5] H. Robert Bartell, Jr.'s study of union and jointly administered pension funds and Elizabeth T. Simpson's study of the pension plans of nonprofit organizations, *Pension Funds of Multiemployer Industrial Groups, Unions, and Nonprofit Organizations,* New York, NBER, 1968, fill in gaps in our knowledge about these special types of funds.

That survey attempted to delimit the economic aspects by excluding from consideration medical, sociological, and psychological problems of the aged. While admittedly of great importance, these topics require specialized treatment and a different preparation for the investigators.

The conception of this particular study was that it would build upon the work of the National Bureau in the fields of capital formation and financial institutions. The timing seemed good since the research program on postwar capital markets had been largely completed. Without that wealth of material, this study could not have been undertaken with confidence. In a very specific sense, we are simply carrying on these previous studies with particular emphasis on a new and dynamic factor in the perpetually changing roles of financial intermediaries.

In identifying the present and future impact of public and private pension systems on saving and investment as the most important economic aspects of pensions, we do not mean to imply that these are the only important considerations. Berle, Harbrecht, and Tilove [6] have discussed some of the issues arising from the institutional ownership of a large and growing share of equity securities. Dan M. McGill has dealt in a major study with the problem of assuring the fulfillment of pension expectations.[7] Similar concerns about the legal aspects of pension commitments prompted Merton C. Bernstein to write *The Future of Private Pensions.*[8] Finally, the Cabinet Committee Report of January 1965 [9] has raised a wide range of issues regarding the regulation of private pension arrangements.

[6] Adolph A. Berle, Jr., *Power Without Property,* New York, 1959; Paul P. Harbrecht, *Pension Funds and Economic Power,* New York, 1959; Robert Tilove, *Pension Funds and Economic Freedom,* New York, 1959.

[7] Summarized in his *Fulfilling Pension Expectations,* Homewood, Ill., 1962.

[8] New York, 1964.

[9] *Public Policy and Private Pension Programs, A Report to the President on Private Employee Retirement Plans,* by the President's Committee on Corporate Pension Funds and Other Private Retirement and Welfare Programs, Washington, 1965. Reference will be made elsewhere to earlier studies by other agencies of government.

These various studies, and numerous other writings, deal with problems of fairness and equity to the employee: matters of proper public concern. As citizens, our sense of justice is particularly outraged if an individual has been led to believe that provision has been made for his old age and this turns out not to be the case. When he has lost his capacity to support himself, it seems a particularly cruel form of injustice to have his expectations destroyed by careless, incompetent, or venal administration of his retirement income program.

Our concentration on the economics of pensions should not be interpreted as reflecting a lack of concern for this whole range of questions. We are simply trying to provide a basis for judgment about the economic implications of the range of steps which might be taken in the area of the public interest in the pension structure.

Comparable choices had to be made in deciding whether we ought to be concerned with the adequacy of pension benefits. Here we determined to express no judgments apart from our role of analyzing the costs and economic impact of steps taken to improve the level of benefits.[10]

The narrowing of the focus of this study to the saving and investment process may seem to exclude some of the burning issues of our time. Clearly, it skirts some areas of lively controversy. Yet we make no apologies for the design of the study, believing that we have attacked the hard core of the subject. Among the wide range of topics, we had to make a selection on the basis of our backgrounds and the objectives of the National Bureau's research program. Furthermore, we were concerned about losing sight of the relationship of man-made pension arrangements to the underlying realities of the economic process. Perhaps, in the final analysis, economic growth, economic stability, and inflation are such prime determinants of our ability to provide systematic programs to

[10] The writer, as an individual, has participated in hearings held by the Subcommittee on Retirement Income of the Special Committee on Aging, United States Senate, July 12–13, 1961, and March 4, 5, 10, 1965.

spread income beyond the years of productive employment that they deserve the priorities which we have given them by our concentration on the saving and investment process.

A Central Theme

As previously emphasized, in our urban industrialized society, we deal primarily in claims rather than in tangible goods. A typical employee today accumulates the right to receive income after age 65 from the OASI system of the federal government and from a pension plan established by his employer. He can read booklets and calculate what his benefits and those of his survivors will be if and when he attains age 65 in his present employment.

These prospective benefits are translated by him into a certain degree of financial independence, a level of living rather than a money income. At that future date, he expects to have a reliable command over the goods and services which others will be engaged in producing. His very inability to provide for his own retirement by storing up a major portion of his living standard makes him wholly dependent upon the purchasing power of those accumulated claims.

If, by reason of stable economic growth during his remaining working years and during the period of his retirement, productivity gains are substantial, those claims will give him a command over a good level of living. Stable prices and quality improvements are essential for this happy outcome.

Furthermore, he must take into account the attitudes of those who will be providing him with goods and services during his years of retirement. They must be willing to forgo current consumption of real output in exchange for their own accumulation of claims to retirement income. Their willingness to do so depends upon their standard of living, a function of the productivity gains achieved in the economy through investment in all forms.

If the claims to real output of the retired population seem burdensome to the younger employed workers, they will be willing to tolerate or even to stimulate a lightening of the burden through the traditional route of inflation. On the other hand, rising real incomes for the working population make acceptable the diversion of real output to those no longer working. This is especially so if widespread coverage by pension programs relieves the worker of personal responsibility for retired members of his immediate family.

In short, the emerging pension structure has a great potential for good if confidence in claims to retirement income is sustained by an economy which is showing stable economic growth without inflation. Since saving and capital formation play a key role in this process, it is crucially important to determine that public and private pension programs operate in a manner to contribute constructively to the kind of economic progress which will translate their promises into realities.

The central theme of the research project summarized in this volume is the search for a better understanding of the economic effects of the mammoth structure of commitments, benefit payments, and fund accumulations which we are still in the process of creating. Is it well designed to accomplish its exceedingly worthwhile objectives? Can it be improved in some respects? Does it suggest the desirability of other economic policies to reinforce or offset its effects? And finally, what difference does it make if the shares in the total provision of retirement income are altered as between private plans and the tax-supported programs of the federal government?