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Pensions, Economics and  
Public Policy

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**RICHARD A. IPPOLITO**

Director, Policy and Research  
Office of Pension and Welfare Benefit Programs  
U. S. Department of Labor

1986

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To my great-uncle Freddie who continues to shape me.  
Wilfred Ouellette  
1892-1969

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The Pension Research Council was formed in 1952 to undertake academic research into those institutional arrangements designed to provide financial resources for secure and dignified old age. It seeks to broaden public understanding of these complex arrangements through basic research into their social, economic, legal, actuarial, and financial foundations. While generally geared to the long view of the pension institution, projects undertaken by the Council are always relevant to real life concerns and frequently focus on issues under current debate. The Council does not speak with one voice and espouses no particular point of view. The members do share a general desire to encourage and strengthen private-sector approaches to old-age economic security, while recognizing the essential role of social security and other income-maintenance programs in the public sector.

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## Foreword

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In its original form, the manuscript that constitutes the basis of this book was public document. It was produced by Dr. Richard Ippolito over a five-year period, during which he was an official of the U. S. Department of Labor, enjoying full financial support from the government and having unrestricted access to a great mass of data accumulated at public expense, along with the assistance of a technical staff. His goal was ambitious: to explore the nature, causes, and economic consequences of the private pension movement. He set out to explain the behavior of pension plan sponsors, participants, and affiliated labor unions in terms of basic economic principles articulated in language comprehensible by intelligent laymen. Stated differently, he wanted to develop a theoretical framework for the attitudes and practices observable within the private pension institution. His economic analysis led him to a set of recommendations for public policy.

The book will be controversial. Many will disagree with Dr. Ippolito's economic analyses and the conclusions that he derives from them. Some may agree with his analyses but disagree with his conclusions. Many will feel that his assumptions and conclusions do not comport with reality as they perceive it. Others will be troubled by the book's unique approach to many technical details of pension plan design and operations. Almost everyone will find something in the book to criticize; few conclusions will lack critics.

The Council is publishing the manuscript because it believes that the book will contribute in significant measure to a fuller understanding of the economics of employer-sponsored pension plans. These plans have become a major force in the economy, the implications of which up to this point have been only dimly perceived. Economists have only

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recently begun to study the pension phenomenon and have generally tended to look at isolated facets of the institution. Many of these studies have been flawed by unfamiliarity with the actual workings of pension plans or the assuming away of critically important operational realities. This study is the first one that attempts to build a general theory of pensions supported by empirical data. Dr. Ippolito is to be commended for that reason alone, irrespective of the number of critics that he draws.

The author is the Director of Research and Policy in the U.S. Department of Labor's Office of Pension and Welfare Benefit Programs; he has held this position since 1979. He has also held positions at the Civil Aeronautics Board, the Federal Trade Commission, and the Antitrust Division at the U.S. Department of Justice. He received his B.S. from Lowell Technological Institute in 1970 and his Ph.D. in economics from the University of Chicago in 1974. Mr. Ippolito has published numerous articles in the economics literature and is a frequent speaker at academic and industry conferences.

Books published by the Council do not purport to have the endorsement of all members of the Council. By design, many viewpoints are represented on the Council. Members may express their disagreement with any portion of the published work in a dissent included in the book. Two such statements appear at the end of this volume.

*Dan M. McGill*

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## Preface

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This volume stemmed from an inclination on my part, shared by some of my colleagues, to bring together in one place all of the pension research I did over a five-year period in the Office of Pension and Welfare Benefit Programs at the U. S. Department of Labor. The work had been developed for various outlets including journal articles, conferences, testimony, and internal memoranda and studies. In the course of preparing these materials, a tremendous data base was created which, prior to now, was being accessed for pension universe characteristics on an ad hoc basis. It was decided that an assemblage of this material in a reasonably cohesive volume would make the data and the research findings more accessible and hence more valuable to policymakers, industry participants, and researchers.

An effort was made to avoid creating a volume containing a series of unrelated articles and data. At the same time, the volume is not a single theme book. Generally speaking, the materials comprise a study of the economic foundations of pensions and the impact of public policy in the United States. Within this framework, the volume has handbook qualities, in the sense that each of five parts to the volume (if not each of 13 chapters) can be read independently by those interested in particular pieces of the research.

Part One deals with the fundamental building blocks of pensions: the tax structure that rationalizes pensions, and the implicit contract between workers and firms that defines pension value and pension liabilities. These materials provide the basis for understanding why pensions exist and for calculating true pension liabilities and firm funding policies. This groundwork provides the basis for a rational model

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of pension growth: these growth calculations and projections through the year 2000 comprise Part Two of the volume. Part Three assembles the data and arguments dealing with the economic impact of pension growth for capital and labor markets in America.

In Part Four, attention is turned toward explaining one of the true pension puzzles, one having significant implications for capital markets: why some firms disdain full funding policies even though large tax advantages are forgone. Interestingly, the answers return the reader to thinking about the fundamental nature and function of pensions. Evidence is uncovered showing that pre-ERISA, underfunding may have been used to give unionized workers a stake in the long-term survivorship of the firm. Thus, pensions may in the past have been used to promote efficiency in markets, a use no longer available to firms since ERISA. Finally, in Part Five after an appreciation has been gained, it is hoped, for the nature and growth of pensions, the public policy toward pensions in the United States is examined, and a series of recommendations designed to create a more efficient retirement system are presented.

Throughout the volume, an attempt is made to present a plethora of pension statistics; there are over 50 tables in the volume. If readers neither agree with the analyses nor the conclusions found in the volume, it is hoped that they can gain a quantitative feel for the pension industry. An attempt is also made to keep essential economic arguments and principles simple, even if in many cases simplicity comes at the expense of imprecision in describing particulars about pensions. The volume is decidedly not a textbook, and hence should not be viewed as a definitive source for pension concepts. Instead, it is a volume aimed at the big pension and public policy issues that have been emerging over the past 60 years.

Notwithstanding my affiliation with the sponsoring agency, the views expressed in this study are entirely my own. They therefore should not be construed to represent the views of the pension program or the Department of Labor.

*Richard A. Ippolito*

## ACKNOWLEDGMENTS

The research reported in this volume was done over a five-year period, 1980–1984. During this time, Pauline Ippolito discussed countless pension issues and ideas with me and helped develop some of the key ideas in the volume from their infant stage. In addition, various portions of the study benefited from comments and discussions from many researchers and seminar/conference participants, far too many to list. The work was influenced by seminal work in pension economics done by Fisher Black, Jeremy Bulow, Richard Burkhauser, Martin Feldstein, William Sharpe, Irwin Tepper, and especially Jack Treynor whose early pension work provided the foundations for the implicit contract theory of pension value developed in this volume. I am grateful to all of the Pension Research Council members who read and commented on the book, and especially to Donald Grubbs for his painstaking, detailed critique of large portions of the manuscript and to Jerry Rosenbloom for a series of particularly insightful comments. None of these people, of course, are responsible for the opinions and remaining errors in the volume.

Many people were responsible in various ways for the direct research product. Of principal importance was my secretary, Sylvia Thomas, who happily retyped this manuscript in many different forms—many, many times. I am also indebted to Daniel Beller who prepared countless data tapes and counseled me on their proper use; to Arnold Hoffman who developed most of the financial data from the Federal Reserve and whose constant concern about details made it impossible for me to stray from his exacting standards of research; to Helen Lawrence for her excellent graphical work; and to my principal pension mentor, Walter Kolodrubetz, who always was the first to listen and critique my ideas and the first to offer me continued encouragement. Finally, I am grateful to Robert A. G. Monks for supporting the writing of the volume and to Dan McGill for making its timely publication possible.



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