

Pensions (1949)

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## Information for the Press

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... THE PENSION DRIVE: SOCIAL AND ECONOMIC IMPLICATIONS ;

Talk by Marion B. Folsom, Treasurer and Director, Eastman Kodak Company, before the 308th Regular Meeting of the National Industrial Conference Board, Inc. ~~Delivered on the evening of~~  
November 22, 1949, ~~in the Grand Ball Room,~~  
~~The Waldorf-Astoria Hotel, New York~~

New York, November 22 . . . Until recent years comparatively few businessmen were interested in pension plans, primarily because they have felt that under a system of individual enterprise, initiative and thrift, an individual could provide for his own old age without assistance from the government or from his employer. When we consider the high percentage of home-owners, the liquid savings of over 175 billion dollars in the hands of individuals, and two hundred billion dollars worth of life insurance, it is evident that the individual has done a good job in looking out for himself. The percentage of aged persons who do provide for themselves is probably higher in this country than in any other country in the world.

Businessmen also know that we can obtain economic security only through production and that if we are to give more goods and services to those who no longer work, those who are working must produce more. Otherwise everybody's standard of living will fall.

During the past fifty years there has been a change in the security problem due to the increasing number and proportion of older people and to our shift from a rural to an urban, industrial society. There are now eleven million persons aged 65 or over, compared with five million in 1920. About 60% of our people now live in cities and towns of over 2500, contrasted with only 15% in 1850 and 35% in 1890. Three out of four of those working are now employees. Individuals have become specialists and the family is no longer an economic unit. It has become more difficult for the family to take care of its aged members. About one-fourth of those aged 65 or over receive grants on the basis of need under the Old Age Assistance program.

### Federal O.A.S.I. Plan

Most businessmen now realize that the Federal Old Age and Survivors Insurance program is a sound approach to providing a basic level of economic protection to the aged. They favor the underlying principle of this plan, under which workers and employers contribute equally and benefits are paid regardless of need. Benefits depend upon earnings and thus the plan strengthens the incentive for the individual to increase his earnings. With this basic protection the individual can supplement

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his income through his own savings and an employer can assist through private pension plans.

This obviously is a better plan than Old Age Assistance, which is simply charity relief and offers no incentive for the individual to provide for his own old age. The fears which many had about this plan at the beginning have already been realized in many states. Due to laxity of administration and eligibility requirements, a high percentage of aged persons qualify; the grants are increasing constantly (they are now about double the insurance plan benefits); the Federal government's share has been greatly increased; and the plan has become the football of politicians.

Unless steps are taken very soon to strengthen the contributory insurance plan, the country faces the grave danger of losing this plan by default and adopting the charity approach entirely. The aim should be to extend the insurance program as soon as possible to all those gainfully employed and then to shift the Old Age Assistance entirely to the states for those who cannot be covered adequately under the insurance program. There are two major defects in the present O.A.S.I. -- the coverage is too limited and the benefits too low in relation to present wages and the cost of living.

The bill amending the Social Security Act (HR-6000), which recently passed the lower House, goes part way in extending the coverage of the insurance program but still leaves out important groups such as farmers and other self-employed, farm laborers, employees of the government and railroads. It would extend the coverage to eleven million out of twenty-five million not now covered.

The bill goes a long way toward correcting the defect of inadequate benefits. For instance, the man whose average wage is \$200 a month would receive \$39 under the present plan if he is in the system for twelve years. Under the House bill he would receive \$64, an increase of 64%. An additional payment of 50% would be made if a man and wife were both over 65. The proposed formula -- 50% of the first \$100 of monthly wages and 10% of wages between \$100 and \$300 -- is weighted heavily in favor of the low wage group, as it should be in a social insurance plan. There is a question, however, as to whether this formula has not gone too far in that direction. For instance, a \$300 a month man would pay three times as much in taxes as the \$100 a month man and his benefits would be only 40% higher. This low differential is apt to lead to criticism by all those above the lower wage group. It might be better to have the rate for wages above \$100 a month increased to 15%.

It is questionable whether it is necessary to change the tax base, as the House bill does, from the first \$3000 to the first \$3600 of annual income. The objective of the governmental plan, to provide a minimum basic protection, can be obtained within the present tax base. Since all the state unemployment compensation laws and the existing private pension plans are built on the \$3000 base, a change in the base would greatly complicate matters.

It is greatly to be hoped that the Senate will give early consideration to the House bill so that legislation will soon be enacted to improve and extend the insurance plan. Companies will then be in a better position to set up their own supplementary plans.

#### Growth and Purpose of Private Pension Plans

Long before the enactment of Social Security legislation many companies, established in the 80's and 90's, were beginning to realize the need for private

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pension plans. The real growth of the plans came after 1935, when businessmen began to study the question and management found that the Social Security program would not entirely meet the retirement problem in industry. The high wartime taxes provided further impetus as companies were able to launch plans with substantial savings in the initial cost.

It is estimated that there are now over twelve thousand private plans in operation. Less than one thousand of these were established before 1940 and about nine thousand between 1942 and 1947. Over one thousand plans have been submitted to the tax authorities for approval during the past year. The movement is now gaining considerable impetus because of the drive for pensions in the larger industries.

Why do companies adopt pension plans to supplement the government program?

When, after a company has been in business for a number of years and employees begin to approach the point where because of advanced age they are no longer efficient, the employer has three choices. He can keep the worker on the payroll as long as he lives; second, he can release him without retirement provision; or, third, he can retire him on a pension. If the first choice is taken, the efficiency of the organization suffers and there is a pension cost but it is buried among other costs of the business. If the second choice is made, the employer's standing in the community is impaired and the morale of his organization is affected. Modern management does not think it is fair to release a long-service worker if it is known that he will have to take too sharp a drop in his living standard. The third choice, which has been taken by thousands of companies, has distinct advantages over the first two.

A pension plan does entail a substantial direct cost but it is not hidden. We are hearing much these days about the cost of pensions -- whether it will be 8¢, 10¢ or 12¢ an hour -- but little has been said of the advantages to a company of a sound and adequate pension plan. There are definite savings. The organization is kept on a more efficient basis because those who are past their period of usefulness can be replaced by younger and more productive workers. If a supervisor retires, promotion can often be made affecting several individuals; the morale of the organization is thus improved. A sense of security is brought to the older worker and there is a good effect on the younger worker as well. There is a better feeling among the employees and in the community toward a company which looks after its older workers. As a result of these factors labor turnover will be lower.

These savings cannot be measured but it would not take very much of an increase in productivity to offset a large part of the cost. In any event, with the increase in the number of companies adopting pension plans, it is becoming more difficult for companies to attract and hold desirable workers without a plan.

If benefits under the Old Age and Survivors Insurance Plan are increased along the lines of the House bill, companies in some sections of the country and smaller cities and towns, where living costs are lower, might find it necessary to add only small additional benefits in the way of a supplementary plan for those in the lower wage groups. However, in the larger industrial cities larger supplementary benefits, especially for those in the upper wage groups, will be necessary.

Some may urge that the benefits under the government plan should be high enough to make it unnecessary for even the companies in industrial centers to have a supplementary plan. This, however, gets away from the basic principle underlying the government plan, which is to provide only a minimum protection to prevent dependency. That should be the extent of the government's obligation. Once the government attempts to provide income above this level, we would be establishing a new principle

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which could lead to guaranteed income for other groups in the community and, eventually, to a planned economy.

### Financial Problems

There are many complex problems in setting up a sound pension plan and they must be carefully studied. A pension plan covers a long period of time. Mistakes made at the start may bring very serious financial difficulties as the plan develops in the future.

It should not be expected that the details of a pension plan can be worked out satisfactorily in a few conferences over a short period of time. It involves very careful estimates by experts in the field, careful consideration by the management as to type of plan and the individual features which would best fit its particular situation. Many features -- retirement age, provision for optional retirement, death benefits after retirement, the rate of benefits, the amount of contributions by employer and employee, vesting rights -- would depend upon the individual company and the funds available. Each one of these variable factors will affect the cost. Obviously there can be no one pattern for industry as a whole or for one industry. Each plan should be worked out on an individual company basis.

Likewise, individual companies will select different methods for handling the funds. There are advantages and disadvantages to group annuity plans or deposit administration plans underwritten by insurance companies and to trust funds handled by trust companies. Many experts from insurance companies and trust companies and independent consultants are available to assist the individual company in devising a plan on a sound financial basis.

If a company at its beginning were to set aside a sum for each dollar of payroll in order to provide pensions, only a small amount would be necessary; the interest accumulation would take care of a good share of the cost. Few companies, however, begin to think of pensions until some of their employees approach retirement age -- about twenty-five or thirty years after the company commences operations. The first step is generally to retire the older worker on an informal basis, the amount depending upon need. Such a plan will soon prove unsatisfactory and is not fair to those who have been thrifty. It is thus found necessary to set up a definite plan to pay pensions to all retired workers. These payments begin to increase quite rapidly.

The reasons for the rapid increase are obvious. Each year additional persons are put on the pension roll and if the same number were added each year, the cost would not become stabilized until the number of deaths would equal those newly added. An increasing number, however, reach retirement age each year because the people who are now reaching retirement age are those who were employed twenty-five or thirty years ago and at that time it is likely the company was growing rapidly. As the result of these two factors, the payments will continue to rise in the future and will not become stabilized even as a percentage of the payroll for many years.

If the plan is financed on a pay-as-you-go basis and no provision is made to accumulate funds to meet future costs the annual pension expenditures in time may reach a large percentage of annual payroll. The conservative policy is to "fund" a plan. Under a funded plan a careful estimate is made of the liability which is already accrued for the past service of employees and of the liability accruing each year and payments are made to an insurance or trust company to meet this liability. After the company has been in business for a number of years it will be found that the amount of the accrued liability for past service will be a substantial item.

Very few companies will be able to pay this in a lump sum. It, however, can be financed over a period of years.

The Bureau of Internal Revenue permits payments for the accrued liability to be deducted for income tax purposes if the payment is spread over a period of ten or more years, and also permits payments for current liability of 5% of payroll or more if it can be justified.

#### Integration with O.A.S.I.

To qualify for tax deduction, a plan must be set up on a systematic basis, must be so "integrated" with the O.A.S.I. plan, that it is non-discriminatory as between higher and lower paid employees, and the payments cannot be returnable to the employer.

The best method is to have the company plan provide a definite benefit, based upon salary and length of service with the rate set lower for that part of the pay covered by Social Security. An ideal plan is one which would provide from both private and government plans a benefit of 2% for each year of service. This is generally done by providing 1% of the first three thousand dollars of earnings and 2% of earnings over three thousand dollars. This formula can be changed in many ways to lower the cost.

Another method, such as used in the recent Steel settlements, is to provide an over-all benefit from which the Social Security benefit is deducted. There is danger that this method will cause difficulty with any company and with Congress, as any increase in the Social Security benefits will result in lower costs to the company rather than in increased benefits to the employees. It is also more difficult to administer.

A number of company plans, adopted since Social Security was enacted, provide benefits only for persons earning over \$3000 on the assumption that the O.A.S.I. would provide adequate benefits for those below \$3000. However, especially since the sharp increase in wage levels in recent years, the government benefits are inadequate and many of those companies are now facing the problem of providing pensions for the lower paid people. Even if the increased benefits provided in the House bill were enacted into law, most companies would still find that it would be necessary to have a supplementary plan for those both below and above \$3000, or \$3600, if the level is changed.

If the Social Security benefits are increased along the lines of the House bill, companies with supplementary pension plans will face the decision as to what, if any, change should be made in the benefits of their plan. As very few pension plans now provide adequate benefits, particularly because of the increase in wages and cost of living during the last few years, most companies will probably find it advisable to continue to pay the same benefit under the company plan as heretofore so that workers will receive full benefit from the increase in the government plan. Many companies have already found it necessary to pay additional pensions because of the increase in cost of living.

#### Contributory vs. Non-Contributory Plans

Early plans adopted in this country were generally of the non-contributory type, with the employer paying the full cost. These were a natural development from the informal plans which the companies originally had. With the growth of company plans, especially the group annuity plans, during the 30's there was a definite trend

toward contributory plans. Employees became interested in participating so that larger benefits could be provided.

The movement toward contributory plans was given considerable impetus when the Federal Old Age Insurance Plan was put on a contributory basis, with equal contributions from employer and employee. It was easy to tie in a contributory company plan with the government plan. Thus a large percentage of plans adopted between 1935 and 1942 were of the contributory type. During the war and the early postwar period of high corporation income and excess profits taxes, this tendency was reversed and many companies started plans on a non-contributory basis. The cost to the company was considerably reduced by taxes and the tight employment situation induced companies to bear the entire cost rather than to ask the employees to contribute. Since the repeal of the Excess Profits Tax, the trend toward contributory plans has been resumed.

There are certain advantages in the non-contributory plan. It is assured that all employees will be covered. The administration cost is lower and the employer retains more control. The employer's cost is reduced by corporation income tax but the employee's contributions are not deductible from income tax. Thus the combined net cost of the non-contributory plan will be less. There is a movement under way to permit employee's contributions to be deductible -- this would stimulate the adoption of contributory plans.

Under the contributory plan, higher benefits can be provided for the employee because of his own contribution. He has a greater interest in the plan and probably appreciates it more. It is more in keeping with our system of individual initiative and thrift. It is an ideal method of accumulating savings. When this plan is offered to the employees a very high percentage generally accept it. The employer pays the entire cost of the accrued liability, and all employees, except those of very short service, share in this payment. Sometimes the current cost is financed on an equal basis but in other plans the employer pays a somewhat higher proportion than the employee.

Another advantage to the employee is that under most contributory plans the "vesting" period, i.e. the period of service after which an employee is entitled to the full pension accumulated, is generally shorter in the contributory than in the non-contributory plans. In the past, under most non-contributory plans, the employee would not be entitled to a pension until he had a service of twenty or twenty-five years. Recently this period has been reduced but seldom is less than fifteen years' service required.

Contributory plans always provide for the return of the employee's contributions, generally with interest. These plans often provide that if a person stays with a company for five years and leaves his own contribution with the insurance company, he would be entitled to part of the benefits due to employer's contribution; if he remains in service for, say, ten years, sometimes he would receive benefit from all of the employer's contributions.

With the wider adoption of pension plans throughout industry, the problem of vesting is one of considerable importance. It would seem desirable to have the vesting period reduced so that more persons would be entitled to the annuities accumulated with different companies.

Some company plans provide a combination of non-contributory and contributory plans. A minimum benefit is provided for everyone on a non-contributory basis and additional benefit is provided on a contributory basis.

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An impartial analysis of the advantages and disadvantages of the two plans would lead to the conclusion that the contributory plan is better. It is greatly to be hoped that the recent recommendation of the Steel Panel will not result in a decline in the contributory plans.

### Cost of Pension Plans

It is impossible to make a reasonably accurate estimate of the cost of a pension plan of an individual company until an analysis has been made of the people on the payroll -- salary, age, and length of service. With this information an insurance or trust company or consultant can give the management fairly accurate estimates with variations for different features.

In the long run the cost of a funded pension plan will be the sum of actual payments made to retired persons plus the cost of administration, minus interest earned on funds accumulated in advance. The uncertain factors in estimating the cost are: first, the number of people who will leave before reaching retirement age; second, the mortality rate; third, the interest rate. Under trust company plans estimates are made of the turnover and allowance made for it. Under the group annuity plan no allowance is made for turnover but annuities generally are purchased only for those who have completed a certain length of service, the greatest turnover occurring among the shorter-service employees.

The big increase in the cost of pension plans in recent years has been due to both the mortality rate being lower than anticipated and lower interest rates. More people are reaching retirement age and living longer after retirement. This trend will probably continue. On the other hand, we have probably reached the low level of interest rates, but whether there will be any improvement is highly questionable.

### Level of Benefits

Those who have had considerable experience with pension plans feel that for the worker in the lower wage groups a combined annuity from the government plan and the private plan of approximately 50% of pay is about right. For the middle income group a rate between 40% and 45% would be adequate, with lower percentages for the higher salary group. There would thus still be strong incentive for the individual to practice thrift throughout his working lifetime so that he can live in retirement without too much of a drop in the scale of living to which he has been accustomed.

There is a difference of opinion as to whether the retirement age should be compulsory. Some companies have compulsory retirement and feel that this is the only way to get full benefit from a pension plan. They also find that administration is easier if no exceptions are made. Other companies provide for exceptions to be made only on approval of a pension committee and with approval necessary each year after 65. Other companies are more flexible in enforcing the rule, varying the retirement age with the nature of the work and the physical condition and capacity of the individual.

In the high employment period during the war and thereafter many companies relaxed the retirement provisions but with the decline in employment, because of the recent recession, normal retirement practices have been resumed.

There is wide variation in provisions for minimum and maximum benefits. There has been a distinct tendency in recent years of high taxes to raise the maximum

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and to treat the higher salaried groups on more nearly the same basis as others.

Investment Problems of  
Government and Private Plans

One phase of the Federal Old Age Insurance Plan which causes greatest discussion and which is the least understood by businessmen, is the handling of the funds which are collected from employers and employees. Many who have not thought through the problem state that the whole plan is fraudulent, that the monies which have been collected for old age benefits have been used for other purposes and thus we will be taxed twice for the same benefits.

It should first be recognized that the financing of an over-all government plan is entirely different from that of a private plan. A private plan should be financed so that the liability when due can be paid from funds in hand, otherwise employees will not be protected or else charges will have to be made against current operations of the company. The government, on the other hand, does not have to set up a reserve fund for accrued liability or to have funds in hand as it has taxing or borrowing powers to collect revenues when the liability has to be met.

Secondly, under a contributory pension plan the collections during the early years are bound to exceed benefit payments. Everyone will be putting money in and only a few will be drawing benefits during the first few years. To avoid excess collections under the government plan it would have been necessary to start out with a contribution rate of less than 1/10 of 1% on each employer and employee and the rate would have to be increased each year. This would not only be impractical but such a low contribution rate would give people the impression that the benefits could be greatly increased without much cost. Even a slight increase in benefit rates during the early years would lead to heavy costs in the future.

The contribution rate was originally set at 1% on each employer and employee and it has been kept at that level although the original Act provided for periodic increases. From 1937 to date eleven billion dollars has been collected in excess of payments. This excess has been greater than originally anticipated for two reasons: receipts have been high because of the sharp increase in wage rates and payrolls during the war, and payments have been less because a higher percentage of older persons remained in employment during the war and postwar years.

What could the government do with these excess funds except invest them in government securities? No one would suggest leaving them idle in the cash drawer. If they were invested in securities of private corporations it might lead to government control of private industries. The only feasible investment is United States securities, the same investments which insurance companies, business corporations and banks have used for their surplus funds in recent years.

The proceeds have, of course, been used to pay government expenses, principally the cost of the war, as have the proceeds from the sale of all other government bonds to private holders. On the other hand, if these funds were not available in the Old Age Insurance Plan for the purchase of securities, it would have been necessary for the Treasury to have sold eleven billion dollars more of securities to the public. For this reason the statement is not true that the people would be taxed twice for the same benefits. This statement would only be true in case the appropriations made by Congress for government expenditures were increased solely because of the presence of this reserve fund. It would seem unlikely that the reserve fund of eleven billion dollars in the presence of a public debt of 250 billion dollars would have much influence on Congress in voting appropriations.

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The question we face now concerns the rate at which this fund will be accumulated in the future. The law provides that the tax rate be increased to  $1\frac{1}{2}\%$  on each employer and employee on January 1, 1950. It is likely that the benefits will be increased early in the year. Even with increased benefits, the funds will continue to accumulate because of the still comparatively small number of persons drawing benefits. The House bill provides for another increase in taxes to 2% rate in 1951 and further increases periodically until the rate of  $3\frac{1}{2}\%$  each is reached in 1970. The actuaries estimate that on this tax schedule the reserve fund would reach 33 billion dollars in 1960 and, eventually, 80 billion dollars -- about 1980. The Ways and Means Committee contemplated that under this schedule the plan would be approximately self-supporting, i.e., the receipts from the payroll taxes and the interest on the reserve fund would be sufficient to finance the plan so that there would be no need to draw on general revenues now or any time in the future.

There are strong arguments against putting the government plan on a full reserve basis. With a steadily increasing reserve fund and with the increase in taxes it would be very difficult to prevent a substantial increase in benefits. This would lead to very high costs in the future. If the reserve fund reached the large amounts contemplated, it might very well have an indirect effect toward increasing appropriations for other purposes.

Thus, there are practical arguments against both the strictly pay-as-you-go method and the full reserve method of financing O.A.S.I. The logical solution would be a modified pay-as-you-go plan which would provide for the continued accumulation of a reasonable contingency reserve during the early years. Before the fund reached large proportions a decision could be made as to whether to continue to increase the payroll taxes or to put the plan at that time on a pay-as-you-go basis without further accumulation of the contingency reserve.

The accumulation of reserves under the government plan must be considered in conjunction with the accumulation of reserves in the private plans. With many more pension plans in operation, the investment problem will be one of larger proportions than in the past. Only a comparatively few companies will be able to finance the accrued liability in a lump sum payment and the funds will be accumulated only gradually. When they reach larger proportions a few years from now, the government plan could then be on a more nearly pay-as-you-go basis and the funds available for investment annually might not be much more than they have been during the period while the government reserve was being accumulated.

Consideration should also be given to the type of securities purchased for these pension funds. Practically all the funds held by insurance companies are invested in government or corporation bonds and a small amount in preferred stock. Recently Massachusetts has permitted insurance companies to invest up to 10% in common stocks. The trust companies which handle large pension funds are permitted wider range and small percentages of the funds are now invested in common stocks. Many people now feel that it probably would be sound to invest a certain percentage of the pension funds in equities. Better yields can generally be obtained and they would, over the years, serve better to maintain purchasing power of the fund than investments of fixed obligations.

There are no accurate estimates of the investments in private pension plans. It might be well for The Conference Board to collect information regarding the present portfolios of these pension funds and the annual accumulations so that better analysis can be made of the investment problem involved.

Conclusion

Businessmen now have a great opportunity to assist in solving the problem of providing economic protection for the aged. They should first support early Congressional action to extend the coverage of the contributory Old Age Insurance Plan to most of those gainfully employed and to bring the benefits more in line with present living costs. Secondly, companies without pension plans should study their particular situation to determine if a supplementary plan is necessary to provide adequate protection for the worker who has spent his lifetime in industry.

Under such a program the worker would thus be assured of a moderate degree of comfort in his old age but his pension would still be well below his pay while employed. Thus there would still be a strong incentive for the individual to produce more and save more so that he could live more nearly on the same scale when retired as during his working life. These plans, both government and private, if kept on a reasonable basis should not be considered as conflicting with the private enterprise system. On the other hand, they should prove to be strong adjuncts to it.

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