Pension Fund Possibilities

If U.S. households controlled the use of their pension funds, they would command enormous economic clout that could change how corporate America does business. In 2000, household pension fund assets totaled over $9.8 trillion. By comparison, total assets of the entire commercial banking sector were only $6.4 trillion. Despite the potential power and influence pension funds represent, most people have no say in how these financial resources are used.

The Employee Retirement Income Security Act (ERISA, for short) governs how pension funds are managed in the U.S. According to ERISA, pension funds should be managed as if the owners of the assets were “incompetent heirs” – that is, as if they were unable to make decisions on their own about what their own best interests are. Instead of having the real owners make their own choices, managers of pension funds are supposed to objectively maximize rates of return in the financial market, adjusting for risk.

In the real world of pension fund management, the interests of the workers who own the assets are often ignored. Pension funds are often invested in ways that try to capture short-term returns instead of focusing on long-term strategies. Managers of the funds have an incentive to overlook more stable, long-term investments because such strategies reduce the commissions and transactions fees they earn. Increasingly, pension funds are being channeled into short-term overseas investments. Rapid movement of these funds into and out of economies can destabilize the international financial environment, putting pension fund assets at risk.

Pension funds (with assets at nearly $10 trillion) have overtaken banks as the primary institutions through which households build up a stock of savings. Although the banking industry is less regulated now than in the past, there are still important channels of public influence over banking behavior. On the other hand, securities markets (such as stock and bond markets) do not have the same level of regulation as banks. Therefore, as pension funds continue to grow in size relative to the banking sector, there will be less and less public oversight in the management of the bulk of the household savings.

Arguably, pension funds could be better used in more long-term, productive investments. During their working lives, the employees that own pension funds have an interest in insuring stable employment opportunities. Furthermore, investments that improve social outcomes will benefit both working and retired households. Instead of simply getting the highest short-term return, many pension fund owners would prefer investment strategies that both improve the future economic health of society and secure their income for retirement. Finally, long-term investments could reduce the volatility of financial markets, making pension fund benefits more predictable.

There is another rational for using pension funds for socially productive investments. Pension funds enjoy very favorable tax treatment – contributions are tax-exempt and benefits are generally taxed at a lower rate (since retirement income is often less than the income earned when working). This tax-exempt status is a major reason why savings in the form of pension funds has grown dramatically in recent decades. However, the tax-free status also...
amounts to a subsidy to large corporations that profit through the management of pension fund assets. Since taxpayers are effectively supporting the pension fund industry, they should be able to demand that a portion of the financial resources be used in a way that produces real lasting benefits.

Institutional changes can help democratize the role of pension funds in the economy. For example, the tax treatment of pension funds could be changed to encourage long-term investments and discourage short-term, speculative activities. The principles for managing pension funds (ERISA) could be changed to capture a wide set of benefits for employees during both their working and retirement years. Finally, mandates for increased employee-owner representation in decision-making processes could be established to monitor potential conflicts of interest. Taken together, these steps would begin to harness the economic muscle of pension funds for socially beneficial ends.

Sources:
Federal Reserve Board of Govenors. Various years. *Flow of Funds*. Table L.

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