

markets now, and will continue as such in the years ahead. If our projections are not wide of the mark, these systems represent one of the most dynamic groups of financial intermediaries. Attention has been devoted primarily to corporate pension programs during the last 15 years. It is high time that the changing role of these governmental systems be recognized as the most important single development affecting the capital markets of the next decade and more.<sup>1</sup>

Whether or not we have correctly appraised future growth in State and local government retirement systems, the dramatic changes in their investment management policies and practices are bound to have a major impact on the capital markets, a portion of which has been witnessed in recent years. These developments have been especially important because of the extent of the changes which have taken place.

Historically, the typical State or municipal pension fund was handled by the State or city controller as a part of the debt management function of his office. It was considered analogous to the management of the sinking fund for term bonds, and the choice of investments was similarly restricted. In 1942, for example, the assets of State and local retirement systems were distributed as is shown below:

|                                            | Amount<br>(millions) | Percent of<br>total |
|--------------------------------------------|----------------------|---------------------|
| Cash and deposits.....                     | \$72                 | 3.9                 |
| U.S. Government securities.....            | 318                  | 17.1                |
| State and local government securities..... | 1,342                | 72.0                |
| Other securities.....                      | 131                  | 7.0                 |
| Total.....                                 | 1,865                | 100.0               |

Source: Bureau of the Census.

The increase in Federal income taxes, enhancing the value of the tax exemption privilege, and the low volume of State and local bond offerings caused a shift to U.S. Government securities during World War II. By 1947, over 70 percent of assets were in Federal securities and only 20.4 percent remained in State and local obligations. Other securities and mortgages, however, still represented less than 7 percent of the total.

By 1957, total asset holdings had grown to more than \$11 billion. The low rate of return, contributing to the high cost of retirement benefits,<sup>2</sup> and the example of noninsured corporate funds fostered a continuing trend toward relaxation of statutory restrictions on eligible investments. The resulting change in the distribution of assets is shown in chart VI-1.

<sup>1</sup> These expectations may not be realized, of course, if full funding is abandoned by some of the more important governmental units. It is idle to speculate on whether or when this will occur, but the possibility must be recognized.

<sup>2</sup> The extreme case was that of the New York City Retirement Systems, which as late as 1959 were 72.6 percent invested in New York City bonds and 16.9 percent in U.S. Government securities. The deficiency of interest earned on their contributions below rates guaranteed to members of the systems between 1938 and 1964 aggregated \$205 million. Maturities and sales of New York City bonds reduced the proportion to 32 percent of the \$4.5 billion of assets on June 30, 1966. Nevertheless, the remaining \$1.4 billion of city bonds represents 57 percent of all tax-exempt bonds held by State and local government retirement systems. Almost one-half of the bonds will mature during the next decade.