Funding the Future

The future of pensions - part 2

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Yesterday I looked at problems in our current pension arrangements. Today I address the solutions.

There is a pension problem that faces everyone associated with them, and it is about time we recognised that the problem is not about now, but about the future. Put quite simply, there is no guarantee that current arrangements for funding private pensions will pay out in accordance with expectation, or at all.

Private pension funds exist, and should continue to do so as long as they are seen simply as a form of saving. But the taxation system should not be used to influence the economic behaviour of one sector of society in a way that is likely to benefit it at the expense of another. It is quite clear that tax benefits given to pension contributions do just that. They benefit the better off, and the company's who tend to employ them.

The consequence has been an over-emphasis upon long term, personally irreversible investment, that has distorted the stock market. We need to reverse this trend. Gradual elimination of pension contribution relief is an essential stage in pension reform. Nothing can help to gradually deflate the market and restore fundamentals more than this.

There is another benefit to be had. If pension arrangements were not subject to tax relief then there would be no reason why they should be restricted in use. They will simply become formalised saving arrangements. In that case it should be possible to reclaim contributions made and to generally treat them as just another form of savings. As a result the continual pressure upon the market to handle what has been, to date, an ever-increasing cash input will reduce more naturally through the pressure of changing demographics. This has to be of benefit.

But these changes will not solve the problem of how to provide for pensions. For this to happen we have to be much more radical. What we need is a means of investing pension funds whereby the contributions really do give rise to the benefit of the pension at the time that it is paid. This would mean that the working population at the time pensions are paid could see that it is not just a payment out of current income to which they also have a claim. Only in this way can we afford to pay the pensions we want in the future.

What I propose is that the government should, once again become the main pension provider for the old. A new state pension should be a combination of two parts: a basic entitlement and a top up element.

We are familiar with the first part. The big difference is that the second part would not be earnings related. It would be dependent upon the contributions made into a government pension fund by the potential pensioner. This arrangement sounds, and is, rather like a private pension policy, except that the private pension policy is almost entirely dependent upon indirect investment in the stock exchange to provide the anticipated returns. An equivalent government-run arrangement would be entirely dependent upon investment in real projects to provide its returns.

So, for example, a government-backed pension fund of this sort would be used to fund essential infrastructure projects such as schools, hospitals, roads, government buildings, and the like. In effect such a fund could entirely replace the Private Finance Initiative, and could do so at somewhat lower cost than PFI because the transfer of risk payments could be eliminated. The government pension fund would lease the assets it financed to the Government on realistic commercial terms. Periodic reviews would have to take place to ensure equity in the arrangements between the parties. This review would allow for inflation and the need to make a fair return for investors.

This whole arrangement has the great attraction of not distorting Government borrowing, the asset effectively remaining off the Government's balance sheet as is required by current conventions of national accounting.

The attraction of such a fund is obvious. For the government it reduces the burden upon current taxation and does not abuse the rules on government borrowing as the assets stay off its balance sheet. It also effectively provides the opportunity to raise what are hypothecated funds to support public causes.

The economy wins because money excess to current requirements will not be put into useless second-hand pieces of paper but will instead be used for social good. And the resources in question will still provide a return when the pensioner retires, so providing the link between their pension and the contribution they made.

For the pensioner the attraction is equally obvious. Many potential pension contributors do currently have doubts as to the ability of pension companies to make payment out of the contributions that they make. Payment to a Government backed fund linked to identifiable projects, will be seriously attractive to many.

To suggest that the Government has a major role in pension provision is, at present, most unusual. All thinking has moved against this possibility, but I believe that the privatisation of pensions will, if the policy is continued, provoke major economic difficulties.

The proposals I have made allow the private sector a soft landing so that there is no radical shift from one form of pension provision to another, and the option of continued use of private pension arrangements will remain, albeit in a different, and less tax-favoured format.

So what is the downside? The value of the stock market will, inevitably, over time begin to fall. So too might the value of commercial property and domestic housing as the pressure upon these which is driven by property companies and by the relatively over inflated salaries paid within the City of London, also fall in line with the reduction in investment values.

Will that fall in investment value be of consequence? I do not think so. This change will be gradual. A change that takes place over time, rather than as a consequence of a mass change in perception, can be accommodated by the market.

Why must the government run this new type of pension fund? Simply because the public doubts that public companies can run and provide infrastructure projects without excess charges being levied. If pensions are ultimately a confidence trick, that one generation will be looked after by the next, there is no room for doubt in the arrangement. The future of our pensions lies in the hands of the government.