

The fundamentals of the real pension contract we're all...

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I was talking to a friend yesterday about fundamental economic reforms and the subject of pensions came into debate. That friend was concerned that in the event of fundamental economic reform pension contracts might fail. I explained that in my opinion that failure of pension contracts was inevitable in any case because, as I explained in a publication called '[Making Pensions Work](#)', they have ignored the fundamental pension contract that should exist within any society:

This is that one generation, the older one, will through its own efforts create capital assets and infrastructure in both the state and private sectors which the following younger generation can use in the course of their work. In exchange for their subsequent use of these assets for their own benefit that succeeding younger generation will, in effect, meet the income needs of the older generation when they are in retirement. Unless this fundamental compact that underpins all pensions is honoured any pension system will fail.

As I then argued of private pensions:

This compact is ignored in the existing pension system that does not even recognise that it exists. Our state subsidised saving for pensions makes no link between that activity and the necessary investment in new capital goods, infrastructure, job creation and skills that we need as a country. As a result state subsidy is being given with no return to the state appearing to arise as a consequence, precisely because this is a subsidy for saving which does not generate any new wealth. This is the fundamental economic problem and malaise in our current pension arrangement.

I would argue that pay as you go pensions also do so, but at least they recognise one side of the equation correctly, whilst the private pension system fails to do so altogether. Public sector pay as you go pensions recognise that we divert income of those currently in work through the pension system to the old. By expressing the cost of pensions as an expense of those in work it gets half the equation right. What it does not do is recognise the capital value of the assets those in old age created whilst they were in work. That's what it gets wrong.

What we need to do to get the rest of the pension equation right is to recognise that current pension contributions must be used to create capital value within society to meet the needs of future generations — at the same time as the needs of current pensioners are met from the depletion of the capital stock they left to those currently in work.

This is really not a difficult issue to comprehend: it's a simple investment cycle. And yet we have got this fundamental wrong and for one very simple reason. We confuse saving with investment.

Saving is putting money in the bank. Or it's buying and speculating in second hand shares issued by companies many years ago and now quoted on a stock exchange. Or its dealing in land and second hand building. And it's financing speculation which simply seeks a financial return. They're all saving. That's fine but for one thing: none of them earn a return. They do not directly, and many of them cannot indirectly, add value to society by creating gainful employment as a result of which they add to the sum lot of human capital or income. They merely reallocate that income and capital that already exists. And that's not the same thing at all.

So the last thing we need is saving for pensions. That's a complete mistake. Savings for pensions takes money out of the productive economy and deflates that economy as a consequence. Saving diverts resources from productive activity. It inflates the return to unproductive activity within the financial services sector. It reduces well being. And saving can, by misallocating resources, reduce income and so reduce our capacity to pay pensions. Those are all things we'd best avoid.

What we want is investment in pensions. Investment is very different from saving. Investment creates new assets, tangible or intangible. Some tangible assets we can see and touch, and use in the long term. They include private sector assets such as plant and machinery, offices and IT, transport and agricultural equipment, power plants and recycling equipment. Intangibles can include inventions, copyrights and music. They also include education, training, and social infrastructure. This is spending money for a purpose, to achieve a goal, to increase income and to increase well being and the support structures in society.

Investment and savings are terms often used interchangeably. That's wrong. Investment does not need saving to happen, it just needs cash. It's indifferent as to where that cash comes from: it can be from savings and it can be from borrowing and it can be from tax. There is no tie between investment and saving: it's just one can be used for the other, but need not be.

We can afford pensions for the old in this country, now and in the future. But we can't if we save for them. Saving removes our chance of meeting the needs of the old. In fact, as 'Making Pensions Work' shows, that saving arrangement in the private sector has already failed. The tax subsidy the private sector pension now receives annually has

already provided the private pension sector with more cash each year than it has paid out in payments to those in retirement. The result is that the situation has already arisen where every single penny of pension paid in this country is at cost to the state.

The reality is that we can only meet the needs of those already in retirement and those who will retire if we invest for the future, now. And we can only meet those needs if that investment is wisely managed for the benefit of all. And I mean all. That means the state has a duty to direct that investment.

Some of that investment must be in the resources the state sector needs — in dedicated funds showing how state infrastructure is paid for by current taxes the benefit of which is deferred to meet future pension obligations which will arise when the returns on the current investment are generated.

Some of that investment must be in the resources the private sector needs — but as I recommend in 'Making Pensions Work' that has to be secured by attaching a condition to the tax relief on pension contributions — a condition that at least 25% of all money invested in pension funds must be used to generate new wealth creating and employment generating activity in the UK. It's a price of the tax subsidy. And it will ensure we get more than £20 billion of new investment in our economy each year — investment our economy needs to boost it now and get us out of recession.

There is a solution to the pensions crisis. We can afford to live in old age. But so far none of the solutions the government is looking at are heading in the right direction.

And that's what's really worrying.