The fundamental pension contract that should be at the ...

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I was asked yesterday if I would write about pensions as part of the series of blogs I have done over the last few weeks on pretty fundamental economic issues. I'd have liked to do something new, but work (and holiday) has got in the way and so I offer [something that's two years old](), but which I would only have updated a little at most. I hope this does the job:

The need to save is innate to many humans (not all, I know: some always assume tomorrow will sort itself out). The reasons for saving vary from simple caution about the proverbial rainy day, to family provision (education, weddings, housing), to retirement. I suspect the variety of motives is remarkably small the world over and these three explain most savings. In most cases there is also likely to be strong risk aversion on the part of the saver: those who save are, almost by definition, cautious people.

What the world offers them are essentially three products. The first is cash and its close relations, including gilts (although these have downside risk, especially with present interest rates) and (maybe) corporate bonds. The latter tend to merge risk into the next category for saving, which us broadly based around shares. Beyond these there is the illiquid market. That's made up of your own business (yes, that can be a savings mechanism if the aim is to realise a lump sum) and property. Go much further into categorisation and you come into a derivative of any of these.

The difficulty in all this is multifold. First, cash saving is essentially a negative act. In times of low inflation it is a safe act and, with deposit guarantees, broadly secure but it yields next to nothing and, as importantly, does nothing for the economy. Saving in cash effectively takes money out of active use. It is a loan to a bank that then forms part of its capital (it no longer remains your money: it does belong to the bank once deposited and all you own is a loan recorded in a bank statement) but what we now know is that banks do not then lend this money on: all the loans they create are made out of new money created for the purpose. They do not therefore, effectively, need deposits to make loans. Unsurprisingly, as this realisation has dawned so too have cash deposit rates fallen, in real terms, to near enough nothing to reflect their near worthless economic status.

Gilts are a surprisingly hard to access savings mechanism for the average person: National Savings is the alternative product for many. What's the plus? The person you're lending the money to is guaranteed to repay. Plus, they use the money for social purposes and there is no intermediary: the government sells the product and it uses the money. It's a surprisingly rational savings mechanism, but one with a dull reputation unless the rates are out of line with expectation.

Then there's the stock market. In this case we go out of our way to incentivise this arrangement. Once almost all mortgage savings were in it. Now a significant (but falling) part of pension savings are. And ISAs are still used to encourage it. The incentive is even encouraged by subliminal messaging: on the hour almost every hour the news tells you what is happening on the markets and most of the time that induces feelings of good news: markets rise steadily and do down sides rapidly. It's as if there is a conspiracy to lure money in.

But why are we promoting stock market saving, which it is what it is unless the shares are newly issued, which the vast majority are not? This stock market trading is almost entirely about redundant money: almost as useless as cash in its economic impact. When you buy a share it is almost invariably a second hand piece of paper you are acquiring: someone else other than the company whose name is on the share certificate sold a property right in that company to you and (although many people seem to think otherwise) the company that created the share that has been sold gains or loses not a penny in the process. In the case of many companies it is also many years since they created any new shares: the stock market in shares is now rarely used as a mechanism for raising money for investment, which is a process undertaken almost entirely through corporate bonds, which few smaller investors have any knowledge of, and which are almost entirely institutionally owned. So, the truth is that the stock market, and saving in it, does not produce new investment funds. It is almost as hopeless in this regard as saving in cash.

No investment conspiracy is needed to get money into property. For those who can access the market the appeal is obvious: it is in short supply, there is a real demand for it and, just as importantly (if not more so), it's utterly comprehensible. Do not fail to notice this last point: ask most people to explain the economic realities of any of the other savings mechanisms and I expect they may well have real difficulties, even with the reality of cash deposits. Property also has an obvious use as a long term savings mechanism, even if the very process of using it as such means many who want to own property are denied the chance to do so: that's the paradox in this savings market; using it for saving frequently undermines the goal of providing secure housing.

Small business saving does, I think, fall into a wholly different category. I am going to ignore it.

But having made these points let me be clear. What they reveal are three things. The first is the difficulty people have with understanding savings. Very few people have any real understanding of the mechanisms that they use to save or what the impact of those mechanisms on the real economy is. This leads to serious errors of judgement, mismatched expectation and to exposure to mis-selling, loss and even fraud.

Second, most 'saving' is unrelated to any investment activity, meaning that little economic gain arises from it.

Third, saving in these largely economically useless ways allocates vast amounts of energy to supporting this activity when in many cases little or no return is actually generated as a result of that activity.

Last, and perhaps most significant, given that the most important reason for saving is, without doubt, to provide for old age, the fact that many of these savings mechanisms cannot actually generate the returns needed to support people in their old age means that in large part they are unsuited for that purpose. There is massive market failure as a result.

I explained the essence of this in a short publication I wrote in 2010 called '*Making Pensions Work*'*. A lot of what I wrote then does, I think, remain completely relevant today. At the heart of my concern was the failure of what I called the '***fundamental pension contract***':

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 contract that underpins all pensions is honoured any pension system will fail.

As I then argued of private pensions:

This contract 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.

If anything matters are now worse than I envisaged at the time. George Osborne's pension reforms are turning what was meant to be a pension system into a tax subsidised short-term savings arrangement for those already well off: it is staggering that, as the FT ***has reported this week, two-thirds of customers surveyed by Royal London, the largest mutual life, pension and investment company in the***

UK, took their entire pension pot as a cash lump sum following the introduction of the pension freedoms in April. Most seem to have no intention of using those funds for pension purposes now, and George Osborne is simply exploiting this financial short termism for the purposes of securing his own short term tax hit.

In the face of this effective collapse of the private pension system some radical re-thinking of pensions is needed. This is no small issue either. As this table, adapted from that published by HMRC, shows, the cost of pension tax relief over the last 13 years for which records are published is £509 billion (click for a larger version) :

For the sake of clarity the data for 2013/14 alone was:

Now, I accept that if totals are considered some offset of tax collected is appropriate, (although of course much of the tax collected would have related to contributions from before this period, so the direct offset of tax against cost is not appropriate), but however looked at the cost of these reliefs in proportion to total government spending is enormous. In 2013/14 total government spending was £720 billion. And let me be clear, the taxes on past pensions would have been received in that year in almost exactly the same amount if no new tax relief had been given. So, the net effect was that a subsidy of £48.3 billion was given to the pension sector, equivalent to 6.7% of all public spending. To put this on context, defence spending in the year was £40 billion, housing and environment spending was £21 billion and public order and safety cost £31 billion.

The latest reliable data I can find on allocation of these sums comes from the ONS in Pension Trends — Chapter 9: Pension Scheme Funding and Investment, 2013 Edition. There the mix of assets invested in the largest category of pension funds is shown to be as follows:

There was a flattening in corporate exposure post 2009, and this figure includes bonds and equity with overseas holdings growing significantly over time:

This is a trend seemingly associated with a growing use of mutual fund investment:

Now I stress that I know that this is not the whole picture on pension fund investment, but what seems to be fairly obvious is that the trends that are occurring are broadly towards increasing financialisation, less direct engagement with UK corporates and an increasing international diversification to the point that the obvious question has to be asked, which is what is in this for the UK government and what now justifies its massive spending on pension subsidies?

To put it another way, why are we willing to spend £48 billion a year subsidising the financial services sector in the UK and abroad when doing so is not resulting in funds being used to, in almost any way, fulfil that fundamental pension contract that I outline above?

And why, at the same time, are we tolerating the use of those funds to a) support the increasing financialisation of our society b) support activity largely based in the south east of England c) increase wealth divides in society, which is what this process, inevitably, does?

I can no longer find reasonable answers to those questions. I stress, I am not alone in doing so: George Osborne is floating the idea of an ISA based pension with substantially less tax relief given. There does, however, remain a problem with that: the fundamental pension contract that requires we pass on real assets — houses, infrastructure, functioning businesses, knowledge, intellectual knowledge and the mechanisms that support all these things — is likely to be even more ignored in a personal ISA based pension than it is at present. What we will actually have instead us a continuing savings deception largely, it seems, designed to ensure that the financial services sector got rich in real time.

It was for this reason that I suggested People's Pensions along with Colin Hines and Alan Simpson (then an MP) in 2003. The idea was simple. The government would create a pension fund, or funds, in which people could invest. This fund would then fund the creation of the assets that the nation needs to ensure that the fundamental pension contract was fulfilled. So it would finance the building of hospitals, schools, broadband for rural locations, insulated properties and invest in small business and high tech and so much more. The fund would attract tax reliefs: an ISA wrapper may work for investments in it. Alternatively, capital gains and income received from it, to a limit, could be considered tax free. And the fund would then work in partnership with (let's call it) a National Investment Bank, whose bonds it would buy and who would actually deliver the projects. The same National Investment Bank would also issue those bonds into the broader market for those who wanted to buy them: they would also be available for the purposes of People's Quantitative Easing when the government, via the Bank of England, believed it needed to stimulate the economy by increasing

investment in these assets.

How would returns be paid? Three ways. First, by way of interest payment: that's hardly surprising. The government is used to paying interest on its borrowing.

Second, there would be a real current return on the investment: I think it would be entirely appropriate to designate local funds or sector funds so people could see that the money they were investing was linked to a real economic output. Nothing could make investment more comprehensible than that.

Third, there is, of course, in the long term a return to be paid as a state backed pension based on contributions. The mechanisms would need refinement, but given that government bonds have for decades underpinned the annuities used by private pension funds such an arrangement is completely normal. The important point to make though is that this pension could be economically justified precisely because the assets underpinning it would still be in use: this is a pension contract that reflects the inter-generational agreement that must underpin such arrangements with real assets.

How much could be spent a year on new investments? Well, let's start with most of that £48 billion, shall we?

The gains are obvious. First the fundamental pension contract would be recognised and be the basis for pension provision, for maybe the first time ever.

Second, the savings mechanism would be readily comprehensible, have low risk and be secure.

Third, a mechanism for increasing the flow of funds into the productive economy and away from the financial services sector — an essential part of rebalancing the economy — would have been created.

What's not to like? Ask the City. But for the rest of us this is all gain.

First this is a programme to deliver real investment.

Second, it redirects pension subsidy to public gain.

Third, it rebalances the economy.

Fourth it creates jobs in every constituency in the UK.

Fifth it creates an understandable savings mechanism.

Sixth, that mechanism reflects the fundamental pension contract that must exist in the macro economy.

Seventh, this provides a mechanism for enduring people's quantitative easing when it is needed.

Eighth, this is clear economic narrative that is straightforward to explain both as to the reason for its creation and as to its long term benefit.

And it’s open to any political party to use.