Funding the Future

Pension investment could help transform this country. P...

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Martin Wolf had an article in the FT, published yesterday that began by saying:

> In his Mansion House speech early this month, Jeremy Hunt, chancellor of the exchequer, recognised some of the defects of the UK's pensions mess. He acknowledged, for example, the low prospective returns on pension assets and the failure of institutional investors to back high-growth home companies. But he failed to deliver hope for radical reforms.

He then lamented three things.

The first is that we have too many pension funds.

The second was that these are run with a view to minimal risk by insurance companies and fund managers influenced by them.

So, thirdly, he lamented the fact that UK pension funds hold many more bonds than do those of most countries. He blamed this on regulation.

Based on these arguments (which I think I correctly summarise) he suggested that Jeremy Hunt's plan to ask pension funds to diversify by investing five per cent of their money in the notoriously unreliable venture capital sector was misguided and much more fundamental reform, including the massive consolidation of funds into a few large entities was the answer, before saying:

> We need, instead, to decide now where we want to end up and how to get there. A good pensions system should be built on a multigenerational, national contract designed to deliver decent pensions and support prosperity into the future. It needs to generate adequate savings, invest them in productive assets and insure pensioners against volatile returns and uncertain longevity. What we have now fails on all counts. We have to do better. If this government does not dare, the next must.

In essence, it looks as though Martin Wolf and I agree with each other, but we do not.

I have long argued that there is a 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 compact that underpins all pensions is honoured any pension system will fail.

As I have 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 fail this test, 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 the 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 had shares issued by companies many years ago and now quoted on a stock exchange.

Alternatively, it is dealing in land and second-hand building.

It can also be the financing of speculation which simply seeks a financial return.

All those things are savings activities. That's fine, but for one thing: none of them earn a real economic return. They do not directly, and many of them cannot indirectly, add value to society by creating gainful employment. As such they do not add to the sum 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 more 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. We can see, touch, and use some tangible assets 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.

It is an unfortunate fact that the terms 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 or 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 without creating a specific link between those savings and new investments. Simply saving removes our chance of meeting the needs of the old.

In that case Martin Wolf is wrong when he demands reforms intended to increase savings without in any way suggesting how these will result in increased real investment in the economy.

Pension investment could help transform this country. Pension saving cannot. It's a fundamental point that has to be understood.