On 23 March 1998, the role of the State in pension provision was debated at the Institute of Actuaries in the UK.

The motion was:

"This house believes that the aims of universal Social Security in old age are best met by the development of independently funded and invested pension provision"

Copies of the advance papers are attached by kind permission of the authors, Terry Arthur, Philip Booth, Bryn Davies and Chris Daykin. The authors would like to point out that the papers should be read in the context of the purpose for which they were prepared - they are not fully 'polished' papers in their own right.

Paul Thornton
"This house believes that the aims of universal Social Security in old age are best met by the development of independently funded and invested pension provision".

Advance paper by the proposers, T G Arthur and P M Booth

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“There was at the existing time great political pressure from Governments to adopt or maintain ambitious programmes of so-called social security, with perhaps too little understanding of their ultimate effect on the social and economic structure. A sound social insurance and superannuation programme could sustain and strengthen a nation; on the other hand, a sufficiently unsound one could ultimately destroy it. Furthermore, once such a programme was put into effect it became politically impossible to discard it or to reduce benefit scales which it was beyond the ability of the nation's economy to support”.

Edward Marshall, First Business Meeting of the Centenary Assembly of the Institute of Actuaries, 22nd June 1948.
1. Redistribution: the heart of PAYGO

1.1 The rhetoric used to justify a state-run PAYGO pension scheme is along the following lines:

(i) All citizens must have an annuity at some point, (irrespective of any other personal circumstances or preferences).

(ii) Government must administer a nation-wide scheme; not only is this cheap and efficient, but also it ensures that everybody is covered.

(iii) Government has no desire to take over industry, so it is not feasible for the government to fund a state scheme in advance.

(iv) When a system is introduced, naturally an immediate start must be made by making payments to people in or approaching retirement; the development of a fund is inconsistent with this aim.

(v) All workers (and employers) must pay contributions henceforth, as part of a "tripartite" arrangement.

(vi) Benefit and contribution formulae will be based on timeless and equitable principles; "the turn of the current workers to receive their pensions will come."

1.2 The actual facts, as opposed to rhetoric, are items (iv) and (v) only. In particular items (iii) and (vi) together are incompatible. Demographic and other risks inherent in a PAYGO system mean that equitable, timeless formulae for both contributions and benefits are not possible.

1.3 The inevitable result is enforced and haphazard redistribution and consequent insecurity as to whether contributors will receive benefits. The scale of this potential redistribution can be massive. Consider a young family in Britain today: that family probably does not feel secure that the state will provide an adequate benefit in retirement; it may not feel secure in the health services which will be provided by the state; it will not receive the same state support for education or for child-rearing through child benefit (in real terms) or tax allowances as it would have done thirty years ago. Yet have social insurance taxes for that family reduced? Quite the reverse. The standard (employees) rate of national insurance has increased by 1.5% of earnings in the last twenty two years; the employers' rate has also increased by 1.5% and is now levied on all earnings (including those above the upper earnings limit), thus breaking the contributory principle upon which the system was based. The phrase "so-called" social security (see Edward Marshall) was prophetic indeed. The unfunded social insurance system has led to massive haphazard income redistribution from today's
young to those who were middle-aged in the immediate post-war period. This is not merely a demographic problem. It is a result of the inherent faultiness of the system.

1.4 Furthermore, redistribution is not merely generational. It is also socio-economic. The educated professional classes probably contribute on average for as much as 10 years fewer than those who start work at 16; on top of that they receive benefits for several years longer because of mortality differences. As with many other aspects of the welfare state (for example the one-time existence of free higher education) the implicit redistribution of income inherent in PAYGO pensions, long-term care and health provision could be from poor to rich.

1.5 In criticising the implicit income redistribution of PAYGO pension schemes, we are not arguing against explicit income redistribution. This may involve the Government contributing to funded pension schemes of the less well off or making pension payments in retirement to the needy. But helping the needy or less well off is not specifically a retirement or old age problem.
2. The Tragedy of The Commons: moral hazard, depletion of resources, and social conflict

2.1 Consider two little boys, each sucking a glass of lemonade through a straw, and study the time taken to drain the glass assuming no external pressure. No doubt the two times will differ, but each is responsible for, and bears the consequences of, his own actions. Now consider the situation where they have only one glass but still have two straws. Almost certainly the glass will be sucked dry very quickly indeed. This illustrates The Tragedy of The Commons.

2.2 The phrase "Tragedy of The Commons" (first used by the biologist Hardin in 1968) is now well documented, and relates to the difficulties of public ("common") ownership of a large pool of resources in the shape of over-exploitation, under-investment, and pollution. Publicly owned roads, streets, parks, rivers, and seas all have these problems.

2.3 Successful commons are almost always small, have a genuine "common" interest, with rules that are open, visible, generally accepted, and well-policed. A simple example is the common parts of a block of flats, including hallways and gardens, which tend to be neglected without rules (such as "no fouling") under a clear contract signed on entry to membership. (Thus, because the common is a small one, the two little boys mentioned in 2.1 may be able to agree on a method for sharing the lemonade to ensure "fair shares" and thus conserve some of the lemonade for later.)

2.4 In contrast, unsuccessful commons have one or more of the opposite features: large size, lack of identity, opaque rules subject to change, poorly defined contracts.

2.5 The state PAYGO pension and welfare schemes are spectacularly ill-designed commons and display all the tragic features. Membership is compulsory, there is no contract, rules are Byzantine and changes regular. Behaviour modification to extract the best deal is routine; self denial or prudence does not pay. Such behaviour modification includes deferral of entry to work ("permanent students"), cessation or reduction of work on reaching retirement age, partial contracting out in one form or another, minimising contributions to the qualifying level (migration is important here) and so on. Even the tendency towards lower birth rates in modern welfare states may be explained partly by the belief that our own children are no longer expected to provide support in old age: we can all rely on everybody else having children to support the PAYGO system, with the inevitable effect of a lower birth rate. High birth rates are necessary to sustain the state-pensions common but there is nothing within the system to encourage the bearing of the requisite number of children to ensure that pensions can be paid. We do not propose incentives to have children. Instead we propose a sustainable funded system of pension provision.
2.6 This tragedy of the commons should be recognisable to insurance economists as a form of moral hazard, which may be more familiar in areas such as state disability and unemployment insurance. The problems with state pensions are often characterised as being due to an accident of demographics or discussed in accounting terms in relation to the absence of a fund. Booth (1998) develops the theory that the problems of PAYGO state pensions may give the appearance of being due to demographics but can be explained in economic terms as being due to moral hazard.

2.7 We believe that state PAYGO pension schemes are riddled with moral hazard. Individuals are not required to make independent provision for themselves. The system relies on a generation as a whole having sufficient children and those children participating in the labour force when they reach adulthood. This is a socialised, mutually insured common where everybody can rely on everybody else having children and them participating in the labour force. Yet there is no incentive for any individual family to have children and, indeed, the progressively increased social insurance taxes, which are necessary to provide for pensions as the demographic situation worsens, actually discourages the necessary labour force participation, as we see throughout the EU. Individuals who act in their own best interests deplete the social insurance fund rather than build it up.

2.8 Thus our first fundamental argument is that the arrangements of PAYGO social security systems are fundamentally insecure. The very nature of the system encourages behaviour which undermines it. If, due to demographic or financial pressures or, indeed, because of the faultiness of the system, benefits can no longer be provided at reasonable contribution rates one of two things (or a mixture of two things) can happen. Benefits can be reduced thus undermining the security of the system for participants. Alternately, social insurance taxes can be increased, thus undermining the security of contributors. Thus whilst we do not question that income redistribution must take place, we do not believe that mass membership, PAYGO, state pension provision can provide people with the retirement security that they desire; their very design makes the achievement of their aims impossible.

2.9 The "mass common" in welfare is probably on its way to extinction, having now reached the point where it generates precisely the sort of insecurity it was designed to relieve. It is now devouring its own young, who face the pensions burden of an ageing society who, in many EU countries, have put nothing aside for their own retirement. At the same time, throughout the EU, the young cannot obtain work partly due to the very taxes which are raised to finance pensions. The only answer is to "internalise" the externalities by extension of private ownership. Pollution of private land is rare; conservation of fish under privately owned fishing rights is routine; funding of private pension arrangements is the norm.
3. Policy Induced Risk

3.1 It is worth expanding a little on the remarks made in paragraph 2.5 about lack of contracts, Byzantine rules and regular changes. Lindbeck (1994) describes these features as "policy induced risk". There are two aspects of this problem. Firstly, if a social insurance system is unsustainable because of moral hazard, governments may constantly change rules in order to reduce costs and to ameliorate the effects of moral hazard. The UK state pension scheme is a prime example. Most of the rule changes (for example removal of wage indexation and reductions in SERPS benefits) are retrospective and would never be permitted in an occupational scheme. Some rules (such as those relating to emigration) amount to arbitrary rationing—a feature already prevalent in health care. Similar changes, such as increasing retirement ages, are now mooted.

3.2 The second aspect is that, whilst with private pension provision there is an enforceable contract between provider and contributor, with state pensions there is no such contract. Pension promises made by government are not enforceable. This situation creates, "social insecurity" as well as the potential for conflicts between interest groups (such as pensioners and the unemployed, who cannot get jobs because of high labour taxes or between pensioners and taxpayers). The private sector resolves such conflicts and also provides that degree of security which is possible by a system of enforceable, voluntary contracting and the establishment of property rights.

3.3 Of course, risks are not absent in the private sector. However, it is possible to set up systems which, whilst not absolutely secure in any sense, provide a secure framework within which people can plan for retirement. They can plan knowing the sort of risks which will undermine their retirement income (for example investment risk in a defined contribution pension scheme). They can often control, manage or insure those risks. And, most importantly, they can provide for their retirement within a framework (funding, investment, contracting and property rights) which is economically sustainable. The fundamental economics of such a funded system work in favour of the achievements of the objective of security unlike, in a state PAYGO system, where they work against it. In short, state PAYGO systems attempt the impossible (absolute security of earnings related pensions) within a framework which undermines any security. Funded pensions attempt the possible (the accumulation of the means by which a stable income could be obtained in retirement) in a framework which provides the means for its continuation and success. The evidence for this proposition, which paraphrases the motion, is clear around the world (see Section 5).

3.4 Of course, government can change private contracts. They can also change tax frameworks as happened in the November 1997 Budget. That Budget changed the taxation regime under which irrevocably invested contributions could be accumulated. However, it seems to us a strange argument to suggest that because the Government
can, *in extremis*, retrospectively change private contracts, we should trust the political system with the provision of our pensions.
4. Efficiency and Justice

Efficiency

4.1 Paragraph 1.1 (ii) refers to claims for efficiency and coverage not possible under private arrangements. Taking firstly the question of administrative cost, the claims appear to be a relic of the intellectual fashion for nationalisation. After the collapse of state planning all over Europe, and two decades of UK privatisation—mainly highly successful—most now appreciate that such claims were always illusory.

4.2 The direct costs of the DSS for collection and redistribution of funds may be low, but this is more a feature of the PAYGO mechanism than anything else. We have little doubt that contracting out this work to the private sector would mean significant savings. Economies of scale become diseconomies of scale much sooner than is commonly realised, which is why few, if any, genuine monopolies (unsupported by Government explicitly or implicitly) exist.

4.3. Efficiency measures must somehow encompass quality as well as cost. As a simple example, it is revealing that supporters of the NHS argue that it is cheaper, in terms of costs per head, than the USA system. But why is this necessarily good? The UK doctor/patient ratio is much lower and the services available are much narrower and more bureaucratic. Similarly, the state pension system imposes a uniform contract on all workers, regardless of their personal preferences. Why have a single retirement age? Why insist upon a lifetime annuity with a particular method of index-linking? Private markets do not behave in this way. Instead, they offer a diversity of products at any one time and, more importantly, they are always developing new ones. The question of innovation is almost wholly absent in state social security, unless it is born of crisis in which case it usually consists of imposing dubious restrictions, levies, or other changes.

4.4 Government is very adept at making the private sector bear many of the costs of state provision. The private sector already bears many compliance costs—collection and submission of contributions, keeping track of benefits, asking questions, benefit collection including queueing, extra cost of “integration”, SERPS and Contracting Out, etc.

Justice

4.5. Turning to “justice”, we would merely point out that justice is not synonymous with enforced equality, even if attainable, regardless of condition. Of course, PAYGO state pension schemes are often praised as “social security”, “social solidarity” or “social justice”—combinations of words described by Hayek as “weasel words”. A weasel sucks out the contents of eggs leaving the shell intact. The resulting shell gives the appearance of something of substance (indeed it is most plausible and convincing)
but, when you take it apart, there is nothing there. Similarly, PAYGO state pension schemes give the appearance of "social security" or "social solidarity" but when you look at the detail the phrases become devoid of any meaning. As has been discussed in Sections 2 and 3, the systems are not "secure" because they do not provide the means for their own continuation. They do no provide "solidarity" but, on the contrary, can promote social conflict between pensioner groups who fear having their benefits cut and younger people whose employment prospects are undermined by high social insurance taxes. As for "social justice", for a state PAYGO system featuring many of the inequities described herein the words "social" and "just" do not immediately come to mind. If we vote in an election for high pensions for today's generation coming up to retirement and those pensions are to be financed, not by their contributions, but by the contributions of a generation who cannot yet vote and may not even be born, to what extent is this "social" or "just"?

**Universality and means testing**

4.6 Similarly there is nothing *inherently* desirable in "universal coverage" or "no means testing"; alternative terms might be "compulsory" and "paper shuffling". Expensive middlemen are not necessary to rearrange money amongst people in similar circumstances; if the aim is to redistribute according to *different* circumstances (a function to which we have no objection *per se*) such differences can be discovered only by means testing in one form or another. Such income redistribution may be desirable but it is not the subject of our debate. It is easy to forget, because private provision in the UK amongst people of our own income level is the norm, that, in most EU countries, there is mass provision of PAYGO state pensions to the whole population, the great majority of whom could choose to make their own arrangements.
5. Funding and Investment

5.1 In his editorial in *The Actuary* of August 1996 ("To fund or not to fund") Martin Lunnon wrote: "It is not true that, with funding, current workers do not pay the pensions of those who are retired: all consume what is produced by those working currently".

5.2. We take direct issue with this statement. In fact all consume what is currently produced by *the mix of capital and labour*. This output is far in excess of what labour could produce on its own. If, in a simple fishing community (using a plentiful sea) one generation spends a lot of time building boats for the following generation to use, *it is* true that current workers "do not pay the pensions of those who are retired"; all that current workers do is operate somebody else's boats (or purchase or hire them). It is the efforts of those who accumulated capital (in the form of boats) which provide the increased productivity of fish. Funding pension requires the accumulation of capital and therefore leads to the increased productivity which finances pensions. The existence of capital and securities markets ensures that tomorrow's pensioners can accumulate claims over that future increased production.

5.3 In any civilisation worthy of the name, pensioners owning shares of capital stock being operated by workers, most certainly have *direct and enforceable* rights to a share of the output. And that capital stock increases the productivity of workers to enable the pensioners to take their share of output without harming the workers. In a PAYGO system there are no such property rights. The pension benefits can be removed by the whim of a democratic majority. The PAYGO system also has no such security. In a PAYGO system it is simply an act of faith that there will be sufficient workers to pay retirement pensions to the next generation.

5.4 It is the issue of the ownership of the capital stock of the economy, rather than whether or not funding increases capital formation in aggregate, which is crucial. We believe that a likely side effect of private funding is indeed more capital formation (see below) but of itself this is neither good nor bad. It is equally silly to spend all ones time building boats as it is to spend *no* time building boats. There is no pre-ordained optimum level of capital, since it can be formed only by abstinence from consumption; there must be a trade-off. Precautionary saving may take place in a PAYGO system (if only to pay future social insurance taxes). However, there is no direct incentive to accumulate capital and the ownership of capital need not lie with those who need it to pay their pensions.

5.5 Under free markets, the trade-off is revealed by market-determined interest rates which follow directly from consumer time-preferences. Under high preference (for consumption today as opposed to tomorrow) the economy will be geared more to consumption; under low preferences (waiting to consume is not a problem) the
economy will be geared more to capital formation. Although this means more prolific output in future, it is not “better” to prefer less today and more tomorrow.

5.6 Accordingly the merits of funding private pension plans are not a matter of aggregate capital formation. What funding provides is personal security. Personal security for all members of society through funding leads to a meaningful “social security”. We have seen how PAYGO is not only at the mercy of demography; it is inherently risky and insecure. Privately funded plans do carry risks—for example poorer-than-anticipated returns—but these risks can be controlled with the help of our profession, well in advance. (We assume here that funding is not deliberately only partial; shortfalls in Local Authority schemes for certain benefits such as index links or early retirement hikes are due essentially to deliberate use of a PAYGO element.)

5.7 Other forms of security, if available, may be equally valid. For example, within families, inter-generational and largely unspoken contracts may suffice. Certain “blue chip” organisations may be strong enough in both spirit and letter to make and honour limited promises which are relatively “unsecured”. In effect, however, these are common pools which, as previously stated, work only in small, tightly knit groups. In the vast majority of cases, advance funding is the only form of security.

5.8 Let us now return to the simple fishing community. Here, advance funding means building boats. What happens if the boat-building generation has few children? To that extent, some boats may lie idle for want of operators, although capital can always be added so that a shrinking labour force can produce more: for example, engines could be added to the boats. Free trade also enables capital to be moved to where it is most productive and for claims on the returns to foreign capital to be held by domestic pension funds. Pensioners can then use the returns from investment abroad to import goods and services in retirement. We do accept that there are potential difficulties for funded pension schemes in times of demographic change. However, these are problems of a frictional nature which are substantially eased by markets. When there is net dis-saving, due to an ageing population collecting their pensions, labour and capital will fall, after an initial adjustment process, in the same proportions; interest rates can change to equilibrate savings and investment; or the income from overseas assets can be used to finance the import of consumer goods. The market is a constant process of adjustment to new information such as changing demographics. A funded system of pensions participates in that market and prepares, through funding, a stock of capital which, despite being affected by demographics, is relatively insulated from demographic changes. In stark contrast, a PAYGO system is held to ransom by demographic change.

5.9 As mentioned above, greater capital formation is not in itself an argument for private funding, but we would nevertheless expect it as a by-product. If people are responsible to fund for their own pension (and the poor are given the income to do that), whilst there may be some reduction in other forms of saving, a one for one
reduction is highly unlikely. More fundamentally, there would be an enormous long-term reduction in taxation. Provided that a portion of this reduction is applied to savings, then the "tax wedge" between lenders and borrowers (suppliers and users of capital) also reduces and the activity itself becomes larger.

5.10 We argue that PAYGO pension systems are economically and politically faulty. They do not provide security. It is simply impossible for an 18 year old German, for example, to predict the circumstances in which he or she may be paid a PAYGO pension during a retirement which might end in 70 or more years time. In the PAYGO systems there are no property rights, no funds and no contracts. Not only is there no guarantee of sustainability there is no attempt to ensure sustainability: indeed the system is designed to destroy itself.

5.11 Let us finish by looking at some specific figures, continuing with Germany as an example. The following is based on OECD figures developed in Chand & Jaeger (1996) and Paribas (1995) and discussed in Booth & Dickinson (1997). The net pension liability accrued in Germany (after allowing for future contributions at the current rate, therefore not allowing for any transition to a funded scheme) is 110.7% of GDP. On current policies, Germany will build up a debt to GDP ratio of over 100% and have a budget deficit of 9% of GDP by 2030. The UK, with its low state PAYGO liabilities and high funded pensions, has a projected budget surplus and a debt to GDP ratio of below 10% (reduced from 54% in 1996). In Germany taxes are already heading towards 60% of GDP. There is very little taxable capacity. On the other hand Germany has a high savings ratio, but high aggregate saving does not provide security of pension income to those who rely on the state PAYGO system. Tax rates can clearly not be increased significantly. High taxes ultimately undermine the tax base by discouraging work and saving. PAYGO pension schemes have only one trump card when the demographics go wrong: an increase in taxes. Germany has played that trump card. The security of the pensions of Germany's young workers is now at risk, at least in real terms.

5.12 Demographic changes also highlight the enormous problems of care—for both ill health and general infirmity—for the elderly and old. The true costs of such care can be the largest budget item for anyone over 70—larger than either housing or food, for example. Here, the UK as well as Germany, has already played its trump card. Rationing is already with us in the form of age criteria and lifestyle criteria (such as smoking) for operations, as well as lengthening queues. Asset means tests—retrospectively applied—are increasingly used in calculating support for residential care. The care and level of service which people now receive, relative to the increases in income and wealth people have achieved in the last 50 years, has declined. The implicit PAYGO contracts are not now being delivered; to what extent can they be said to have provided security?
5.13 We submit that the security of pensions, in those countries with comprehensive state PAYGO schemes, is illusory. "Social security" is a weasel word when applied to their schemes. They would be better served from the security angle, with an independently funded and invested pension.
6. The End and the Means

6.1 The long term solution is clear; hence our motion. In considering this, some imagination is necessary; what would private arrangements be like in those countries which have not developed them? This is a familiar problem for those proposing any form of privatisation; the current nationalised arrangement is, whilst anything else is sheer star gazing. In some ways this is a strength; one of the beauties of private enterprise is that it unfolds in unexpected ways. (Who would have forecast in 1985, the shape or the diversity, of today's telephone industry?) We know that it will fill the void but we do not know precisely how.

6.2 For it cannot be denied that "crowding out" has occurred in most EU countries. The state system has stunted the private developments that would otherwise have taken place, particularly for those on low incomes.

6.3 We do know some things that the private sector would have done differently. Occupational schemes would not have integrated! In all probability, "retirement age" would be a far more diverse concept than it is, and not necessarily linked to physical retirement. Inflexible lifetime annuities, from ages as young as 60, especially for females, could be the exception rather than the norm. Perhaps people would like to receive their annuity from a later starting age but incorporate insurance for long-term care. We do not know.

6.4 In essence risk bearing and risk protection, which is all we are really talking about, save for a small minority, would have been more diverse. We are safe in saying this by looking at related financial services. Friendly Societies, with-profit policies and unit-linked contracts are just three examples of how private markets have developed products to meet varying consumer needs and attitudes at different times. Private long-term care insurers have also been far more successful than Local Authorities in developing "care in ones own home" as well as "care in a retirement home". And equity-release home schemes (dismissed carte blanche by trigger-happy regulators) have done much, and can do much more, to provide a far safer and more substantial income than a state pension.

We would not have started here.......

6.5 Thus the objective is the withdrawal of the state from pension provision although it could finance provision for the low paid. "Retirement" and "age" should cease to be issues in determining state welfare. State-provided income in retirement from work should be provided under the same terms as state-provided income in work—namely means-tested income support.
6.6 If the merits of private systems from a clean sheet of paper are accepted, there remains the genuine problem of getting from A to B. Detailed suggestions are outside the scope of the debate but some broad possibilities may be considered.

6.7 There are some genuine problems of reform. There are cash-flow difficulties for countries with substantial PAYGO pensions (such as Germany and France). If funded provision is built-up by the young, are the young also going to pay the PAYGO pensions of the retired? Of course, these are only accounting problems. The development of funded provision merely recognises implicit PAYGO pension liabilities as explicit debt. They always were part of the national debt. No doubt changes need to be phased to avoid cash flow problems. The use of non-tradable “recognition bonds”, as in the Chilean system, also eases the debt management problems of transition. Privatisation of state assets can be used to finance transition as in Poland (effectively this represents the simultaneous privatisation of state assets and liabilities). Different solutions are probably appropriate for different countries. Countries which are used to a high degree of centralised control may prefer reforms such as those in Chile, which impose a uniform private sector solution on the whole population. More liberal countries, such as our own, may prefer the route of “contracting-out” where the state has to compete with the private sector on equal terms. Nevertheless, the authors would like to see SERPS closed to new entrants.

6.8 It is of comfort to the authors that in the UK, at least in pensions, the political establishment has taken heed of this motion, although more private, funded provision would be welcome for the low paid. In the rest of the EU, independently invested and funded pension provision must be developed urgently if people are to feel secure in their retirement.
References


Sessional Meeting - The Role of the State in Pension Provision

A summary of the case for opposing the motion “This house believes that the aims of universal Social Security in old age are best met by the development of independently funded and invested pension provision”, to be discussed at the Institute of Actuaries, 23rd March 1998.

Introduction

The motion should be opposed principally on the grounds that no single system of pension provision can be regarded as “best”, as all the different methods available have advantages and disadvantages. Experience suggests instead that there is no single panacea for the very real problems that face Social Security systems, nor one particular method of pension provision that is universally better than any other. It also leads to the conclusion that the most appropriate way of achieving the aims of universal Social Security in old age solution will differ from country to country, involving a combination of elements in a ‘mixed portfolio’ of provision. This includes, in particular, an important and continuing role for a State pension operated on a pay-as-you-go basis.

The proposers of this motion believe that State provision has little or no role in providing universal Social Security in old age. To oppose the motion does not imply a commitment to a unique alternative model of how pensions ought to be provided but it does involve recognition that State pensions should have an important and continuing role as part of a universal Social Security system. This is because State provision on a pay-as-you-go basis has some important advantages, whilst there are some significant drawbacks associated with a reliance on independent funded provision.

The Key Arguments

The most productive approach to Social Security is to identify the respective advantages of different approaches to pension provision and see how they can work together to meet the aims of universal provision in old age. The motion, claims, without qualification, that “independently funded and invested pension provision” is better than other forms of old age provision. The clear implication of the motion is that funded pensions are better than pay-as-you-go, and private provision is superior to State provision.

Whilst in no way suggesting that private funded pension provision does not have an important role to play, it is important to recognise the limitations of such an approach and the advantages of having a certain level of pay-as-you-go State provision.

The key arguments in this debate relate to:
Savings and Growth: the effect that the choice of pension system has on the level of saving within an economy and hence on the ability to pay given levels of benefit in times to come;  
Risk: the relative risk that different systems will fail to deliver the pensions that are expected or expose individuals to an unduly high risk of making ill-informed and potentially harmful decisions;  
Equity: the ability of a pension system to offer fair benefits to all;  
Costs of Administration: the relative costs of running different systems and ensuring universal coverage; and  
Costs of Change: the cost of effecting any change in the system of provision.

These issues are discussed in turn below.

Savings and Growth

It is frequently claimed that investment returns on funded pensions will reduce the cost of providing a given level of pension benefits. At a macroeconomic level it is argued that funding increases real investment within an economy, which means that, when the pensions come to be paid, that economy is more productive than it would otherwise have been. The conclusion is therefore drawn that higher pensions can be paid without reducing the income of those at work. In practice there is little or no hard evidence to support this argument.

The effect that different forms of pension provision have on net capital formation has been studied and debated over many years. However, tracing the cause and effect of capital flows within an economy is difficult and the conclusions reached by different studies have been contradictory. While it may be true that an individual can defer income through reduced consumption and increased saving, it is not necessarily possible for an economy as a whole. The reason for this is that increased saving through a pension scheme can simply create disinvestment elsewhere in the economy. In other words, a reduction in consumption by pension scheme members is matched, at least in part, by an increase in consumption. This could happen as people spend the money they received from selling their investments to those in pension schemes and as the increased flow of funds forces up security prices. It is also clear that when people increase their savings under one method, for example under a pension scheme, they may cut back on their other forms of saving. Such interactions are difficult to measure, let alone interpret.

The result is that it is far from clear that funding pensions has anything like the effect that is often supposed. Much of the academic literature seems to dispute there being any measurable gain in economic growth as a result of funded pensions. Even
favourable studies suggest that the net increase in capital formation is only a small proportion of the money that is contributed to pension funds. Furthermore, even to the extent that putting money into pension schemes does cause some increase in funds for investment, questions can be raised about the quality of the investments that are made in such circumstances. There seems good reason to doubt whether pouring more money into existing channels of investment will have any beneficial effect on economic growth, except in those countries where there is a dearth of funds for worthwhile capital projects and undeveloped capital markets. Indeed, some economists argue that increased saving can be deflationary and actually lead to a reduction in economic growth.

This is not to say that it is not an important issue whether society allocates money to current expenditure or to capital formation. However, the decision to provide pensions through a funded system has a far from certain effect on the economy's capital stock and therefore on its capacity to pay higher pensions in the future, than is often suggested. For example, a comparison of the UK experience of capital formation with that in other successful economies does little to suggest that the greater use of funded pensions is an essential element in building a more prosperous economic future. If the relationship between funding pensions and economic growth were as straightforward as the proponents of funded pensions suggest, one would expect the UK, with the highest level of funded pensions in Europe, to be its most prosperous economy. Equally one would expect Italy to have a low level of economic growth, because there is little funding of pensions in that country. In practice, however, the Italian economy has grown in the longer term at least as quickly as that of the UK.

It is clear, therefore, that there is no simple direct link between an increase in the flow of money into funded pensions and increased capital formation. The factors that determine the level of capital formation are many and disparate. Even the evidence that is most favourable to the view that funding pensions leads to additional capital formation, suggests that it is blunt and inefficient instrument to that end. The conclusion is that funding pension schemes does not necessarily create additional resources that will significantly ease the cost of future pensions.

Risk

It is often argued that funded pensions, as compared to unfunded State provision, provide greater security for members' expected rights. The underlying argument is that pensions are better protected by real assets, rather than a promise by a Government, and it is more difficult for future generations to cut back on the former than the latter. The problem with this argument is that it underplays the much greater financial and economic risks inherent in funded schemes, as compared to a pay-as-you-go State scheme, as well as the risks of moral hazard. Funded pensions are also not immune to political, fiscal and regulatory risk.
The idea that funded pensions provide greater security than pay-as-you-go pensions is based, in part, on a misconception about where the money comes from to pay a funded pension. It seems to imply that the goods and services that pensioners consume come directly from the work they undertook many years previously. In practice this is not possible; real resources cannot be transferred over time in this way. When pensioners eat their lunch, they do not eat the food they abstained from eating 20 or 30 years before, in order to pay higher contributions to their pension fund; the food has to have been produced by the current working population. Similar arguments apply to other aspects of consumption by those in receipt of pensions.

Thus, all that is carried forward by a funded scheme is a legal entitlement to a share in future income. But this is as equally true under the pay-as-you-go model. The source of the goods consumed by pensioners does not differ between the models. This has to be the goods and services produced by those currently at work. All that is different between the two models is the form of the legal instrument that gives the pensioner a claim to a share of that production. Either way, if working people believe that the share of the economy's productive capacity going to pensioners is too great, then pressure for increased wages rather than higher dividends can have an impact on the real value of pensions under a funded scheme, just as pressures might emerge to cut back pensions under a pay-as-you-go scheme.

Avoiding a commitment to pay funded pensions could be achieved in several ways. For example, those at work can seek to restrict the proportion of the national product that is paid as a return on the capital assets that secure the pension promises. The poor investment returns that result will mean that the benefits pensioners expected to receive could not be afforded. Another method would be to change the basis upon which pensions are taxed. Neither option can be dismissed as inherently less likely than a decision to cut back on State benefits.

At the same time it is clear that funded schemes face much higher economic and financial risks than a pay-as-you-go scheme. There is the risk that future investment returns will be worse than anticipated and that, as a result, benefits will turn out to be significantly worse than expected or the costs will be significantly higher than expected. There is also the risk that ill-advised investments will be made, even if investment returns overall are favourable. Such risks do not arise with State provision and the generally favourable investment returns of the last two decades appear to have masked the real problems that they entail. The reality is that funded systems cannot avoid investment risk and the inevitable fluctuations in outcome can lead to real problems for many pensioners.

In particular, funded pension schemes cannot escape from the impact of population ageing. Asset values will be forced up during periods when pension funds are being built up, but as the population ages and schemes become mature, significant disinvestment may become necessary and prices will be driven down, resulting in
lower returns for pension funds. This will mean lower benefits in real terms than might have been expected, other things being equal, or increased costs to pension scheme sponsors if the level of benefits is to be maintained.

Any assessment of the relative risks of different forms of pension provision needs to take into account the whole spectrum of risks that are faced. It is the multi-variant nature of the different risks that affect pension provision, as described in this section, that produces one of the strongest arguments in favour of a mixed system of pension provision, rather than reliance on funded schemes as the only significant form of provision.

Equity

It is argued by the proponents of funded systems that they can produce benefits that are not just higher than unfunded State systems but are also more equitable. In large part this argument is just a different form of the argument that funded systems produce economic growth and hence enable higher pensions to be afforded, which is dealt with above. To the extent that funded systems produce higher pensions without creating higher economic growth, then they are being paid for by someone else, presumably in the form of lower returns on their investments. Whether such redistribution can be regarded as equitable is a matter of opinion, but it is unreasonable to exclude the 'losers' from consideration. Of course, for a fixed cost, investment returns increase the absolute amount of the pension, but this will only be in line with growth in the economy generally, unless there is a switch in the balance of who gains from production - workers or pensioners.

An associated argument is that unfunded systems are poor value for money for certain generations. This is backed up by calculations of what benefits would have been or might be produced by a funded system in return for the contributions paid to an unfunded State scheme. The usual conclusion is that certain generations would be better off with the funded option, with the consequence that the unfunded option is inequitable.

The problem is that the claim that the best pension system is one that gives members the best rate of return on their contributions closes off consideration of other bases for the provision of pensions. For example, it is argued that pay-as-you-go schemes operate to the benefit of the first generations of retirees and to the detriment of those who follow. This ignores the need to draw a distinction between that part of any pension system where benefits are based on contributions, and that part where benefits are influenced by solidarity and the sharing of risks. From this perspective the individual approach may be seen as inequitable as it fails to consider the
responsibilities that each of us has for one another within a community. Many funded 
pension systems tend to accentuate in retirement the inequalities of income that exist 
during people's working lives.

The concept of solidarity deserves an important role within any debate on pension 
systems. Inevitably it brings with it other issues, such as what is the right definition of 
the group or groups within which this solidarity takes place (inhabitants, citizens, 
working population, employees etc.). In particular, it raises the question as to the 
length of time and the activities for which rights not based directly on contributions 
paid should be granted: these might include low paid employment, unemployment, 
maternity and other family responsibilities. These are difficult decisions, but handling 
these issues with sensitivity is part of society's responsibilities.

Costs of Administration

In the UK the cost of administering State pension arrangements is low and standards 
of administration are generally high. It is possible to point to other countries where 
State schemes have high costs and inefficient administration, but this seems to be a 
result of local circumstances rather than anything intrinsic to State provision. Indeed, 
in the UK there seems good reason to argue that it is independent provision where 
costs can be excessive, particularly in individual arrangements as opposed to collective 
schemes.

Thus, one of the major causes of the personal pension scandal has been the level of 
costs incurred in such arrangements. These costs can be considered in two parts; first 
there are the inevitable administrative costs, in setting up the arrangement, collecting 
the contributions and paying the benefits. Secondly there are selling costs, in 
particular the remuneration of intermediaries. As far as administrative costs are 
concerned, it is possible, at least in principle, that independent pension providers 
could reduce their costs to match those of the State scheme, providing they can 
achieve similar economies of scale. In practice, however, this will always be difficult 
and there is little evidence that competitive pressures, by themselves, lead to low 
administration costs across the board. Selling costs, on the other hand, are an almost 
avoidable problem for the independent sector, even if coverage is obligatory, so long 
as the choice of a provider is up to the individual. The standard response to this 
problem, of imposing tighter regulation for retail financial products, itself results in 
substantial compliance costs.

The overall result of the relatively high costs that have to be met by private sector 
pension providers, with a significant flat rate component, is that such arrangements 
can become uneconomic for those paying relatively low and irregular contributions. 
Given the aim of universal provision and the way in which the earnings distribution is 
skewed towards the lower levels of income, it means that there are millions of low 
paid employees who cannot look to private arrangements for a reasonable deal. The
financial services industry is not in the business of redistributing income between their customers and they therefore expect each policyholder to cover his or her own administrative costs. The inevitable result is that independent provision becomes less economic for those who can only afford to pay low and irregular contributions. Such a problem does not arise with a State system, which is therefore better able to ensure full coverage and equitable benefits at a reasonable cost for those on low and variable incomes.

Costs of Change

Any discussion of the relative merits of different forms of pension provision must recognise where we are starting from in the United Kingdom, with its substantial unfunded liabilities for State pensions. It is now widely understood that any switch from pay-as-you-go State provision to independent funded provision places a double burden on the current working population. There is simply no way round the problem that if you want to save more money for tomorrow's pensions while maintaining, or even increasing, the pensions currently being paid on a pay-as-you-go basis, then pension costs will be higher over the period of transition.

A number of proposals have been made that attempt to deal with the problem of the costs of transition. One suggestion has been to cover the additional cost by deferring tax relief on funded pension provision. The problem with this approach, quite apart from the extra political risk that this adds to the existing risks of funded provision identified above, is that it does not, in itself, generate any extra money for pension provision. This is also the case with the proposal to allow the National Insurance Fund to borrow in order to enable pay-as-you-go contributions to be kept low, finance for the borrowing being provided by the growth in the assets of funded pension schemes. Another suggestion is that funded schemes generate higher rates of return and that these higher returns will cover part, if not all, of the costs of transition. The limitations of this argument have already been addressed.

The conclusion to be drawn is not that it would be wrong to meet the double cost of shifting to funded pension provision. It simply means that those who propose such a shift in provision should be open about the price that would have to be paid by the generations affected by the transition.

Conclusions

There is considerable scope for debate and discussion on the issue of the appropriate model for providing pensions and the case for a move to universal funded provision is not as clear cut as suggested by the motion. In particular:

- the use of State provision as part of a 'mixed portfolio' approach does not mean the economy need be any worse off when benefits come to be paid;
all types of pension provision face a variety of risks and funded schemes are subject to significant levels of risk;

looking just at value for money for particular generations takes too narrow a view, there are also strong arguments for solidarity both within and across generations;

State provision has clear advantages in terms of ensuring universal low-cost pensions, particularly for those on low and intermittent earnings; and

there are unavoidable costs for the present generation in shifting to a fully funded system.

It is clear that independently funded and invested provision does not provide a complete solution to the question of how to ensure the aims of universal Social Security. Instead we ought also have regard to the merits of State provision and adopt a system that is an appropriate mixture between the two.

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