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THE ROLE OF THE STATE IN PENSION PROVISION

A DEBATE

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

[A Debate on the above Motion held by the Institute of Actuaries, 23 March 1998]

Proposed by T.G. ARTHUR
Proposal Seconded by P. M. BOOTH
Opposed by B.H. DAVIES
Opposition Seconded by C.D. DAYKIN

INTRODUCTION

Most actuaries will be aware of the change in the climate of opinion on state pensions which has taken place in the last few years. In the United Kingdom, State Earnings Related Pensions (SERPS) has been cut back and may well be abolished, the link between earnings and increases in the Basic State Pension has been broken, and the Government is undertaking a root and branch review of the whole system, with compulsory saving for retirement under active consideration.

The main participants in this debate believe that the new climate is a result of several forces. Two of the most prominent are of particular interest to actuaries, namely demographic change and concern about the effect that the financial basis for pension provision has on savings and economic growth. A third force is the broad advance of privatisation in many areas of economic activity which were previously seen as the responsibility of the state.

These forces are global, and the role of the state in pension provision is a live topic in many countries.

Before the debate both sides prepared papers to summarise their cases for proposing and for opposing the motion, and these are set out below.

Also, the paper 'Pensions and the Ageing Population', by A. P. Jollans, which had been presented to the Staple Inn Actuarial Society on 14 October 1997, is recommended as being useful for background reading.

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THE CASE IN SUPPORT OF 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

BY T. G. ARTHUR AND P. M. BOOTH

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, 22 June 1948

1. REDISTRIBUTION: THE HEART OF PAY AS YOU GO

1.1 The rhetoric used to justify a state-run pay-as-you-go pension scheme is along the following lines:

(1) All citizens must have an annuity at some point, (irrespective of any other personal circumstances or preferences).
(2) Government must administer a nation-wide scheme; not only is this cheap and efficient, but also it ensures that everybody is covered.
(3) Government has no desire to take over industry, so it is not feasible for the government to fund a state scheme in advance.
(4) 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.
(5) All workers (and employers) must pay contributions henceforth, as part of a 'tripartite' arrangement.
(6) 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 (4) and (5) only. In particular, items (3) and (6) together are *incompatible*. Demographic and other risks inherent in a pay-as-you-go 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

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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 pay-as-you-go pensions, long-term care and health provision could be from poor to rich.

1.5 In criticising the implicit income redistribution of pay-as-you-go 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 'The 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'

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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 pay-as-you-go 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 pay-as-you-go 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 pay-as-you-go 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 pay-as-you-go 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

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discourage the necessary labour force participation, as we see throughout the European Union. 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 pay-as-you-go 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, pay-as-you-go, 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 that it was designed to relieve. It is now devouring its own young, who face the pensions burden of an ageing society who, in many E.U. countries, have put nothing aside for their own retirement. At the same time, throughout the E.U., 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 ¶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 U.K. 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

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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 pay-as-you-go system, where they work against it. In short, state pay-as-you-go 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. It 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(2) 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 U.K. 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 pay-as-you-go 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

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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 United States system, but why is this necessarily good? The U.K. 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, pay-as-you-go 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, pay-as-you-go 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 not 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 pay-as-you-go 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'?

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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 U.K. amongst people of our own income level is the norm, that, in most E.U. countries, there is mass provision of pay-as-you-go 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 pensions 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 pay-as-you-go system there are no such property rights. The pension benefits can be removed by the whim of a democratic majority. The pay-as-you-go system also has no such security. In a pay-as-you-go 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

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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 pay-as-you-go 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 pay-as-you-go 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 pay-as-you-go 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

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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 pay-as-you-go 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 pay-as-you-go 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 pay-as-you-go pension during a retirement which might end in 70 or more years time. In the pay-as-you-go 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 U.K., with its low state pay-as-you-go 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 pay-as-you-go system. Tax rates can clearly not be increased significantly. High taxes ultimately undermine the tax base by discouraging work and saving. Pay-as-you-go 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 —

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in 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 U.K., 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 pay-as-you-go 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 pay-as-you-go 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 E.U. 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 are 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-profits 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

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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 pay-as-you-go pensions (such as Germany and France). If funded provision is built up by the young, are the young also going to pay the pay-as-you-go pensions of the retired? Of course, these are only accounting problems. The development of funded provision merely recognises implicit pay-as-you-go 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 U.K., 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 E.U., independently invested and funded pension provision must be developed urgently if people are to feel secure in their retirement.

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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

BY B. H. DAVIES AND C. D. DAYKIN

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 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 pensions, and that 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:

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— *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 macro-economic 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

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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 less 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 United Kingdom 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 U.K., 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 U.K.

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 a 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 that they undertook many years

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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 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 that 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 pay-as-you-go schemes. 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

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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

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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 U.K. 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 U.K. 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; and 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 that 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 unavoidable 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.

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COSTS OF CHANGE

Any discussion of the relative merits of different forms of pension provision must recognise where we are starting from in the U.K., 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 that 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

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— 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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ABSTRACT OF THE DEBATE

Mr T. G. Arthur, F.I.A. (proposing the motion): I am confident that we will win this debate if you have all read the advance papers. The ideas in the opposers' paper date from the early 1970s, and in it they say that experience suggests a mixed approach. We should ask: what experience? My experience shows me that state systems are in trouble all over the world, and that we, in the United Kingdom, have experienced the state reneging on pensions promises in ways that offend every principle of accrual, ways which would be in clear breach of the trust deed and rules of every occupational scheme.

Moreover, the opposers' paper is riddled with fallacies. One has been the unfortunate error of many other brilliant minds: "When pensioners eat their lunch, they do not eat the food they abstained from eating 20 or 30 years before,...; the food has to have been produced by the current working population." This is not so. Abstinence is not just a matter of deferral, although, given refrigeration, pensioners could eat the food they produced 20 years ago. Markets provide a far better solution in which abstinence now means more later. By abstaining from consumption 20 years ago, today's pensioners built productive machinery and other physical capital. For example, by abstaining from catching and eating fish, they built productive boats. It is their boats, it is their machinery, which combine with what current workers do to produce today's lunch. Current workers do not produce it on their own, any more than current machines produce it on their own, and the pensioners own the machinery. It is the ownership of capital goods, through the mechanism of the stock markets, which entitles them to their lunch. Interest is not usury. Surely that is the nub, yet our opponents argue that an individual's abstinence is not relevant. A share in the benefits is available only if there have been aggregate savings. If others have been on an orgy of consumption, all that you have is a form of legal instrument, not a right to your own property.

The question of whether or not pensions funding increases aggregate saving is a straw man. It does not matter if pensions saving displaces other saving, as long as there is pensions saving. Nevertheless, both logic and evidence dictate that aggregate savings would, indeed, increase, and, furthermore, additional saving of itself does not create upward movement in asset prices. It creates more assets. Of course, some diehards want it all ways. "Individuals can save", they say, "but whole economies cannot. The nature of production will not let them". This is poppycock.

Production changes in response to price signals, moving, not only between different consumer goods, but also along a continuous spectrum between consumer and pure capital goods. Here, the main guiding price is expressed in market interest rates. In other words, if a whole market economy wants to do less fishing and more boat building, then that is precisely what will happen.

The real case for funding is that it avoids the massive re-distribution which is inherent in pay-as-you-go. In his paper, Jollans (Jollans 1997) sets out some benefit and contribution figures, but pensions are only part of intergenerational transfers. There is an Australian paper stating that the generation now aged about 60, in both Australia and New Zealand, has obtained an extra 10 years' income from its parents and its children combined through state welfare redistribution. That is not solidarity, that is smash and grab.

State pay-as-you-go systems create a large, and badly defined, common pool, which is ripe for exploitation by our baser instincts, and which gets depleted far too quickly. They are rife with moral hazards, lousy incentives and retrospective rule changes.

The real case for funding is not that it has no inefficiencies nor injustices, nor that it can sail through an ageing population, nor that it has no problems of cost; it is, quite simply, that it minimises all these difficulties; it deals with them far more satisfactorily than the alternative of a state pay-as-you-go.

Mr B. H. Davies. F.I.A. (opposing the motion): A vote against the motion is not a vote in favour of a wholly unfunded system of pensions. We recognise an important role for funded pensions, as well as an important role for unfunded state systems. The essential difference between us and the movers is that they see no significant role for an unfunded state pension, and would wish to see it eliminated as quickly as is practical. We prefer a mixed system of provision: where funded pensions do what they do best; and an unfunded state system does what it does best.

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This leaves plenty of scope for discussion about the balance between state and independent provision — I dare say that opponents of the motion have a variety of views on that subject, but I hope that we can agree that there is still an important role for an unfunded state pension.

I now want to make two key points:

(1) about the economic arguments advanced in favour of funding; and
(2) about the security of pensions.

As far as the economic arguments in favour of funding are concerned, it is interesting that the movers of the motion, in their advance paper, place little weight on the argument that is frequently advanced; that funded pensions promote economic growth, which, in turn, enables better pensions to be paid than otherwise. They still say, however, that a funded system is relatively insulated from demographic changes, which is effectively the same thing. I believe that such an argument is unproven and unprovable. There is no evidence that increased saving creates the increased stock of capital that the movers' argument relies upon. So, my first assertion is that the effect of funded pensions on an economy's ability to pay future pensions, if any, is strictly second order. In other words, it is not possible to insulate your future from what is happening in the wider economy. As individuals, perhaps we can do it by investing abroad; but the idea that an entire generation can pursue such a line is an illusion.

The proposers stress what they regard as the greater security of funded pensions, and I agree that individual ownership of assets provides a form of security that a state scheme finds it difficult to offer. The argument goes wrong, however:

(1) in the suggestion that there are no other forms of security that matter;
(2) by overstating the extent of the security of funded pensions; and
(3) by under-rating the possibility of increasing the security of state benefits.

Funded schemes are, of their very nature, invested, and the use of investments involves risks that do not arise with a state scheme. There are techniques to reduce risk, but only at a cost. What, for example, happens to the pensioners in the proposers' fishing community if fish stocks disappear from local waters? The working population will turn to other ways of making a living, and the boats will become worthless. There is no security in funding in the way that the proponents of funding would have us believe.

In addition, funded schemes are not immune to political risk, as we now well know, while there are ways of reducing the riskiness of state schemes. I would like to see greater openness about the rights which people accrue in the state scheme, possibly including some form of notional funding. Despite what the proposers say in their paper, even under the present system the last Government left accrued rights to SERPS benefits largely alone, with the single key exception of increasing the retirement age of women.

So, my second assertion is that all pension systems involve an element of risk, and that what we should do in the face of a range of risks is to diversify our portfolio. In other words, there is an important role for unfunded state pensions alongside a system of funded pensions, particularly for those groups such as the low paid, who, quite properly, have an aversion to investment risk.

Mr P. M. Booth, F.I.A. (seconding the motion): There has been much discussion about the idea that both funded and pay-as-you-go systems require transfers from those who are working to those who are retired. This discussion entirely misses the point. The relevant question is which system most securely facilitates those transfers, both for individuals and in aggregate.

A funded system requires the accumulation of financial assets represented by physical assets. The discipline of funding ensures that the accumulation takes place. The yield from those assets can never be known with certainty, but the financial consequences of low returns are controlled through the investment and valuation process. The opposition confuse certainty with security. We can never be certain about the cost of a given benefit in a funded scheme, but we can be secure in the knowledge that a scheme has been developed which is sustainable and not self-destructive, and provides the means by which future pensions can be paid.

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The assets of the pay-as-you-go system are, in crude terms, babies. The equivalent of the yield is the taxes that the children pay in their future participation in the labour force. There is nothing in the pay-as-you-go mechanism which provides the discipline to produce the requisite number of children, and, when the demographics go wrong, the consequential rise in taxes undermines the very labour market participation which is necessary to keep the system solvent. The system is self-destructive. In today's pay-as-you-go schemes, either the security of pensioners is subverted or, if their pensions are not cut, the security of those who work is subverted by higher taxes, which do not just mean additional discomfort, but, across Continental Europe, have led to a situation where employers simply cannot employ workers at a gross wage which will give employees a decent net living wage.

I have heard many German trade unionists say that, if it were not for unemployment, they could afford their pay-as-you-go schemes. If it were not for the effect of the pay-as-you-go schemes on the social insurance taxes to which they are linked, there would not be nearly 5 million unemployed Germans.

The policy-induced risk and social insecurity of these pay-as-you-go mechanisms is enormous. In the U.K., earnings links have become prices links. Retrospective changes to SERPS have been made, and retirement ages have been changed in a way which has undermined all concepts of accrual. In France and Italy, one week the pensioners are marching through the streets, protesting about their pensions being taken away, and the following week the unemployed are marching through the streets instead. This political unease and conflict is what the opposers call security and social solidarity.

Let us think, not of our own relatively comfortable situation, but ask ourselves what security there is for the 20-year-old German entering a pay-as-you-go system in which debts have been built up of about 150% of GDP in just 40 years. He relies for his pension entirely on the generosity of German voters in 40 years' time. There is no funding discipline, no pension fund assets to represent the pension fund liabilities, and taxes are already nearly 55% of GDP. He cannot develop his own risk control mechanisms as he could if he had a more diverse range of funded provision.

The opposers have tried to seduce you into believing that the motion is an extreme position. In fact, somebody entering the U.K. labour force today and earning average earnings throughout life would have 94% of their pension from funded sources in 40 years' time. This is not a mixed system. Those countries with significant earnings-related pay-as-you-go provision would benefit from developing funded provision in a way compatible with their own traditions.

The opposers point to the transition costs of such a move. This is a red herring. Social security debts are debts. Recognising them explicitly does not involve one generation paying twice, it is simply facing up to the uncomfortable reality of past pay-as-you-go profligacies. Like any debt, it can be amortised over any number of generations, and, indeed, the fact that the debt exists illustrates the injustice of the pay-as-you-go system.

Pensions mis-selling is a real problem, which has to be faced by appropriate regulation and professional and consumer responsibility, backed up by some learning from trial and error. However, Europe's pay-as-you-go pensions systems are a huge mis-sold pyramid investment fund. They have created social conflict and income redistribution away from today's youngsters, who have been left with a trillion pound debt; a balance sheet with liabilities on one side and nothing on the other. Security is the subject of this debate, and whatever the merits of universal pay-as-you-go earnings-related schemes, they have nothing to recommend them in terms of security, either at an individual level or for society as a whole.

Mr C. D. Daykin, C.B., F.I.A., Hon F.F.A. (seconding the opposition to the motion): The proposers of the motion paint a rosy and unsubstantiated view of independently funded and invested pension provision, skating conveniently over moral hazard, market risk, mis-selling and all the traps that befall the unwary in the complex and, to most people, incomprehensible world of private pensions, implying that it is only governments, and not other employers, who renege on promises, and that investment in markets provides security — just look at what has happened to markets in the Far East recently!

Private pensions, especially those of a defined contribution nature, perpetuate into old age the inequalities of income and employment which were experienced during the working lifetime. Social

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security is a means of providing protection to vulnerable members of society, and of building a community where risk is shared and borne by all, rather than simply by the most vulnerable.

Pay-as-you-go social security creates a bond of mutual interest across the generations and across society. We all recognise our responsibility to care for elderly or sick relatives, as well as for our children. Pay-as-you-go social security enables those values to be implemented at a national level, for example by giving credits for home responsibilities, times of sickness and unemployment. It also enables a fair and equitable financing structure to be adopted, whereby benefits are received which bear some relationship to need, whilst contributions reflect, to some degree, people's ability to pay.

Recent enthusiasm about personal pensions, or money purchase as it used to be known before it became discredited in the 1960s and 1970s, is dangerous, and the profession should be issuing health warnings. It feeds off individualism and destroys the community of interest on which society is based. It sends out the message: "Every man or woman for his or her self". It puts the individual at the mercy of market volatility and interest rates, of market failures and insolvencies, of salesmen and their devices, and of a giant bubble of inflated market prices which, one day, will burst. If anything is a pyramid-selling operation, it is funded pensions.

It is important, also, to consider the cost and efficiency of different modes of delivery. Our current U.K. contributory social security scheme, covering both basic pensions and additional pensions, incurs administrative costs which are at the level of about 2.5% of income. Contributions are collected with taxes, and there are huge economies of scale. Occupational pension schemes can also operate relatively cost effectively, although not quite in the same league. The results of a GAD survey show that the costs are about 8% of contribution income, on average. That is heavily weighted by the larger schemes. For weighting by numbers, it would be about 13% of contribution income.

Charges of 20% to 25% of contributions are typical for individual account pensions. These are not just administrative or fund management costs, as personal pension products are priced to deliver a profit to the provider, and a significant part of the cost is accounted for by the need to remunerate an army of salesmen.

There is little doubt, therefore, that a national pay-as-you-go social security scheme wins hands down on cost-effectiveness.

Of course, it is widely recognised that social security schemes face tough decisions in many countries. Through inadequate resort to actuarial advice, or failure to heed such advice, many social security schemes have failed to plan ahead for demographic changes. This is now necessitating serious reform, which will include, in some cases, the development of funded pension provision where they have not had it before, as well as turning the social security schemes into more robust structures. However, funded schemes should not be seen as a panacea, or as a substitute for a well-designed and well-administered public pay-as-you-go system, which the majority of the population trust and feel that they can rely on. In many of our Continental European neighbours there is considerable fear of over-exposure to the risks which private provision entails, particularly in the light of the historic failure of funded systems in some of those countries.

As in most matters of life, and certainly in the fields in which actuaries work, risk is often best managed through diversification. Putting too many of the eggs of retirement provision into the basket of funded private provision will simply result in too great a concentration of risk.

Mr J. Blundell (a visitor): In 1997, for the first time in British history, income tax, value added tax and corporation tax were no longer enough to pay for health and social security. Out of the health and social security budget, by far the biggest single element (taking up somewhere between a quarter and a third of all expenditure) is pensions. Attempts to reform welfare provision, which now have cross-party support, must get a handle on this topic.

The survey firm MORI did some work on this in late 1997, and found that: 44% of the British population favour compulsory private provision for pensions; 33% are against; and 23% do not know.

In Chile, the then Minister for Welfare Reform, Dr José Piñera, privatised the state-run pension scheme on May Day 1981. Under privatisation, pensions in Chile are 50% to 100% higher than they were under the old state scheme. The voluntary savings ratio has rocketed from 10% to 29%. The first 10% is mandatory; you have to save that, and it is tax free. The next 10% is voluntary and also

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tax free, but the final 9% comes out of taxed income. The Chilean system also now includes insurance against death and disability, so another aspect of the welfare state is effectively being privatised. The goal of the Chilean system is that all workers will enjoy a private pension of a stunning 70% of final salary. Contributions to the new private scheme are lower than the contributions to the old state scheme, so, as well as enjoying pensions that are 50% to 100% higher, net salaries also rose by 5%.

Chilean savings in the new private accounts now total 30bn U.S. dollars, and this is from a small country. Chile's GDP is a mere $70bn, and the population is just 14 million. Already the Chileans have saved $30bn. The Chilean model is spreading throughout Latin America. I have just been informed that there are 34 million people throughout Latin America with private retirement accounts totalling $250bn dollars under Chilean-type privatisations. The idea is here and spreading. The opposers of the motion will find themselves on the losing side in this battle.

Mr I. J. Kenna, A.I.A.: *In ¶6.5 of their paper the proposers write:* "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". Put more simply, the proposers want insured benefits, in respect of which contributions have been paid, to be means-tested. Why means-test these state-provided insured benefits in particular? Is it the state provision to which the proposers take exception? In this case it might be a money-saving idea if savers were obliged to prove genuine need for the money before they were permitted to draw their savings out of the National Savings Bank. On the other hand, do the proposers take exception to the insurance element? If someone's car is damaged in an accident, should he be means-tested before the insurance company decides how much it will pay out?

Millions of people have paid National Insurance contributions for their state retirement pensions. Means-testing insured benefits will do for the insurance principle what Adolf Hitler did for demography.

The problems of pensions mis-selling show the difficulties that ordinary people have to deal with. Who regulates the regulators? Who regulates anybody?

The analogy of the primitive fishing community is naïve. We are not like that because we have a sophisticated investment system with very little investment in boats or other real assets. Investment is in shares, with new money continually boosting the value of shares. Pensions, as they fall due, are paid out of new money as it comes in, the balance being invested in the stock market, which goes up because it has a record of going up.

The state should provide a basic old age pension of, say, £6,000 p.a. to everybody when they reach a certain age. The cost should be met out of taxation on incomes. The present Byzantine jungle of regulations, means tests, tax concessions, and National Insurance contributions should be scrapped. There would still be plenty of scope for good pension schemes to live on top. Total contributions to private pension schemes would fall gradually. This would lead to a soft landing for the over-priced world stock market.

Higher income taxation is the best way to pay for state pensions, since it would force better-off people to face up to the consequences of living in a civilised society.

I ask this house to vote against the motion.

Mr C. S. S. Lyon, F.I.A.: I have an acute sense of *déja vu* in speaking against this motion. I do not believe that, without the involvement of the state, we could ever achieve universal social security in retirement. I refer to 'retirement', partly because 'old age' has a pejorative flavour to someone already in his seventies, and partly because pensions are not only for the elderly.

People who retire with minimal resources fall back on the taxpayer for means-tested support, so we have a common interest in creating a universally sound foundation for the future. It will not be achieved solely through the basic pay-as-you-go state pension, but requires a second tier. Although there may be a residual role for SERPS, we can be sure that the future of second-tier pensions — certainly those outside the public sector — lies almost entirely with funded arrangements. To belong to one may become compulsory, and, indeed, I would argue that the objective of universality cannot

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be achieved without compulsion, nor, indeed, without minimum standards, though there is room for debate as to what these should be.

One essential component of good second-tier design is in danger of being overlooked; namely, provision for those whose working life is cut short, either permanently or for a long time, by disease or disability. Most defined benefits schemes provide ill-health early retirement pensions on a generous basis, with added years of service or the waiving of an actuarial reduction for early payment, or both. This is seldom the case with schemes based on defined contributions, and never — I think — with personal pensions. Permanent health insurance may be offered to fill the gap, and, of course, it has the advantage of being able to cover loss of working capacity that is not necessarily permanent — something that the Inland Revenue has consistently refused to allow within an approved occupational scheme. However, PHI is not sold universally, there is no preservation on change of employment, and if bought individually — for example, with a personal pension — it can be subject to restrictions which should have no place in a second-tier substitute for social security.

The Government's recent consultative document on stakeholder pensions included the question: "Should Stakeholder Pensions include provision for early retirement on ill-health grounds, or disability insurance, and, if so, should this be a core feature or an additional element which scheme members could elect to take up?"

The background to this question is that the earnings-related supplement for invalidity, which was a feature of the original SERPS and was not eligible for contracting out, was removed, in two stages, by the previous Government. The basic state Incapacity Benefit (which replaced Invalidity Benefit two years ago) is no greater than the basic retirement pension; so, although there are anxieties about the misuse of ill-health early retirement in some occupations, is not there a real need for second-tier pensions to cover genuine incapacity?

The Institute and the Faculty replied to the question about the inclusion of ill-health early retirement or disability insurance in stakeholder pensions with the one word 'no', but surely those who set the question were looking for a reasoned answer, which our profession is well qualified to give. I urge the Councils to prepare a further submission in which they explain why they reached that negative conclusion, and what would need to be done to enable incapacity pensions to be included as standard up to a certain level, not just in stakeholder pensions, but in all second-tier pensions. There is a Swiss model for this that deserves close examination.

If that prospect defeats us, the motion, too, must surely fail.

Mr P. G. Kennedy, F.I.A.: I too oppose the motion, though not for the principal reason put forward by the opposers, that no single system can be regarded as the best. Private provision may be fine for topping up the better off, but state provision is the best and, indeed, the only way of achieving universal social security in old age. It is no accident that the proposers are so reluctant to condescend to particulars of any serious private alternative. There is none. I agree with the proposers' criticisms of pay-as-you-go and with the quote from Edward Marshall at the start of their paper, that the state can offer the worst as well as the best in pension provision, but the last sentence of ¶3.2 in their paper is pure propaganda, and I do not accept that the proposition at the end of ¶3.3 accurately paraphrases the motion.

As for the proposers' claimed clear evidence around the world, all I could find in Section 5 was the famous parable about fishing boats. Only at the very end have the proposers mentioned Chilean quasi-private 'recognition bonds'.

Having said this, I do not accept the opposers' complacency either. The state must be open about the extent of its pension liability and its funding. I am also concerned about the 'universal' status, or otherwise, of migrant workers within the European Union, and it seems to me that pension provision may not always be a matter that can be left safely to member governments by virtue of subsidiarity. A fully-funded Europe-wide system would, arguably, be an example of independently funded and invested pension provision, but I do not understand this to be what the proposers have in mind. I therefore urge this house to reject the motion.

Dr A. Robinson (a visitor): You should vote for the motion because it looks forward to the future,

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which is essential if you are making provisions for retirement. Those opposing the motion make some very good points in their paper, but most of them merely reveal why you simply cannot trust the state with the provision of your pension. Their paper is conceptually clouded. There is a matrix of provision. On one axis you have the state versus private provision; and on the other you have unfunded and funded. From time to time the opposers slip into talking about the state as though it was always unfunded, yet you could have a system in which the state provided a funded scheme, and you could also have unfunded private provision. I think that it is very important to get some conceptual clarity.

One of the interesting things about the state is that it has an interest in compelling contracts made by individuals — that is, it regulates and it makes sure that people keep to their contracts. In the future, because of demography, the democratic pressure will be to cut state benefits. So, if I look at the risks on both sides, I would say that it is better to have the state playing the role as the enforcer of contracts. The 1995 Pensions Act is a classic example.

The opposers of the motion are also wrong about the links with the U.K.'s economic growth. Looking at the post-Second World War period, it is only in the last 20 years that we have had a flourishing economy, and in the past 20 years the assets of pension funds have ballooned to £600 billion. I am no mathematician, but I do see a strong correlation between the size of pension funds and the increasing prosperity of the U.K. economy.

In Italy, pensions are funded, but it is done privately. People buy a property. They live in part of it. They let the rest out, and that is a form of pre-funding your pension.

We must not ignore the effects of capitalism on active institutional shareholders. There is a strong correlation between the size of pension funds and the pressure for good corporate governance, including the demand for transparency from boards of directors.

We have heard the analogy with fishing, but I prefer the analogy of the sofas of the two neighbours. Family number one spent all their money, and bought a new sofa when the children were young. Now they are sitting there on a sofa with broken springs, having never saved nor contributed to their pension. Family number two contributed to their company pension, and now they have enough money to buy a new sofa. I do not think the analogy that was made in the paper was right at all.

Returning to the point that I made at the beginning, the arguments on fiscal and political risk which pepper the paper of those opposing the motion may appear to be sound, but what they tell us is that there is a pre-condition for the successful operation of private and funded pensions, and that is that the role of the government needs defining. I have many times argued in favour of a fiscal constitution, and in Mr Gordon Brown's 1998 Budget a little-noted part was the Code for Fiscal Responsibility, which spoke, not only about redistribution within a given generation, but the need for fairness across the generations. I believe that he has made a great step in the direction of a fiscal constitution, and has thereby laid the foundation for the successful operation of funded private pensions, and I therefore support the motion.

Ms H. Salt, F.I.A.: I begin by looking back to 1798, because this year marks the 200th anniversary of the 'Essay on the Principle of Population as it affects the Future Improvement of Society with remarks on the Speculations of Mr Godwin, Monsieur Cordorcet and other Writers'. Although it was initially published anonymously, Malthus' essay is now a landmark in social pessimism.

I mention this, not only because demography is an important element in this debate, but also because, at the end of this century, we are again swept up in a tide of social pessimism. The difference now is that we do not even have the optimistic belief in progress and rationalism that was then spread by the enlightenment. Although today's pessimism is slightly more sophisticated than that of Malthus, it is no less biblical. We must consume less, produce less, expect less, say the doom-mongers from all political corners. No wonder people agree with compulsory contributions to pension schemes.

In this debate, the proposers said that their proposal could be summarised, as an 'abstinence now, consumption later', funded pension scheme. Contrary to the headlines used to support cuts in consumption, demographic change is entirely irrelevant in judging between funded and unfunded pension schemes. Under both systems demographic change will have an impact, but the macro-economic effect is the same.

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Furthermore, it is no good planning a system around demographic projections, because not even we, as actuaries, nor even the Government Actuary's Department, can say what the population structure will look like in 2040 or 2050. Those projections are highly dependent on fertility, which is subject to massive short-term fluctuations, as well as to long-term change, both of which are completely unpredictable.

The problem is that we, as actuaries, have seen the discussion about demography and have thought "Great! A public discussion to which we can contribute". So we have jumped into that discussion based on the tables produced by GAD, tables which, incidentally, always seem to stop in 2040 or 2050, leaving the public with the impression that the population will carry on rising when, in fact, growth will tail off.

We should have said that demography is not important, and have turned our attention to the important question, which is whether forcing people to save now — and it does not matter what form the savings are in — will raise productive investment and increase wealth in the future. That is a political rather than an actuarial question, as illustrated by the repeated references already to the markets, to property rights and to moral hazards. What matters is whether companies are managing to invest profitably.

Mr Blundell never said what happened to all those savings that had been generated in Chile. Were they used for productive investment? Certainly the research that I have seen suggests that the vast majority of those savings have been taken over by subsidiaries of United States investment banks, and are being used to swap bits of paper on international markets. That is not productive investment.

Mr D. J. Le Grys, F.I.A.: You will recognise that I am not a 20-year-old German worker, but I have spoken to my colleagues in Germany, and the young people there are worried about the burden of tax that they carry now and the burden of tax that they will have to carry in the next century, as the population ages. I predict that the pay-as-you-go schemes on the Continent are going to cause widespread social and political disruption in the next century. I am convinced of the need for funding for the reasons given by the proposers, but a funded solution does not necessarily have to be a private solution.

I envisage a National Pension Fund, where the framework is defined by government, but large parts of the system, the administration, the investment management, the longevity risk and the care risks, are passed on to third party administrators and insurers. Contracting out could be allowed by the individual, by the employer and by an association or affiliation group. I see it as the state's responsibility to provide the framework and the administration. It is very important, not for the high income groups, but for the low paid, frequent job changers, and people who have gaps in their employment.

The National Pension Fund would be in two parts: a fully funded part, where contributions build up benefit entitlements; and an unfunded part, which pays out benefits to existing pensioners, and to people, in the future, who have nil or inadequate contribution records. The fully funded part would be fed by contributions from the employee and the employer, and the unfunded part would be fed out of taxation.

Although I advocate funding for the future, there are two great difficulties. The first is that it will take many years before a person's entitlements are sufficient to pay any reasonable pension. The second problem is that, in the meantime, the shortfall between the pensions which are actually being paid and the entitlements that have been built up will have to be paid out of taxation in some way. If pension levels are increased, then the shortfall will increase and will last longer. So, for the foreseeable future, the current generation of young workers would pay for their own pension provision and their care provision that they are going to need in later life, and, in addition to their own contributions, they would pay for the shortfall in the cost of the current elderly population through taxation. If pension levels are increased, then this inter-generational subsidy may be unrealistically high for one generation to bear.

There is a real burden that has to be carried, and the question is how can that be carried sensibly? I would propose that a new investment vehicle should be created for the fully funded part of the scheme, a special loan to government. Some of the fully funded part could be invested in this investment vehicle. These special loans would be redeemed by payments from government to the fully

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funded part of the scheme over a stated period, say over the next century or over the next 80 years, which is two working lifetimes. The amount repaid would be indexed to match the investment performance of the freely invested part of the fund, and each year dividends or interest would be paid on the outstanding special loans at the same rates achieved by the freely invested portion. Government could then use the special loans to cover some of the costs of providing pensions for the current generation of elderly people, covering the shortfall, and thereby spreading the cost over the long term.

The special loan is repaid out of future taxation. There is no magical solution that allows the Government both to spend money now and to build up a fund for the future. However, the borrowing is measurable, it is on defined terms, it is for defined repayment dates, and it is on terms that do not penalise the current investors. This is more satisfactory than ill-defined schemes such as deferring tax relief, borrowing by irredeemable stock or financing by off-balance-sheet funding.

Dr L. W. G. Tutt, F.F.A.: The continuing effectiveness of pension provision, whether it be financed by pay-as-you-go or by funding, is dependent on a sound basic economy, which, in turn, depends on a continuing productive workforce. As an example of a not-so-productive workforce, some years ago I made an investigation in connection with a large multinational manufacturing corporation. The employees of the British arm of the corporation were being remunerated at lower levels of pay than their counterparts elsewhere. My enquiries of individual employees of all grades invariably resulted in my being informed that this feature was well known, but for them to bring their rates of pay up to the levels of some other countries would require them to raise their work practices up to the standards achieved elsewhere, and they were not willing to make such efforts.

In response to the DSS pension review, some authorities stated that, in this country, people want to work less, start work later, retire earlier and take more career breaks within this diminishing period of time, whilst also expecting to live longer. Such characteristics surely can impinge, in a practical way, on the basic soundness of the national economy on which pensions are dependent.

Should not government policy be directed rather more to effective and productive employment than merely to full employment *per se*, which can be quite aimless (and which was a major contributory factor to the economic collapse of the Soviet Union). Further, should not the claims by both employers' confederations and workers' congresses, that British industry can operate only in conjunction with a national currency which is weak relative to others, be deprecated as inflationary, and thereby harmful in their resultant effects on effective pensions provision by any means?

Dr S. Lawlor (a visitor): I ask those who propose mixed provision between the state and individuals to reflect on the problems that we have seen since the emergence of the state social security system. When the Beveridge Report was introduced, the aim was a social security system. The method would be a flat rate contribution for a flat rate benefit, and this would allow the very mixed provision which has been advocated in this debate. However, part of the problem was political pressures on governments to do things which may not have been so sound in terms of actuarial considerations or economics.

Initially, we saw how the Attlee Government was forced to advance payment of the full retirement pension rather than wait for 20 years, which is what had been recommended. In the 1950s and 1960s there was pressure to increase the rates of pension, and we saw how difficult it was for governments to meet individual expectations and to provide adequately for retirement income. By the 1950s a large proportion of the elderly were again on means-tested benefits to supplement their retirement pensions.

So, political pressures led to high demands, demands which governments could not meet, and, economically, it was found very difficult to meet such political pressures. Partly as a result of these pressures, earnings-related pensions were brought in. The debate about earnings-related pensions was won by the 1960s, although policy followed a little later. This brought state social retirement schemes away from the initial flat rate idea, which had initially been proposed, in order to allow for mixed provision.

I now come back to my question. Given that one means of allowing the mixed provision which you advocate was a notional flat rate minimal contribution which would allow people in the private sector to provide voluntary schemes through a range of means other than through state social security;

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given that this did not work quite so well as was intended over three or four decades; given that the upshot was to move toward state provision; was one of the consequences of this that people, themselves, became psychologically less well equipped and possibly financially less well equipped to make that means provision? If we want mixed provision, we have to get over the politics of government doing things in a certain way which will make it difficult, psychologically, for people to take a lead, which may make it difficult financially, and which may put politicians in the position of having to give in to political pressure in areas where government is taking charge of elements of a person's life.

Mr J. M. MacLeod, F.I.A.: There are two major implications of funding, between which I believe it is necessary to make a clear distinction. First, funding involves the identification and ring-fencing of assets that will be used in the future to meet past pension promises. This is an inevitable consequence of funding. Indeed, you could say it follows by definition. The second implication of funding is that it can lead to generational fairness, in that each generation of the population becomes self-supporting. This, however, is not an automatic consequence of funding. Whether it happens in a particular case will depend on how the assets of the scheme in question are invested. If, for example, the whole of a pension scheme's assets were to be invested in gilt-edged stock, then the costs of pensions would certainly be borne by later generations, for it is they who will be called upon to honour the promises made to holders of that stock.

It could, perhaps, be argued that a scheme that invested wholly in gilt-edged stock was not really a funded scheme at all. After all, the Government could make any of its so-called unfunded schemes into a funded scheme by issuing the necessary amount of gilt-edged stock and decreeing that all the scheme's investments should be in such stock, with any fund surplus reverting to the scheme's sponsors, i.e. the Government.

Be that as it may, when occupational schemes first started they did invest very largely in gilt-edged stock. In those circumstances, Martin Lunnon would have been right when he stated in The Actuary, in August 1996, that even pensioners in funded schemes were reliant on the working population. As the 1950s gave way to the 1960s the so-called 'cult of the equity' gradually took hold. Pension schemes invested less and less in gilt-edged stock and more and more in physical assets such as property and shares. The more this happened, the less true Lunnon's dictum became; though any tendency by schemes to back current pensioners' liabilities with gilt-edged securities, while using equities mainly to support the prospective liabilities of the current workforce, could maintain its validity. Anyway, whether by necessity or choice, we have reached the situation today when only some 10% of occupational pension schemes' assets are invested in gilt-edged stock.

This is a case of the pendulum swinging too far, because the assets of pension funds are swollen by tax waived on past contributions that is allowed to stay in the fund until pensions are eventually paid. This arrangement is actuated by the fact that individual pensioner's eventual tax rates in retirement are unknown at the time when contributions are paid. Yet, to my mind, generational fairness requires that it is at the time that wealth is created and contributions are produced, and not when they are spent, that tax on those contributions should be paid. Pensioners' eventual tax rates could be at higher rate, standard rate, or, if all or part of their pension fell within their personal allowances, nil rate. Because of this unknown, schemes were, from the outset, allowed to retain the whole gross pension contributions, on the basis that they would pay the pensions gross, and the appropriate rate of tax would be paid by each individual in his retirement, according to his particular circumstances at that time.

However, the fact that schemes in those days invested most of their assets, including waived tax, in gilt-edged stock avoided generational unfairness. The waiving of tax on pension scheme contributions became no more than an administrative convenience. What the Government gave with one hand, in the form of tax relief on pension scheme contributions, they immediately recouped with the other when those rebates were fed back into the gilt-edged market.

Now that occupational schemes invest only 10% of their assets in gilt-edged stock, this situation breaks down. The tax waived by pension contributions made by each generation of the working population is being salted away and only made available to future generations. This is the reverse of

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cross-generational subsidisation as we know it, but a case of generational unfairness nevertheless. I believe, therefore, that only the after-tax component of pensions should be funded, and that the tax component should be unfunded.

Thus, when called upon to vote on this motion, I feel that I must abstain.

Dr E. Butler (a visitor): Saving boosts the economy as a whole, just as it boosts the economies of individuals, because the economy is little more than a collection of individuals.

The pay-as-you-go system actually delivers very poor returns. A pay-as-you-go system can only spend benefits as fast as taxation can be expanded, and, generally speaking, taxation can only be expanded as fast as the economy expands. The pay-as-you-go system in this country, as in many others, has delivered appallingly poor results over the years, because it cannot grow by more than 2% and a little more, whereas the private pensions industry since 1950 has delivered returns of 7% and more.

The state system is just as risky, if not more so, than any other system, and we have already seen the last Government tearing up the indexation contract.

If future security is a concern, a written contractual claim on a future fund manager is better than having no contract at all with future politicians.

Mr G. G. Newton, C.B., F.I.A.: Dr Lawlor asked what happened to Beveridge's original flat rate pension and flat rate contribution. The answer is that the flat rate contribution very quickly became much too high for the lower paid to afford, so we had to have earnings related contributions, and that led to earnings related benefits. Another factor was that the flat rate pension came to be recognised as much too low for people who did not have a second occupational pension.

The renewed debate worldwide about the best way of financing pensions, of which this debate is a reflection, stems from concern about the effect of the ageing population on the finances of state pay-as-you-go schemes. For many countries the projections show the need for very substantial increases in contributions, or cuts in benefits, or changes in pension age, or a combination of all these. However, in so far as we are concerned, not with the problem of the maturing of schemes, which could have been foreseen, but solely with the effects of changes in the relative numbers of pensioners and of people of working age, I think that our worries may prove to be overdone.

A counterpart of the missing contributors in the future, because birth rates have been too low, is that there is an acute shortage of labour in the economy, but genuine labour shortages have a way of curing themselves. There are large reservoirs of potential extra employees within the projected population, quite apart from the unemployed. There have been dramatic falls in activity rates over the years, particularly for men. For example, at present only about three quarters of men at ages 55 to 59 are economically active (and the definition of economically active includes people who are registered as unemployed and looking for work), so 25% are not working and are not registered as unemployed. Within the male 60-64 age group, the proportion economically active is only about 50%. If there were well-advertised vacancies, at reasonable rates of pay, many more women, particularly older women, might be attracted into employment, as well as persons over the present pension ages who are still fit and able to work.

Beyond this, any remaining shortages would almost certainly be made good by workers from overseas. It would not be the first time that organisations like London Transport, the National Health Service, and even commercial firms, have actively recruited in the West Indies and elsewhere. This was happening in the 1960s, when the effect of low birth rates between the wars was evident. Published projections of future contribution rates do not make any allowance for developments of this sort, though the point is acknowledged in the Government Actuary's reports. Thus, the problem of the imbalance of the numbers at the working and pensioner ages may solve itself, if that proves to be the problem. However, it seems possible that we may be faced with quite a different scenario, in practice, and this is that the microchip revolution will produce a situation where there will not be work for a significant part of the population of working ages. We would then have the problem of bringing about some redistribution between those who are doing very well in the new environment and those of an underclass who are left behind. A redistributive state pay-as-you-go scheme is quite a good way of achieving this, at least for the pensioner age groups.

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Mr D. R. Linnell, F.I.A.: The effects of funding are likely to be second order so far as the economy, overall, is concerned; it may facilitate growth, but it is unlikely, in itself, to create it.

I suggest that the objective is to minimise the amount of state support needed in retirement by providing an efficient and effective set of pension arrangements which are well understood by the public. Do we have that now? Mr Daykin said that we need a well-designed state scheme on which people can rely. I would categorise the present combination of flat rate state pension, SERPS, contracting out, occupational schemes, personal pensions, Section 32, RAPs, and, around the corner, stakeholder pensions, as not in the well-organised, simple and well-understood class. It has been built up with the best of intentions on all sides, but substantial changes are needed.

Mr Lyon has given compelling reasons why you cannot rule the state out of pension provision. Mr Le Grys gave a compelling case why funding could be the best way forward. The answer may be that we need a compulsory system, because the state is needed to make sure that the arrangements are fair. We also have to find a way through to individual funding, to ensure that people recognise the need to support their own lives in retirement. They also need to be able to see how their pensions are building up, year by year, as they head towards retirement.

Mr P. E. Read, F.I.A.: The motion, as I read it, does not have the words 'in the U.K.' in it. The motion does not have the words 'in Europe' in it. The motion talks about 'universal' social security. It calls for a clean sheet of paper approach. There is no doubt, in my mind, that the 'independently funded' approach is very important. Provision in advance is well understood, and leads to benefit security in maturity, but another key word is 'invested' — this is the biggest challenge for the clean sheet of paper approach. Investment in the government infrastructure of many emerging countries leads to profligacy and corruption. Investment in the private sector leads to costs and risks; but ultimately to wealth creation. So, on a clean sheet approach, there is no doubt that the best approach is independently funded pension provision.

Mr A. P. Jollans, F.I.A.: I shall deal, in particular, about the way in which the two systems cope with the problem of an ageing population, having written a paper on the subject for the Staple Inn Actuarial Society (Jollans, 1997).

That paper concluded that, despite the high proportion of funded pensions in the U.K., Britain has much the same pensions problem arising from the ageing population as do other countries, such as France and Italy. In macro-economic terms, funded pensions have changed very little. In that respect I agree with many of the arguments put forward by the opposers of the motion.

I think that the claims made for funded pensions and against pay-as-you-go pensions are very often exaggerated. For instance, I can see little evidence that funded pensions have increased savings ratios or investment in the past, and, if anything, I can see even less evidence for the argument of the proposers that pay-as-you-go schemes may reduce the fertility rate by not providing incentives to have children. It may be that pension provision, in general, reduces fertility rates, but the trend towards lower fertility seems to exist almost everywhere, independent of funded or pay-as-you-go pension provision.

Nevertheless, I see one major advantage of privately funded pensions, particularly in the current circumstances. That arises from the way in which they decentralise and depoliticise decision making. To adapt the French or Italian pension schemes to cope with the ageing population requires major and highly sensitive political decisions that are very difficult to take, as we are now seeing. By contrast, changing private funded systems can be achieved through a myriad of smaller decisions. Private systems change by gradual adaptation, so, although the U.K. has the same problem of an ageing population as continental countries, I believe that the solution to the problem may be easier for us because of our large element of funding.

I expect that the pension system in the U.K. will adapt to the ageing population. I very much doubt that it will do so by setting aside more resources for the future. I expect it to do so by people gradually working for longer. However, that will be achieved by a large number of people taking individual decisions to defer retirement or choosing to return to work after retirement, largely driven by economic pressures, and, similarly, by individual employers taking decisions, under economic pressure, to employ older workers.

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Mr M. K. Lunnon, F.I.A.: Both the proposers and the opposers of the motion would like an economic argument that could conclusively demonstrate that funded pension schemes were better, or not so good, but I fear that, as usual, economists cannot reach such conclusions. The truth probably lies somewhere in between. As to whether funding pensions leads to increased investment or to higher prices of financial assets, I suspect that there is probably some of both.

Not all investment is necessarily useful. Returning to the over-worn example of the fishing community, if the earlier generation had built more boats than could possibly be used by the next generation, then that could not be a useful investment. I like Mr Jollans' idea of increasing people's education level as an investment for the future (see Jollans, 1997). I am also concerned that, if there is to be investment for pensions schemes, it is investment in real assets, not in government stocks.

Like Mr Jollans, I do not accept the proposers' concern about social security actively discouraging people from having children. People have children for many reasons, very rarely financial. Government attempts to affect fertility are nearly always unsuccessful, and often very distasteful.

I am also worried about these 'commons' that the proposers go on about in their documentation. I think of commons as common land, although it has a wider economic meaning. In ¶2.9 of their paper the proposers assure us that the pollution of private land is rare. Who are they trying to kid? Every day we hear of contaminated brown field sites that someone else, not the original private owner, is having to clear up.

In the absence of social security schemes, old people and, returning to Mr Lyon's point, people who are long-term ill, are often among the poorest in society. Also, people save to provide retirement income and for other reasons. They are not saving just because there is an absence of a social security system, as the proposers suggest in ¶5.4 of their paper; they are saving because of real interest rates. This pattern of saving is often uneven, and some people do not — or, more importantly, cannot — save enough. A social security scheme based on the principles of solidarity, rather than of mutuality, should provide pension benefits for poor people because they are poor, rather than just because they are old. It should also encourage savings by workers or by their employers through pooled vehicles for retirement, and, thus, to allow people to provide more than the basic pension based on the principles of solidarity would do.

In contrast with Mr MacLeod, I think that a tax regime could be an important incentive for encouraging people to make this extra provision, but a compulsory second-tier pension system would be useful. However, the universal social security element must be provided by government and must be unfunded.

Dr K. Stroinski (a visitor): I speak on behalf of the group that worked on the reform of Polish social security from the pay-as-you-go system into the funded system. The basic need for reform is the weakness of the Government and its inability to keep the promises that it once made, and is also to stop it from making new promises that it cannot keep. This may not have any relevance to the situation in the U.K., but in Poland we would support the motion. If you have the patience to see what results that reform will bring, and if it will actually stimulate some economic growth, then you can have, perhaps, a better informed decision than if you wait for a few years.

Mr P. N. Downing, F.I.A.: The interests of both the working population and those in retirement are fundamentally dependent on two features: the nature of the benefit promised; and the credibility that can be attached thereto.

Taking the second point first, the Government's position is very clear. Pensions after retirement will increase by the RPI, and that is generally followed, even by funded occupational schemes. The Government is equally clear that, in the period of active work that is leading up to retirement, the state pension will only be revalued by RPI, and that means that, over a working lifetime of 40 years, assuming only a 1% differential between the earnings index and the prices index, the relative provision by the state will fall by one third. Another feature of the credibility required of the state is that there is no effective retrospective taxation of corporate or private pension provision. I leave you to judge whether there has, or has not, been such retrospective taxation in the last few months. Looking to the future, the credibility of the state scheme's current provision also depends on the

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maintenance of a pension for all, as of right, as opposed to a means-tested basis. It is in the interests of all that the benefit promise is a promise of a pension in retirement. The state wins hands down on this, even though it may be an inadequate and decreasing provision, whereas on the funded side, the argument is clouded. A funded benefit promise is a good promise when it is in the form of a pension, that is a flat rate pension such as the state pension, a final salary pension, or even a revalued average salary pension. If the promise is merely an accumulation during your working lifetime — and heaven help you what the investment conditions are when that lump sum needs to be invested into a pension — it is a far less adequate benefit promise. These issues have been clouded by the debate on funding or pay-as-you-go, notwithstanding that that is a critical part of the total debate.

The evidence of the recent past, with the encouragement of the personal pension, is that the average contribution rate for future pension provision has fallen. A scheme with a good benefit promise requires a contribution level of 15% to 20% of salary. Why should a less adequate benefit promise be allowed, and, more particularly, why should the average contribution rate fall, when the higher investment risk would demand that saving during a working lifetime has to be at a higher level in order to give protection against the downside of the reinvestment risk at retirement?

I hope that the result of this debate is not the end of the issue, but rather an important milestone in the ongoing search of what is the right and proper role of the state, the individual, and the employer in the provision for old age, and what is the right total contribution that should be made by, or on behalf of, each member for their future pension provision.

Mr P. G. Meins, F.I.A.: In relation to the possible effect funding is having on investment prices and returns, strange things do seem to have been happening in stock markets. However, it is a worldwide phenomenon, occurring even in European stock markets that actually have unfunded systems, so, perhaps, all the blame cannot be laid at the door of those funding their schemes.

Funded schemes are actually helpless victims, because of the resulting pressure, not only to cut contributions, but also to improve benefits. If we get the converse of this in the next century, when we are drawing our pensions, and market prices are suffering, it may not be quite so easy to claw back these increases.

Mr R. E. Brimblecombe, C.B.E., F.I.A.: All the discussions between pay-as-you-go versus funding have been fairly evenly balanced; as a couple of speakers have said that, in macro-economic terms, it does not really make much difference. In terms of security and the confidence of the public, again it is evenly balanced. On the state side we have had the removal of the link to earnings of the basic state pension. We have had several changes in SERPS. On the private side, we have had the earnings cap imposed and the changes in ACT. I suggest that, if you are starting a personal pension now, you will get a far-less-value-for-money pension in 40 years' time than you would have if you had a 40-year policy maturing this year.

The motion says that *universal* social security is best delivered privately. This is the question of the cost of delivery. I do not believe that you can deliver pensions for old age in the private sector to the lower paid, and possibly to the increasing number of people who frequently change jobs, in a cost-effective way. I have fears that stakeholder pensions, when they come out, will try to do that in the private sector in a way that is not going to be cost effective, even on a group basis. Many lower-paid people will be disappointed if they think that they are going to get good value for money.

A good model of compulsory second-tier pensions would be based on a revalued total earnings scheme, universally available, and very cheap to deliver. It has already been invented — it is called SERPS, but, unfortunately, it is likely to wither away. On the grounds of the cost of delivery alone, I oppose the motion.

Mr N. J. Braithwaite, F.I.A.: The words of the motion include: "met by the development of independently funded and invested pension provision".

Let us look at just three models:

(1) the Tories' Basic Pension Plus — all funded;
(2) Barbara Castle's beefed up SERPS carry on as we are — all unfunded; and

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(3) stakeholder pensions — some funded, some unfunded.

Stakeholder pensions represent the development of independently funded and invested pension provision. So, if you believe in the mixed economy, you should vote for the motion.

Mr T. G. Arthur, F.I.A. (summarising the arguments for the motion): This debate is not about whether and how the state should arrange to support the poorer members of society; it is about the state (and by that we mean any state around the world) having a direct and major role in transferring resources on a generational basis. Nor is it about whether or not we have responsibilities to each other. We all know that we have; it is a question of how they are fulfilled. The opposition's argument, that a mix of private and state provision is better, because you can choose the best bits of each, implies that we should still have, say, 20% of our motor car industry in the nationalised sector. It is not possible to cherry pick the best parts of any systems that happen to be lying around, and, in contrast to that kind of *naïveté*, our fishing analogy looks highly sophisticated. In any case, it is a very useful model not to be denigrated.

On the question of savings, I think that we have won the arguments on the virtues of funding on a personal level. It is possible to provide for one's individual future, irrespective of the level of aggregate savings, by pinpointing one's savings towards retirement. It is the nature, as well as the amount, of investment that is important.

On the question of aggregate savings, we have to accept that, over the debate, things have been a bit more cloudy. Chile has been mentioned; Asia has been mentioned. We should distinguish between the invisible hand, which is what we, the proposers, are arguing in favour of, and an iron fist, albeit possibly inside a velvet glove, which has been the problem in Asia.

In this weekend's *The Economist* are these words: "combine artificially cheap capital with cronyism and government meddling and the result was that investment frequently went into those projects with the best connections rather than the best economic projects". That is the problem. We must not look around the world to find examples of crony capitalism and use it as an argument against funding.

On the question of costs, does anybody believe that any pension scheme run by the state can cost 2.5% of the contributions? That is achieved by transferring all the costs to the private sector and by removing some spending altogether — for example, on communication, which is disgraceful in all state pension schemes. State schemes also typically exhibit lower returns; how many investment shocks are needed to bring private sector returns down to the same levels?

There is redistribution on top of that which makes all the figures much more cloudy, as Mr Newton pointed out, but let us not pretend that redistribution goes only towards the weaker members of society. It does not, as we have shown in our paper. Furthermore, if you want to give money to the weaker members of society, you have to find them. That raises the question of means testing in one form or another.

On a day when the financial promises of British Telecom enjoy higher ratings than those of the Government of Italy, even when backed by specific bonds, the opposition is here seeking a mandate for a system of substantial transfer payments made by taxation, changeable at government whim, unbacked by any other means, and involving the conscription for life of every adult. By its very nature, such a system must be operated according to timeless principles, and it must span several generations, if not more.

The opposition is further asking you to believe that experience demonstrates that that kind of system works. We beg to differ, and we confidently seek your support.

Mr B. H. Davies, F.I.A. (summarising the arguments against the motion): This debate is not about a range of theoretical approaches to the provision of pensions, it is a practical issue. Do you want a market solution to the provision of pensions, whether an entirely market solution or a market-orientated one, or do you believe that the state has an important and continuing role in pension provision? If you think that the market solution is right, support the motion. If you think that the state still has an important role, despite all that you have heard, then vote against the motion.

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Whenever we talk about the Chilean system we should remember that it was introduced by a regime that seized power by force from a democratically elected government. It is too early to reach a final decision on the Chilean system, but we know already that is does not provide universal care, with 30% or 40% of working people in Chile not being in the system. Therefore, it cannot be used as an example to support the motion.

This is only one stage on an ongoing search for the best form of pension provision. We need to look round the world at other examples. Mr Arthur says that we should not look at cases of crony capitalism; equally, I would say, that you should not look at instances where state systems have been badly run. I am not proposing that we should have a badly-run system. I hope that, in this country and in other democratic countries across the world, we can have well-run state schemes that develop in ways which reduce the political risk that state schemes do suffer from. Thus, while I accept the point, let us look at ways of solving the problem of political risk through mechanisms such as the German system, where pension rights are property rights, which cannot be taken away except by going through the constitutional court. Let us look at such mechanisms to find ways of improving the state scheme.

Proponents of funded pensions in this country expect to be listened to when lecturing other European countries with pension systems more successful than our own in delivering decent benefits. We can learn from other countries about successful state systems which deliver decent benefits now and in the future.

I ask you to oppose the motion; to say that there is still, and will continue to be, an important role for the state in providing pensions on a unfunded basis.

The President (Mr D. G. R. Ferguson, F.I.A.): We will now take a vote on 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".

The votes are: 60 in favour of the motion and 68 against. The motion is therefore not carried and is rejected.

Thank you all for coming. Thank you to all of our speakers, and particular thanks to the proposers and seconders, for and against the motion, making the debate possible.

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