

Providing for Pensions

Savings in a Free Society

Tim Congdon

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Preface

Has the UK a pensions crisis? What are the current and projected trends in the pensions and savings regime? The Pensions Commission, set up to assess the position and look in particular “at current and projected trends”, published its initial report in October 2004. The first report was supposed to be largely a description of present arrangements, without any recommendations. In fact, it prejudged important and very difficult issues, following a pattern common in official documents of this kind. First, it examined existing trends and found them unsatisfactory, then it described “the problems we face” in more detail, and finally it implied that some form of government response was required to overcome the problems. In practice the government response always involves higher taxation. Although pensions provision is complex, one point is clear: over the long run higher taxation will not make the UK richer, but poorer. If distributional issues are put to one side, higher taxation cannot be the answer to the alleged “pensions problem”.

This paper denies the claim that the UK suffers from “a pensions problem”. (I do not deny that the UK may be characterised by inequality of income and wealth in old age, although whether such inequality requires adjustment by public policy is open to debate.) However, the adequacy of pensions cannot be considered in isolation from the adequacy of the nation’s savings as a whole, while certain well-known features of savings behaviour (such as the massive saving every generation makes for the next) have to be introduced into the analysis. The paper is intended to inform the Commission’s second report, due out this autumn, in which policy recommendations are to be more explicit. I will not be upset if the Pensions Commission recommends nothing radical, but endorses what it terms “the muddle-through option”. As it happens I do favour a radical policy change, as set out in Chapter V below. The problems in this area of public policy are not about the level of savings (including pensions savings) for the nation as a whole, but about the inequality of pension incomes. My scheme – which would supersede the present arrangements for the pensions element in National Insurance – is therefore highly redistributive. It would also be funded, personalised and private, even though it would be under the state’s aegis.*

*I would like to thank Mr. Martin Weale of the National Institute of Economic and Social Research for his thoughts, in a fairly extended e-mail exchange, about the difficult subjects of capital consumption and the measurement of savings. I have not reached a final view of these matters, but an appendix sets out some thoughts.

I

What is the Pensions Commission worried about?

The next 50 years will see a major change in Britain's demography. The number of people aged 65 or over (and particularly those aged 85 or over) will rise sharply relative to the number of people under 65. If the elderly are to have satisfactory living standards, that will have obvious implications for the future cost of pensions. Concern has been expressed - notably in the first report of the Pensions Commission chaired by Mr Adair Turner - that inadequate provision has been made to meet this cost. According to the report, "The present level of pension right accrual, private and state combined, will leave many with inadequate pensions." The Pensions Commission's anxiety follows earlier claims from the Association of British Insurers that the UK had a "savings gap" of an estimated £27 billion a year. The gap was defined as the shortfall of savings from the level necessary to deliver pensions in retirement worth half as much as incomes in work.

The purpose of this paper is to set out the key facts about the savings behaviour of the British people and to clarify a number of common misunderstandings on the subject. At the outset it may help to emphasize a basic philosophical issue. Much economic theory rests on the assumption that agents are "rational", in the sense that they process all available information and take intelligent, far-sighted decisions about their own lives. Whether people are economically rational in this way is a matter of controversy, but there is no doubt where the Pensions Commission stands. Its report says bluntly, "Most people do not make rational decisions about long-term savings without encouragement and advice." While conceding that "a muddle-through option" exists, the report says that option "would produce outcomes both less socially equitable and less economically efficient than we could achieve with a consciously planned response". Chapter six is openly sceptical about "a voluntarist solution". The tenor of the report is to favour increased state intervention (and extra taxation) as the answer to - what it terms - "the problems we face".

The underlying premise of this paper is that the Pensions Commission's attitude, which might be characterised as "high-minded paternalism", is misguided. By describing the main features of saving and wealth in Britain today (and for several decades past), the paper will show that on average members of the British public behave with remarkable good sense in their financial planning. However, that does not close the discussion. The motive for the Pension Commission's paternalism may be that its members are worried not about the level of incomes in retirement for the UK's elderly population *in the aggregate*, but about the inequality of the distribution of incomes and wealth *between different pensioners*. The validity of concern about inequality is always subjective to some extent, since the social sciences have no agreed procedure for making inter-personal comparisons of utility. The Pensions Commission is nevertheless fully entitled to draw attention to distributional

questions. The trouble comes when perhaps justified anxiety about inequality becomes muddled with an inappropriate critique of the nation's saving habits.

The Pensions Commission report includes a chapter on non-pension saving and housing, but its tendency is to play down the importance of such assets in pensioners' financial position. This is a mistake. The only purpose of economic activity is consumption, while everyone is of course going to die sooner or later. Plainly, people save with only two motives in mind, to finance their own consumption or that of their heirs. If the bequest motive is put to one side for the moment, people build up savings at certain stages of their lives in order to dissave at other stages. In practice dissaving is heavily concentrated in the final years of life, when people are typically less able to earn a living because of age or infirmity. Whether savings are designated "pension saving" or not is irrelevant. All savings - even houses and antiques - are intended either for consumption in retirement or to be left to the next generation(s).

An analysis of the adequacy of "pension saving" therefore cannot be separated from an analysis of *all* savings. As it happens, economics has quite elaborate theories of optimal savings behaviour to which the Pensions Commission's report does not allude. The core message of these theories is that a society should build up capital assets until that point where the marginal rate of return is equal to the marginal rate of social time preference (i.e., the rate at which future consumption is discounted relative to current consumption). The marginal rate of time preference is itself an abstruse idea, but it is obviously influenced by age. (Someone who knows he is going to die tomorrow is not much interested in consumption a year from now.) The subject already sounds very complex - and so indeed it is. The key point is that any analysis of savings must refer to these basic notions if it is to carry conviction. Can the ideas of the rate of return on capital and time preferences be translated, even in a naive way, into what is found in the real world? And - when this had been done - what does the exercise tell us about the rationality of the savings decisions taken by the British people?

Estimates of the real rate of return on capital assets in the UK vary, but there is not much doubt that the figure is somewhere in the 3% - 5% vicinity. Obtaining a measure of the "social rate of time preference" is difficult, unless current market rates of interest are taken as good measures (and that is controversial). However, one expression of time preferences is the apportionment of lifetimes between education, work and retirement. This apportionment is determined by expectations of life and people's intention to consume as much as possible of what they produce before they die, apart from bequests. Roughly speaking, people build up their educational skills in the first 16 to 22 years of life, work for the next 40 years, and expect to live 10 to 25 years in retirement. Assume - a little more ambitiously than the Association of British Insurers - that people want an income in retirement equal to 60% of incomes in work. The question becomes, "with a working career of 45 years, and a likely rate of return on capital of between 3% and 5% a year, what proportion of their incomes should people save to deliver an income in retirement equal to 60% of income in work?"

With some simplifying assumptions, this is an easy question to answer. Let us assume that people have a constant income during their lifetimes. (The cases of growing and/or variable incomes may be more interesting, but require specialist actuarial expertise to calculate.) Then - with rates of return of 3%, 4% and 5%, and a 45-year accumulation period - the following multiples of income would be accumulated in a "savings fund" if all income were saved. The implied incomes from saving are also easy to estimate and are as indicated (i.e., they would of course be 3%, 4% or 5% of the fund).

	<i>Size of fund accumulated over 45 years of constant annual contribution equal to all income</i>	<i>Implied pensioner income</i>
<i>Rate of return on capital</i>	- As multiple of annual contribution	- As multiple of income in work
3%	92.7	2.78
4%	121.0	4.84
5%	159.7	7.99

So - if all income were saved - people would have saving funds at the end of their working careers able to generate incomes between 2¾ and 8 times their working incomes. But - of course - people want to consume while they are working and it is being taken for granted that they are happy with a lower income in retirement than in employment (i.e., 0.6 of working income, not a multiple of it, in our example). In a world of efficient use of the nation's resources and strong investment returns (i.e., 5%-a-year real), they need to save only 7.5% of income (i.e., 0.6 divided by 7.99) to secure the desired retirement income. In the more likely cases where real returns are between 3% or 4% a year, they have to save between 12.4% and 21.6% of income or - in the middle - 17% of income.

(Notice that the income here has *not* been annuitised. Implicitly, the capital stock accumulated by one generation passes in its entirety to the next generation and, in that sense, the bequest motive is absolute. Of course, if the current generation wanted to consume part of its accumulated savings fund in retirement, the required savings ratio during working careers would be lower. The extent to which the required savings ratio should be reduced to allow for more modest bequests is a matter for the individual judgement of particular savers, but it might come down to between 10% and 15% of income.)

In short, on plausible assumptions about the investment returns and the lifetime patterns of working and saving found in modern Britain, people need to save

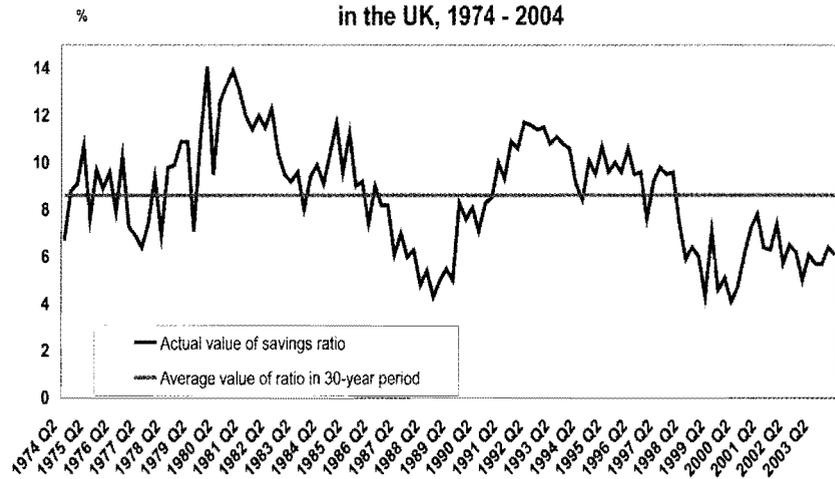
- about 17% of income to achieve their retirement income objectives if the bequest motive is absolute, and
- between 10% and 15% of income if one generation does not pass on all its capital to the next.

How do these numbers compare with the historical record? Have the British people been saving enough?

Jeremiahs about the savings performance of the British people often look at the “household sector savings ratio”. Good official data are available for both household incomes and consumption, and it is easy to calculate the savings ratio as the ratio of income minus consumption to income. It is a volatile series, fluctuating in the last 30 years from a low of 4.2% in the first quarter of 2000 to a high of 14.1% in the final quarter of 1979. (See Chart 1.) Three points are - or at any rate seem to be - obvious. First, the British people are erratic in their financial behaviour. The large swings from a savings ratio of 4% to 14% hardly seem consistent with stable long-term behaviour or with “economic rationality”. Secondly, on average the household sector savings ratio is much beneath the level suggested as necessary in the last section for satisfactory pensioner living standards. Finally, the savings ratio is markedly lower in the last five years of the 30-year period than in the previous 25 years. On the face of it, the UK has a chronic “savings problem” which has worsened radically in the opening years of the 21st century.

The truth is much more reassuring, although it will take a few pages to explain why.

Chart 1: The household savings ratio in the UK, 1974 - 2004



II

How much ought the UK to save?

A vital definitional point has to be emphasized. The correct category in the analysis of “how much the people of a nation are saving” is *not* the household sector. This may seem startling, until it is remembered that the three other sectors (the public sector, industrial and commercial companies, and financial institutions including banks) serve no purpose other than to benefit households. People form companies in order to organise capital assets better and motivate managements, but companies’ assets and liabilities cancel out, and in the final analysis everything in the name of “companies” belongs to shareholders. Similarly, they contribute to savings products created by financial institutions, but financial institutions’ assets and liabilities also cancel out, and property registered by financial institutions is ultimately for the benefit of insurance-policy holders, unit trust holders, pensioners and so on.

The need to focus on the nation, not the household sector, may be explained in a different, perhaps more vivid, way. Considered in the large, an economy consists only of people and things, and the things cannot belong to any agent or set of agents other than “the people”. Some conceptual and definitional issues are raised by the international ownership of assets, and these are addressed shortly. But none of the UK’s buildings, cars, machinery, warehouses and so on belongs to Martians. Some assets may seem remote from the individuals - the private citizens - to whom they belong. This is particularly true of assets registered as in the hands of the state. In the nature of the case, the proportion of such assets to be credited to any one individual is obscure. Do we - in a Britain with almost 60 million people - each own one-sixty-millionth of the Post Office? But the fuzziness of the pattern of entitlement with state-owned assets does not invalidate the point that the state has no meaning apart from the citizens of which it is comprised.

The correct concept of saving in our analysis is therefore the savings of the nation as a whole (i.e., the sum of the savings of the household, public, company and financial institution sectors), *not* household savings. Data for the savings of the four sectors are published by National Statistics, but for financial institutions they are available only from 1987. In order to obtain a longer run of numbers, an approximation can be obtained by adding a current account surplus (or deducting a deficit) on the balance of payments to gross domestic capital formation. The explanation is simple enough, and here we advert to some of the complications arising from international investment. If a country constituted the whole world, its gross savings would equal its gross capital formation. But in practice part of each nation’s accumulation of capital assets reflects the net balance between investment by foreigners within its borders and investment by its citizens in other countries (i.e., the current account deficit or surplus). So the gross capital formation figures need to be adjusted by the

current account position in the balance of payments to arrive at "national savings". Chart 2 sets out the figures for the "national savings ratio", calculated in this way, as far back as 1948; Chart 3 compares the national savings ratio (as a % of GDP) and the household savings ratio (as a % of household resources), using annual data, from 1963 to 2003.

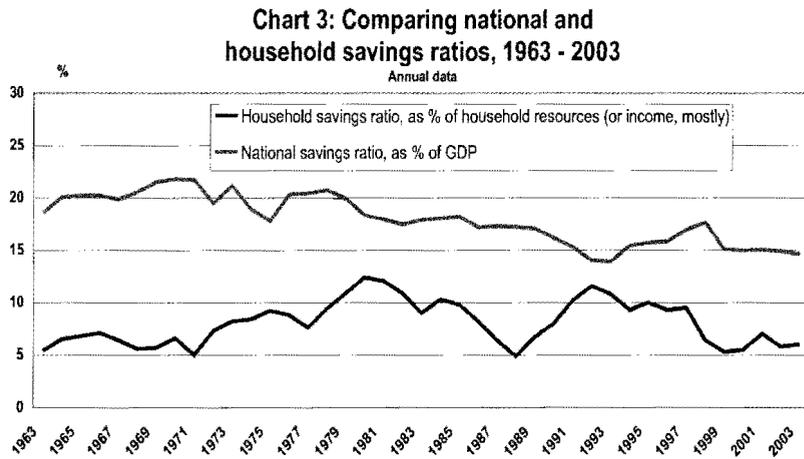
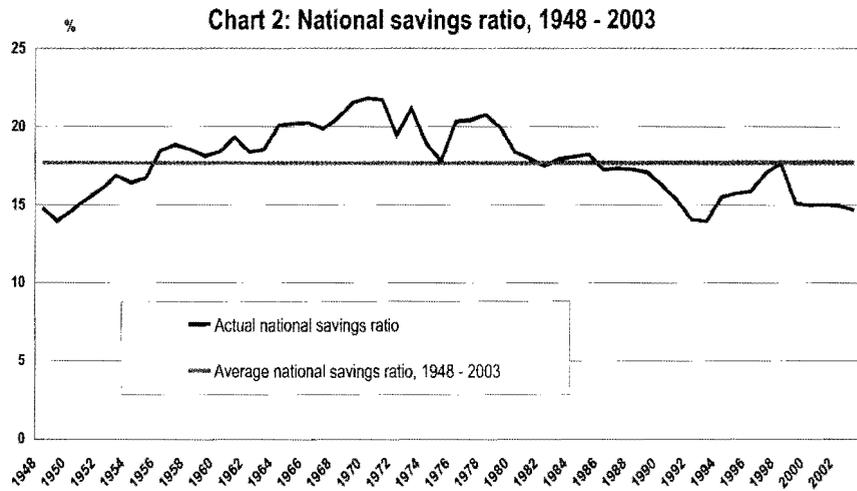
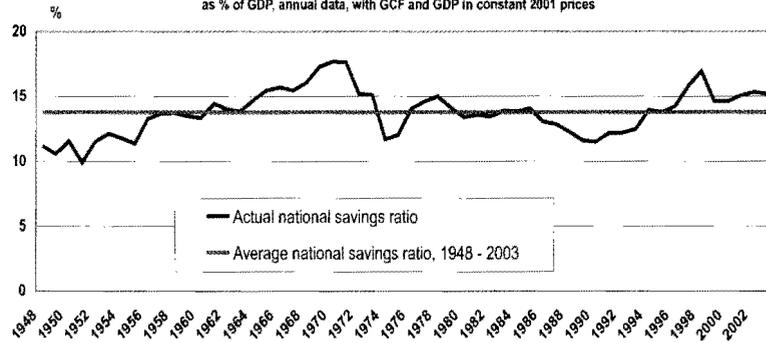


Chart 4: National savings ratio, 1948 - 2003

- Gross capital formation plus the current account surplus,
as % of GDP, annual data, with GCF and GDP in constant 2001 prices



The charts prompt three sets of comments. First, the average figure for the national saving ratio over the whole 55-year period was 17.7%, remarkably close to the number suggested as appropriate for *all* saving by the earlier analysis (i.e., given the balance between work and non-work in a normal lifetime and a real return on capital of 3% - 4%). Whereas the household savings ratio seemed systematically too low relative to the desirable level, the national savings ratio is very close to target. On this basis, the British people – taken as a whole – have behaved for over half a century with impressive financial acumen and foresight. The accusation that they do not make “rational decisions about long-run savings without encouragement and advice” is not just condescending, but wrong.

Second, the national savings ratio is less volatile than the household savings ratio, although this conclusion depends on how the data are interpreted. (The standard deviation of the two ratios is much the same, but the coefficient of variation of the national savings ratio - or the standard deviation divided by the mean - is lower. The explanation is that the national savings ratio is typically over twice the household savings ratio.) If saving is for the very long term, it should be impervious to temporary changes in mood and ought not to fluctuate dramatically from year to year. A fair comment is that, as the national savings ratio is more stable than the household savings ratio, it suggests greater “rationality” in behaviour. The 40-year period under consideration in Chart 3 saw large swings in inflation and budget deficits, crazy boom-bust cycles, a three-day week and extensive strike activity, huge secular variations in asset values superimposed on cyclical instability and warnings from distinguished commentators about the end of British democracy. Yet the standard deviation of the national savings ratio was only an eighth of its mean value. One point is very striking.

The fluctuations in the budget deficit (i.e., in the public sector’s financial deficit) had little effect on the national savings ratio. This is not an exact proof of the so-called

“Ricardian equivalence theorem” proposed by Professor Robert Barro in a famous 1974 article. But it is consistent with the neo-Ricardian idea, and accords with the thesis that people are rational and well-informed in financial matters. (They see, correctly, that additions to government debt do not increase their net wealth.)

Third, in one respect the household and national savings ratios have similar patterns. The national savings ratio has been perceptibly lower in the last five years than on average over the last 40 years, *where both savings and GDP are measured in current price terms*. Superficially, the UK “has been saving less” ahead of the major demographic challenge which lies ahead in coming decades. Apparently the Pensions Commission could use Charts 1, 2 and 3 to support claims that the British people are myopic and, in that sense, irrational. But matters are not so simple. The qualification “where both savings and GDP are measured in current price terms” is critical. The national savings ratio can be estimated on a different basis, in terms of constant prices, where the nominal series for both capital formation and GDP are deflated to allow for the rising price level. Moreover, because the price of capital goods has been rising more slowly than the GDP deflator over the long run, a constant ratio of savings to GDP in current price terms is consistent with a rising ratio of savings to GDP in constant price terms. Chart 4 shows the national savings ratio, *where both gross capital formation and GDP are measured in constant 2001 prices*. On a constant price basis the national savings ratio in the last few years (typically between 14 ½% and 16%) has been above its 1948 - 2003 average of 13.8%. The so-called “savings crisis” evaporates. In terms of the total amount of saving in the UK, there is no problem to discuss.

Admittedly, the choice between the two ways of measuring the national savings ratio is somewhat metaphysical. The current price measure may seem better in that it shows “how much cash has been set aside for the future” and the size of the resulting financial claims; the constant price measure could make claims to superiority because it reflects the greater efficiency of the machinery, ships, planes and so on purchased with saved money. The debate cannot be resolved in a few sentences. At any rate, the uncertainties about the correct analytical approach are related to the importance of successful, high-return investment to pensioners’ living standards (which of course means everyone’s living standards in the end). The table on page 4 above showed that, if the nation’s banks, financial institutions and companies achieve a 5% return on capital, living standards in retirement are dramatically higher than if they achieve a 3% return. The effectiveness (in terms of future output) of a given amount of real expenditure on capital goods is much greater in 2005 than it was in 1955 or 1980. That increased effectiveness – evidenced in the falling relative price of capital goods – has arisen from the active pursuit of new technologies and better methods, mostly in the profit-oriented private sector. The question has to be asked, “should public policy be more concerned about meeting an arbitrarily high target for savings in 2030 or 2050 than in supporting the incentives of a market economy, so that the nation’s savings are deployed as productively as possible?”.

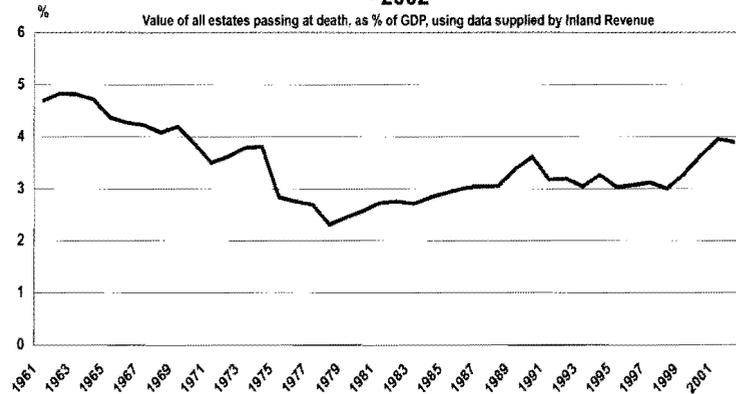
III

Do we save for ourselves or our children?

So far the bequest motive has not played a central role in the discussion. The Pension Commission's report devotes some space to it, particularly in Chapter 5 on 'Non-pension savings and housing' which considers whether the inheritance of houses can significantly boost living standards in retirement. However, a much more detailed discussion is needed. One point is fundamental, if rather obvious. People late in life can increase their own living standards if they leave less for future generations. How large might the benefit to pensioner living standards be from a change of behaviour of this kind?

The first step must be to estimate the importance of the inheritance of assets relative to national saving at present and over the last few decades. Chart 5 shows the size of estates passing at death, expressed as a % of GDP, from the 1960s until recently. Of course, wealth passes between the generations not only at death, but also during the lifetimes of people leaving assets to their heirs. The author is not aware of exact estimates of such wealth transfers, but there cannot be much doubt that they are substantial, particularly among the rich. Indeed, inheritance tax has often been described as "an optional tax", because it can be avoided by gifts *inter vivos*. Inheritance tax receipts in recent years have typically been about 1/4% of GDP, but the net estates of those paying inheritance tax have been much larger at over 2% of GDP. (In 2001-2 the net value of estates above the IHT threshold was £23.1 billion, compared with a GDP of £1,005.2 billion.) If it were assumed that

Chart 5: The importance of inheritance in the UK, 1961
- 2002



gifts *inter vivos* were equal to the value of estates passing at death for those households subject to IHT (and which evidently have an incentive to avoid it), gifts *inter vivos* might reasonably be estimated at 2% of GDP. It follows that the value of all inheritance (i.e., the sum of estates passing at death and of gifts *inter vivos*) in the UK is typically about 5% of GDP. In fact, the value of inheritance is roughly equal to the value of the flow of household saving, although both are much less than the flow of total national saving.

The next stage in the analysis is to ask, "what is likely to happen to inheritance on past trends?". A fair surmise is that the probability of passing on wealth (rather than consuming it) depends on whether the elderly have children or not, as well as the financial circumstances of the prospectively inheriting generation. Of course, if the inheriting generation is wealthy, there is less point in sacrifices by their parents late in life. These considerations are very general, but some specific comments can be made. Home ownership is wider today than ever before and, in that sense, the prospectively inheriting generation is less deserving than earlier generations. Perhaps more fundamentally, the number of childless women has risen sharply in recent decades. According to the 2004 edition of *Social Trends*, "Eleven per cent of women born in 1925 were still childless at age 35; this proportion increased to 25% for women aged 35 born in 1965. It is expected that this trend will continue." The message must be that the bequest motive is likely to be weaker in the next few decades than in the second half of the 20th century.

Indeed, the rise in the proportion of childless women (to the total female population) and the demographic challenges of the early 21st century are related. The demographic challenge arises partly from the increase in life expectancy and partly from the decline in fertility. To the extent that the problem of pension provision arises from the decline in fertility, behaviour is likely to be partly self-correcting. Elderly couples and individuals without children do not have a bequest motive of the same kind as those with children, and they are therefore likely to consume more of their wealth before they die. The attenuation of the bequest motive ought by itself to reduce the aggregate savings ratio. If the savings ratio does fall for this reason, it is not a concern for public policy. (This is not to deny that childless people may have a valid bequest motive, because they wish to donate to charities. Nevertheless, the analytical argument must be right.)

A particularly vivid way of illustrating the point is to consider a population in which everyone is over the age of 70. It becomes essential to distinguish between net and gross savings and investment, with the net figures being equal to gross figures minus depreciation. Obviously, the optimal net savings ratio is likely to be negative, i.e., society should be running down its capital stock. The gross savings ratio cannot be negative, unless the nation is borrowing from abroad, but it may be close to zero.

Descriptions of this sort of society - where the "grey-ing" of society has been taken to extremes - may seem morbid. But that is not the point. To repeat, the only objective of economic activity is consumption - and, insofar as consumption is not carried out by the current generation, it is to be carried out by succeeding generations. Saving has no end in view apart from consumption at a later date and/or the making of a bequest. It must follow that - by weakening the bequest motive (which, as we have seen, is very large relative to household saving) - a society experiencing a large trend decline in fertility has less need to save. If people are indeed saving less, this may not necessarily be a reason for alarm.

IV

The Pensions Commission's flawed interventionism

The Pensions Commission's first report brings together much useful information and analysis, and will enhance the quality of the discussion of UK pensions policy. But its paternalist attitude leads it into a false pessimism and inclines it towards more state intervention (i.e., towards recommending increases in state pension provision and extra taxation to pay for them). The report claims on the first page of its 'Foreword' that in the past the pensions debate has proceeded too often "on the basis of analysis of specific isolated issues". Unfortunately, the same accusation can be levelled at the report itself. Its focus on pension saving is too narrow. Pension saving is only part of "household saving", while so-called "household saving" is itself but one component of a nation's savings. The correct analytical category in an analysis of the adequacy of savings is the total of *all* savings within a nation (i.e., saving by households, companies, financial institutions and the public sector). Further, every chapter of the report contains statements about "unsatisfactory" or "inadequate" pension savings, without clearly relating them to the definition of pensions adequacy it provides on p. 129 of the main text. Nowhere does it recognise certain obvious facts of life and death, and the bearing that these have on the issues under consideration. Because we are all going to die, the rational approach towards his or her life choices by every individual is to consume everything that he or she has produced and saved, *apart from bequests left to later generations*. It follows that the balance between the consumption of savings in retirement and the amount left to the next generation (i.e., between dissaving in retirement and inheritance) is critical to the analysis of pensions adequacy. Yet nowhere is this subject – admittedly a very sensitive and awkward one to discuss – given the attention it deserves.

This paper has identified salient features of savings in the UK. It has shown that – when the analysis runs in terms of the national savings ratio – the British people have been behaving with remarkable foresight and rationality over periods of several decades. Given the typical rate of return on capital in this country, and the traditional apportionment of a lifetime between work and non-work of most people, the UK ought to save about 15% and 20% of its output. And that is exactly what it had been doing, on average, since the Second World War. The 15% - 20% ratio is broadly the right figure to deliver incomes in retirement (which will be a mixture of private and state pension income, *and interest, rents [including imputed rents on owner-occupied houses,] dividends and social security benefits,*) equal to about 50% - 75% of incomes in work. Recent decades have seen a bewildering sequence of policy changes relevant to decisions to save and invest. (Examples are cyclical boom-busts; the wild inflations of the 1970s and 1980s; absurd and never-ending changes in pension rules; Finance Bills of ever-increasing length, complexity and fatuity; the proliferation of savings regimes with BESs, PEPs, ISAs, VCTs and AIM-quoted

stocks; and house price explosions and slumps.) Given the instability of the savings environment – largely imposed on them by an erratic, unpredictable and faddish governing elite – the stability of the British people's behaviour is remarkable.

Further, contrary to the impression of savings inadequacy given by the Pensions Commission's report and much other literature in this area, one generation of British people saves largely for the benefit of the next generation. Inheritance is roughly the same size as the savings which appear in "the household savings ratio", although – as already emphasized – such saving is only part of national saving. The extent of inheritance should make the members of the Pensions Commission pause for thought. It is difficult to believe that decisions to make bequests to the next generation are involuntary. (We are talking about birth, death, families and children, subjects which are the emotional core of our lives.) But – if we (the members of one generation) voluntarily make such large bequests to the next – how can it be that we are not saving enough for ourselves?

It is time to recall our introductory remarks. The Pensions Commission's true concern is not with the inadequacy of saving in the UK, but with the inequality of the distribution of income and wealth. Their first report is plainly inclined towards more state intervention to deal with the alleged mal-distribution and, in the background, there is the threat of more taxation. The redistributive bias is evident, despite some sentences claiming that the job of the first report is only to describe the existing situation and not to make prescriptions. This paper will conclude with two comments.

First, in its discussion of options to deal with the increased future burden of the elderly the report overlooks one possible painless answer, namely an increase in the rate of return on pension saving (and indeed on the capital stock more generally). To make this observation is of course not to suggest that the future rate of return on saving will be higher than it has been in the past. But it is to emphasize that the adequacy of savings will depend critically on the rate of return achieved. The Pensions Commission is deluded if it believes that economic efficiency is unaffected by tax levels. Large rises in taxation will – for example – widen the gap between pre- and post-tax rates of return on capital, and reduce the equilibrium capital stock. The great virtue of voluntarist solutions (i.e., of living in a nation where individual agents, not the state, make decisions about consumption and saving, and production and investment) is that marginal tax rates are lower and the equilibrium national income is higher. If public policy could remove the numerous constraints on economic efficiency which hold back Britain's companies and reduce its output, the nation's savings would achieve a higher return. Pensioners could then enjoy better living standards without straining the nation's resources. In the long run increases in taxation cannot make our nation richer.

Secondly, the Pensions Commission has confirmed the shocking inequality which characterises British society. Bluntly, the bottom quarter of the population (if the expression can be forgiven) make no savings whatsoever, and have no financial or

tangible wealth of any kind. While in work they live off their incomes, but in retirement they rely entirely on the state. Well-wishers (“high-minded paternalists”) may want these people to have more – but that has effects on relativities with people slightly higher up the scale. So the incomes of people in the second quartile have also to be topped up, establishing a trend towards more generous benefits. The trouble is that the members of low-income groups with voluntarily accumulated wealth (i.e., with means of their own) are deemed to deserve less help than those without. The dynamics of state-organized compassion are such that fewer people save and means-tested benefits are extended to an ever-increasing proportion of the population. In fact, estimates have been made that, on current policies, over 80% of pensioners will be in receipt of means-tested benefits by the 2020s.

The effects of the destruction of savings incentives for the majority of the population are easy to predict. As noted, the expansion of means-tested benefits will cause an increasing proportion of the working population to make no voluntary savings for retirement. And what will that do to the inequality of income and wealth? The answer is of course that it will not just entrench such inequality, but intensify it. The ever-increasing inequality may then justify yet more special commissions, official committees and such like to recommend action to reduce inequalities which are in fact the result of previous misguided paternalism and undue state intervention. A malign and ultimately self-defeating spiral of interventionism develops. Further, the traditional incentives to work and save, to have a large capital fund late in life and to make substantial bequests to one’s heirs, will apply to a diminishing number of people. It is clearly implicit in the Pensions Commission’s report that this group – reduced virtually to only a tenth of population – will have to pay the bulk of the extra taxation supposed to deal with “the problems we face”. (Who, pray, are “we”?) As already noted in this paper, the Pensions Commission is wrong to think that British people are irrational in their financial planning. Members of the top 10% are well aware of the sort of society in which they are living. If the tax burden becomes unacceptable, they will make further preparations to move themselves and their assets out of the reach of the British government. The tax base will contract – and the government’s ability to pay satisfactory pensions in future decades will decline. To repeat, in the long run increases in taxation cannot make our nation richer.

V

What needs to be done?

The argument of this paper has been that the British people are intelligent and rational in their long-range financial planning. By implication, a perfectly acceptable answer to the question “how does public policy need to change?” is “not much”. People will see the threats to, and opportunities for, their living standards in old age, and make the appropriate responses. They will choose careers and the length of their working lives, and they will accumulate assets while they are in work and run down assets in retirement, just as they have done for decades and indeed centuries in the past. The overwhelming majority of British people are able to own houses and maintain them in good repair, to buy cars and to insure and drive them safely, and to bring children into this world and raise them to adulthood, as well as performing an astonishing multiplicity of complex and specialised tasks in their workplaces. It is preposterous to claim that – if the state left them alone – they would not save enough to look after themselves in later life.

Of course a variety of interventions by the state are themselves among the threats to, and opportunities for, living standards in old age, and people adjust their plans given this framework of threats and opportunities. Without doubt the most important part of the framework remains the basic state pension financed, nowadays somewhat theoretically, by National Insurance contributions. So – if one is confident that the British people know what they are doing in their career and savings choices – the question “how does public policy need to change?” effectively reduces itself to the question “what should be done to the National Insurance scheme in coming decades?”. Implicit in the following proposal – which has the intention of replacing the present National Insurance arrangements – is that the main concerns of public policy should be to prevent poverty in old age, and to avoid the damage to savings and work incentives from the means-testing of benefits. The state may legitimately have a role in redistributing income and wealth (within certain limits which are morally difficult and politically contentious to define). But as far as possible the state should treat its citizens as grown-ups who will reach the best possible outcomes if they make the big choices themselves.

A proposal for a personal, funded and highly redistributive national pensions scheme, sponsored by the state in a free market economy dominated by private ownership

Broad outline

The intention is that the scheme would replace the current arrangements for state pensions (i.e., the basic state pension and the state earnings-related pension), although the many difficulties of phasing in the new scheme are not discussed. Only a broad outline is given here.

Nowadays the cost of retirement pensions is the dominant claim on the National Insurance Fund. In 2001/2 the National Insurance Fund had total expenditure of £55.8 billion and expenditure on retirement pensions of £45.7 billion. So pensions expenditure was almost 82% of all expenditure financed by National Insurance contributions. It is therefore assumed that a scheme which had a cost similar to the current cost of National Insurance would be affordable.

National Insurance contributions, both employee and employer, were £78.3 billion in 2004/5 and are projected to be £83.1 billion in 2005/6.

Central features of the proposal

The core proposal is that people should pay 8% of incomes between £5,000 and £8,000 per year into a unitised Pension Savings Fund, and that the state would top this up by trebling the units received. So everyone earning £8,000 a year would pay £640 a year into the fund and – if a unit were priced at £1 – would receive 1,920 units (i.e., with 1,280 bonus units) to the initial value of £1,920. Unless people saved from post-tax income, that would be the maximum anyone would receive. (People might be free to save up to another £1,000 a year, say, in the Pension Savings Fund from post-tax income, but such savings would not receive any bonus units.) In the case of married couples, the right to the bonus units could be secured on the husband's (or wife's) income and the units transferred to the wife (or husband). But to secure the extra bonus units in full the husband/wife would have to earn an income of £11,000.

Where would the money to pay for the extra units come from? At present over 27million people are at work in the UK, implying that the average "social security contributions per employed person" are about £3,000. This is above the cost of the units per person (i.e., £1,920). So the burden of NI contributions could remain much as at present. (In the author's view, increases in employment and hours worked would probably follow the introduction of the scheme, as unemployed people or people on low incomes would try to achieve an income of £8,000 at which they would receive all available bonus units.)

Needless to say, the offer of bonus units ought to cause people currently outside the tax-and-benefits system (often working, but not declaring the income) to try to join it.

The investment of the funds

The annual inflow into the Pension Savings Fund would be enormous, in line with the £80 billion or so of social security contributions at present. The money would be parcelled out between, say, 100 fund management companies, with the decision on the allocation

between companies decided by a parliamentary committee or a committee subject to legislation, such as the Monetary Policy Committee. The aim would be to achieve a 4%-a-year real return. (The fund management companies would make bids, "we wish to manage £2 billion and promise a minimum return of 2 ³/₄% real, and will make good shortfalls from capital", "we wish to manage £500 million and will plan to achieve the total return on the FT all-share index plus 1%, with no fee to us if the return is that on the FT all-share index or lower, but will not make good shortfalls from our own capital", etc.) If the actual return were 1% or so beneath 4%, the shortfall would be made good from taxation; if the return were more than 1% beneath 4%, the rate might have to be re-set; and, if the return were above 4%, a reserve would be set aside for a rainy day.

Members of the scheme – which would almost certainly include over 95% of the male population and probably over 85% of the female population – could draw on benefits after 45 years of contributions or from the age of 68. They would be free to defer drawing on their funds until the age of 70 and might receive super bonus units from deferral. Sums would accumulate tax-free inside the fund, as with pension funds at present.

Assuming that a member works for 45 years and that the fund achieves a 4%-a-year real return, the fund would be worth roughly £232,500 in terms of today's money. A married couple, with slightly longer working lives than normal, could look forward to a capital sum of £500,000.

Entitlement and ownership

Every member of the scheme would be given a passbook, with the number of units saved entered on a regular basis. The sums in the passbook – unlike the notional claims people have on the National Insurance Fund – would be the members' private property.

If people die before being able to benefit from the sums saved, the amounts in the fund can be passed on to spouses and heirs. They would form part of a person's estate, like unitised pension fund assets at present.

Sums in the Pension Savings Fund would be ignored in the calculation of means-tested benefits until they were withdrawn at the start of retirement. Sums withdrawn would have to be annuitised. Even with low annuity rates, annuities on sums like £250,000 would imply adequate incomes in retirement for everyone who had belonged to the scheme.

VI

Conclusion: high taxation will reduce economic efficiency

An accepted feature of modern market economies is that – if someone saves – then he or she is entitled to the benefit of the saved asset, plus the income from it, in future. Of course, if this were not so, the incentive to save would be reduced. In the extreme (i.e., in an environment in which property rights were wholly insecure, perhaps because of political instability and civil unrest), the incentive to save might be eliminated entirely. A sequence of influential British thinkers in the early modern period – especially Hobbes, Locke and Adam Smith – understood that one purpose of the state was to provide a stable framework of law to protect property rights. Given that framework people could escape from the uncertainties of a Hobbesian state of nature. By working and saving, they could then build up assets for themselves and their families. This understanding of the state's role in property relationships was essential to the Industrial Revolution. The British people have enjoyed virtually continuous improvements in living standards since Hobbes, Locke and Adam Smith wrote their classic works of political and economic philosophy.

But in the 20th century they were far from being the only influences on British political and economic thinking. Other philosophers focused not on the need for stability to ensure that individuals had incentives to work and accumulate, but on the case for greater equality in the distribution of income and wealth. The principle that “if someone saves, he or she is entitled to the benefit of the saved asset, plus the income from it” was transformed into the principle that “if someone saves, he or she is entitled to part of the benefit of the saved asset and its income, but the rest of it can be appropriated by the state for wider ‘social’ purposes, including redistribution to the less well-off”. The Lockean endorsement of the right to life, liberty and property appealed to one notion of justice, that an individual (and his or her heirs) should be entitled to what that individual has produced. But it came into conflict with another notion of justice, a notion which might be termed “utilitarian” or “socialist”, depending on one's preferences. This was that the state should seek the happiness of all members of society and redistribute to the poor.

In questions of long-term saving, a sharp tension emerges between these different interpretations of distributive justice. Consider two individuals, A and B. A earns throughout his 45-year career twice as much as B, saves twice the proportion of his income that B saves (say, 20% compared with 10%), and achieves an annual rate of return on his savings of 5% real compared with B's 3% real. Few people would regard the differences in the income earning and savings behaviour of these two individuals as particularly remarkable. (In the real world of modern Britain the pre-tax income differential between the top and bottom 10% of the working population is over 10 times, while the top 10% save over 20% of income and the bottom 10%

barely save at all.) However, at the end of their 45-year careers A has assets which are seven times those of B. If the two individuals now run down their assets until they die (for simplicity, at the same age), A – who had an income in work only double that of B – can enjoy an income in retirement which is almost seven times B's.

The large difference in pension incomes between A and B might prompt calls for intervention by the state in order to equalise outcomes. The judgement might simply be, "the seven-times gap in living standards between A and B is too large". But each of the determinants of the inequality between A and B – the difference between incomes, the difference in savings behaviour and the difference in investment returns – would hardly raise an eyebrow of disapproval in a society like modern Britain. So what is the ethical or practical basis on which the state taxes A in order to redistribute to B? If the process by which large inequalities emerge is just, by what criteria can the state defend attempts to reduce these inequalities?

Fundamental here is an assessment of the long-run consequences of high taxation on incentives to work and save. In his book *Just Capital: the Liberal Economy* Adair Turner argued that the modern industrial state could cope with a tax ratio (i.e., a ratio of government expenditure and tax to GDP) of 40% or even 50%, since many European nations have a tax burden of this kind. The claim needs to be considered in more detail. Suppose that we accept that people will not work or accumulate an asset if they face a tax rate of 100%. Suppose we also accept, perhaps more controversially, that working and saving subject to a tax rate of 80% is implausible. Suppose also that, as good liberal democrats (or whatever), we want the state to redistribute 20% of national income. Then – if the tax ratio in the nation being analysed is 60% - it is obvious that the average tax rate on the group subject to net taxation must be 80%, while the average tax rate on the group receiving net income from the state is lower. Inevitably, marginal tax rates are likely to be higher for everyone. Moreover, those groups receiving net income from the state need the increase in post-tax incomes associated with employment to exceed the loss of benefit entitlements during unemployment if they are to have any incentive to work. In short, a nation with a big state sector and redistributive objectives has largely destroyed the incentives to work and save. The oversized state sector cannot be reconciled with both redistribution and economic efficiency. It is hardly surprising that no society has had a tax ratio above 60% for an extended period. *Pace* Mr Turner, beyond a certain point high taxation cripples an economy.

Now it is true that this logic is not quite so compelling if government expenditure is 40% or 50% of GDP. But Britain – like other European societies – faces a long-run demographic problem. If present commitments are honoured, health and social security spending will rise sharply relative to GDP from 2010 onwards, as the baby-boomer generation retires. Tax ratios approaching 60% will become commonplace. Europe, already falling behind other regions in relative economic importance, will become a financial and industrial backwater. In these circumstances it is

irresponsible for any official committee, charged with the task of reviewing public policy in the long run, to make any proposals which would lead to a large rise in the tax burden.

The proposition "if someone saves, he or she is entitled to the benefit of the saved asset, plus the income from it" has a definite corollary. Bluntly, "if someone does *not* save, he or she is *not* entitled to the benefit of the assets that other people have saved." If a life insurance company were to sell savings products with a warning that high savers will be short-changed relative to low savers, it would not sell any products; and, if a pension fund were to tell its members that those with high and continuous contributions records will lose out to members with low and discontinuous records, its members would flee. But the state is different: it does not sell products, and does not have to behave in the same fair and equitable way to its customers as private corporations. That is what makes its power to tax so dangerous. Because of the possibility of heavy taxation in future, every high-saving citizen takes a risk that he or she will not benefit from a lifetime of diligence and thrift, as the state doles out money to citizens who have saved nothing at all.

To repeat the message one last time, in the long run increases in taxation cannot make our nation richer.

Appendix: A short description of savings and investment in the UK

Chapter 2 explained both

- why *the nation's savings*, and not the savings of *the household sector* alone, and
- why *all forms of saving*, and not pension saving by itself,

were relevant in assessing the adequacy of savings. A short description of the nation's savings and investment behaviour is needed. According to official statistics, most of the nation's saving is to cover depreciation (or "capital consumption") on existing capital assets. Net saving and investment (i.e., after deduction of capital consumption) are lower than gross saving and investment. At the time of writing (June 2005) capital consumption estimates are available for 2003, but not 2004. There are two further complications. First, the UK saves less than it invests, with the difference met by foreigners' net acquisition of UK assets. (This approximates the current account deficit on the balance of payments.) Secondly, the notion of the nation's gross "investment" is ambiguous. The word could refer to "gross fixed capital formation" (i.e., the addition to such fixed capital assets as buildings, plant, and equipment) or to GFCF plus the change in inventories. (Deeper ambiguities in the concept of "investment", and particularly investment in "human capital", are discussed below.) The key numbers in 2003 were as set out in Table 1.

	£m.
Gross saving	163,501
Gross fixed capital formation	179,534
Gross capital formation (i.e., including change in inventories)	182,001
Current account balance on balance of payments	-18,739
<i>Memo item: gross saving minus gross capital formation</i>	-18,500
Capital consumption for whole economy	115,342
Net capital formation	66,659
<i>Memo item: Net capital formation is gross capital formation minus capital consumption</i>	
<i>Source: UK Economic Accounts, fourth quarter of 2004 (London: Office for National Statistics, 2005)</i>	

If these figures are to be interpreted properly, they have to be compared to national income and wealth. The idea of "wealth" is very difficult, and a key problem has again to be discussed briefly in a later paragraph. The Office for National Statistics

does have a figure for “national net worth”, estimated at £5,344,305 million at the end of 2003, but it should not be pressed too hard.

Table 2: National income, savings and investment concepts	
Figures for GDP, GNI and GVA are all in money terms and, as in Table 1, relate to the year 2003.	
	£m.
Gross domestic product at market prices	1,101,144
Gross national income at market prices	1,122,575
Gross value added at basic prices	1,030,320
	% of GDP at market prices
Gross saving	14.8
Gross fixed capital formation	16.3
Gross capital formation <i>(i.e., including change in inventories)</i>	16.5
Current account balance on balance of payments	-1.7
<i>Memo item: gross saving minus gross capital formation</i>	-1.7
Capital consumption for whole economy	10.5
Net capital formation	6.1
<i>Memo item: Net capital formation is gross capital formation minus capital consumption</i>	
<i>Source: UK Economic Accounts, as above</i>	

“National income” might seem easier, as it would appear to be the sum of all the incomes (wages, salaries, profits, rents) generated in the UK economy. But two adjustments complicate the matter. First, net income from abroad needs to be added to the UK’s gross *domestic* product to arrive at a figure for gross national income, of which household income is a part. (The household savings ratio – which receives some media attention and has been mentioned in this study – is a measure of savings relative to household income.) Secondly, gross domestic product *at market prices* is boosted by indirect tax (and reduced by subsidies) on the goods and services that people and companies purchase. “Gross value added at basic prices” measures national output with indirect tax payments deducted and subsidies added.

In Chapter II it was argued that – on reasonable assumptions about the rate of return on savings, and the balance between education, work and retirement in a typical lifetime – people need to save about 17% of income to achieve retirement incomes equal to 60% of work incomes. It was also shown that – when the UK’s savings in all forms are expressed as a ratio of its GDP at market prices – the “savings ratio” had

averaged close to 17% over the 55 years to 2003. However, a case could be made that the savings ratio should be estimated relative to either gross national income or gross value added at basic prices. Such estimates would lead to different numbers for “the national saving ratio”. If gross value added at basic prices were chosen (on the very sensible grounds that the adequacy of investment should not be affected by the balance between direct and indirect taxation), the national saving ratio in 2003 was 15.9%. At any rate, Table 2 on the previous page gives three different measures of national income and output, and the main savings and investment aggregates as a percentage of GDP at market prices in 2003.

The discussion so far may seem to be technical and recondite, but in fact several fundamental issues are raised. To repeat, a key argument in the text was that a savings ratio of 17% would deliver adequate incomes in retirement. But are the “savings” (and the associated investment) in this calculation to be gross or net of depreciation? The question is basic, because – as Table 2 demonstrates – net capital formation in 2003 was only 6.1% of GDP, whereas gross capital formation was 16.5% of GDP. If a net-of-depreciation concept is appropriate, the UK is saving too little. In fact, the shortfall from the level of savings required to give satisfactory incomes in retirement is enormous, amounting to perhaps 5% or 10% of GDP. The entire argument of this study would crash to the ground.

Fortunately, a strong argument can be presented that the gross concepts of savings and investment are the right ones. Part of the weakness with a net-of-depreciation concept is the rather dubious nature of almost any estimate of “capital consumption”. For example, national income statisticians have immense difficulties measuring the contribution of new products to GDP. The difficulties are particularly severe with new types of capital equipment, such as computers and mobile phones. It seems likely that standard approaches to the measurement of “capital consumption” (in which capital assets are assumed to have certain lives and that £1 million of expenditure on “gross fixed capital formation” in 2003 has the same product composition as £1 million of such expenditure in 1993 or 1983) overstate the extent to which the capital stock would deteriorate in the absence of new investment. As it happens, official estimates of capital consumption include numbers for the depreciation of intangible capital and land, both of which (in the author’s opinion) are incredible.

A huge problem here – and in every estimate of income and wealth – is the neglect of the improvement in people’s skills (due to learning on the job as well as formal education), the associated importance of “goodwill” in the valuation of corporate equity and the dominance of “human capital” in a broad concept of a nation’s “wealth”. The UK – like other nations – devotes about 5% of GDP to formal education, but most workforce skills are undoubtedly acquired from experience in employment. (The standard pattern of lifetime earnings – with peaks usually 20 or 25 years after starting work – proves the significance of experience in the acquisition of human capital.) If a nation’s entire GDP is capitalised (i.e., multiplied by 20 times

or some such figure, to reflect a discount rate which should presumably be similar to the marginal rate of social time preference), human capital is much larger than the ONS's figure for "national net worth". Indeed, because it is usually some measure of the value of *tangible* and easily-valued capital assets, "national net worth" cannot be the whole story. A large part of the value of corporate equity is goodwill, which might be interpreted as (at least part of) the capitalisation of the human capital of the people who work in companies. *Pace* the Office of National Statistics' view that "intangible assets" depreciate, it must be true that the UK's intangible wealth is continually increasing.

Table 3: Different sectors' contributions to national savings and investment totals

Figures are in money terms and relate to 2004

	Gross saving		Gross fixed capital formation	
	<i>£m.</i>	% of national total	<i>£m.</i>	% of national total
Households	44,989	26.4	65,165	31.7
General government	-14,361	-8.4	20,217	10.3
Financial corporation	14,645	8.6	3,119	2.1
Non-financial corporations	125,029	73.4	107,364	56.1
UK national total		170,302		195,865

Source: UK Economic Accounts, as above

While these matters may not be capable of formal proof, the gross concepts of savings and investment seem the correct ones to use in an assessment of savings adequacy, not the net concepts. (This is surely an important subject for the Pensions Commission to address in a second or later report.) Table 3 breaks down the UK's savings and investment according to the type of economic agent concerned. The preponderant role of companies (labelled "non-financial corporations" in official publications) in the nation's saving is clear. The bulk of investment is financed from retained earnings, not from new issues which tap into the pool of institutional funds built up from household savings. As depreciation is very large relative to both corporate profits and business investment, the need to clarify the relative significance of gross and net savings and investment concepts is clear.

One final comment is in order. It is plain that the concepts of "savings", "investment", "rate of return", "capital" and "wealth" are beset by ambiguities of great complexity. Estimates of a national "savings gap" precisely to one or two billion pounds should be treated with caution.