

# PEOPLE'S PENSIONS

NEW THINKING FOR THE 21<sup>ST</sup> CENTURY

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**A NEF DISCUSSION PAPER**

## Foreword

Where does money come from? Who does it go to? And what does it do when it gets there? These are all key questions for new economics, both on the international stage and at home in Britain. In projects ranging from *Jubilee Research's* work on international debt, to the social function of *Time Banks*, the promotion of complementary currencies, and all aspects of community development finance, including the innovative new *London Rebuilding Society*, the New Economics Foundation is grappling with these issues and searching for creative, effective solutions.

Internationally, in the majority world, money is needed to eradicate poverty and pay for the millennium development goals. But attempts to attract it by making countries more 'investor friendly' can be expensive, ill-focused and counter-productive, often pushing people's most important needs to the bottom of the pile.

One answer in the global development debate has been to shift the focus away from depending on the vagaries of the international capital markets, to look at mobilising domestic resources, such as savings. At home, in Britain, the same problems exist. Attempts to leverage private sector cash to pay for schools and hospitals have repeatedly been exposed as bad deals for the public. At the same time there is a pensions crisis with people in

Britain seeing their life savings destroyed by the same volatile global markets that wreak havoc in poor countries.

This discussion paper published by NEF outlines one, highly flexible, way forward out of this double domestic dilemma. Its approach gives people more control over where their savings go and what they do.

It proposes an adaptable model much more insulated from market turbulence than orthodox pensions schemes. And, as a result, a model that will be highly attractive for the millions of people seeking financial security in old age. It will be capable of raising large sums of money to invest in necessary public services and can easily be adapted to invest in immediate local priorities. Richard Murphy, Colin Hines and Alan Simpson MP have given us something that is necessary, and in short supply: new thinking on pensions for the 21<sup>st</sup> Century.

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# People's Pensions

## New thinking for the 21st Century

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### ■ The pension crisis

There is a pension crisis in the UK. The symptoms are easy to spot:

- the state old age pension is not enough to live on
- pensioners are living in poverty because they are not claiming the means tested top up payments to which they are entitled
- many people doubt the state's commitment to paying a decent pension in old age
- there are some pension companies now at risk of going out of business
- millions of people have seen the value of their private investments decrease as the stock market has fallen in value by 43% in three years
- the National Association of Pension Funds estimate that UK pension funds fell in value by more than £250 billion in 2002 as a result<sup>1</sup>
- companies are closing their pension schemes and substituting less generous arrangements
- individuals are not saving for their old age because they fear that they will be penalised by the state if they do and that they might lose whatever they put in anyway

### ■ The Government response

The Government issued a Green Paper in response to this crisis in December 2002. That Green Paper tinkered with the rules regarding existing pension arrangements but did not:

1. recognise the root cause of the pension crisis
2. promote adequate remedies to the pension crisis

The principle reason for this is that the Green Paper did not recognise that the stock market has proved to be an

irrational place to invest long-term pension savings, and will remain so. The financial services industry and stock markets are no longer able to supply what a modern pension structure demands of them.

No solution to the pension crisis is possible until it is recognised that entirely new arrangements for pension saving are needed. There may be an argument about needing to save more, but what must be recognised is that the pension crisis is the result of pension rules requiring pension cash to be invested in the wrong things. As such more radical solutions than those proposed in the Green Paper are required.

### ■ The People's Pension

This paper proposes an entirely new arrangement for the provision of second<sup>2</sup> pensions in the 21<sup>st</sup> century. This is called the "People's Pension". It is not a mere tinkering with the rules (as, for example, stakeholder pensions were). The People's Pension is different because it looks at the pension crisis as one part of a range of problems affecting the UK economy, and creates a solution that solves both the pension crisis and many of those other problems as well. And, as fundamental elements in that solution:

1. it includes the explicit assumption that the basic state old age pension must be sufficient for a person to live on with dignity and without the need for means testing, and releases finance to assist this. It also incorporates the assumption that this pension will increase in line with earnings
2. it provides a way to substantially improve the State Second Pension which means that this scheme will be much more attractive than it has been
3. it creates an entirely new investment framework, completely free of the stock market, to provide a secure and safe place in which an individual or company pension scheme can invest to provide for a pension in retirement

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## ■ People's Pension Funds

All of this is possible because the People's Pension will be backed by People's Pension Funds. These entirely new funds will be created to provide a way in which pension contributions can be invested in the building of new public infrastructure projects such as:

- schools and universities
- hospitals and other health facilities
- transport systems (including railways, trams and bus networks)
- social housing
- sustainable energy systems

It is not possible for pension contributions to be specifically directed in this way at present. Instead the £750 billion<sup>2</sup> in UK pensions funds at present are invested in (with the proportion in each shown in brackets)<sup>3</sup>:

1. shares issued by private companies (71%)
2. commercial land and buildings (6%)
3. cash and bank accounts (3%)
4. UK government bonds (17%)
5. other bonds (3%)

In 1962 51%<sup>3</sup> of total pension fund assets were invested in UK government bonds. In 1993 it was just 7%<sup>3</sup>. The figures for 2002 quoted above reflect a move out of equities as a result of falling share prices. Even so the amount of cash in pension funds used to help public investment in the UK remains very low. This is because:

- government bonds are an investment option usually only selected by pension fund managers for those approaching retirement
- those with a choice as to where their funds are invested are usually advised against investing in government bonds on the grounds that they are "too safe to provide a useful return"

- people are normally guided towards share based investments. The degree of irrationality in this is detailed below

The creation of People's Pension Funds would change this to create an investment model that is:

- sustainable
- secure
- rational, and
- desirable

As a result it would benefit the pension fund, the pensioner and society at large. It will also, from a national perspective, re-balance the availability of investment funds. It has been illogical that the public sector, which generates over 40% of gross domestic product, has not had direct access to pension funds, the largest source of savings cash in the UK.

## ■ Choice

There will be no compulsion on anyone to save in a People's Pension Fund. It will always be a choice to do so, and it will be an option in addition to those choices already available. There will be a variety of different People's Pension Funds, just as there are a lot of existing pension funds. This is important to provide choice. A People's Pension Fund will be specifically linked to a:

1. government department
2. local authority
3. other statutory authority e.g. an NHS Trust or an education authority
4. charity or other public not for profit body undertaking public work e.g. housing trusts

This organisation will be called the "sponsor" of the People's Pension Fund. The People's Pension Fund will raise the money needed to build the infrastructure projects that these bodies need in order for them to undertake their work. This will mean that a person wishing to make a

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contribution to a People's Pension Fund should be able to choose between investments:

- in the type of services they think desirable and/or
- in the area/region of their choice

To make this possible a person could invest in more than one People's Pension Fund, and would have their own separately identifiable account with each one in which they invest, just as a person has now if they invest with more than one pension scheme or company.

## ■ People's Pension Funds – a real alternative to privatisation and PFI

What a People's Pension Fund will never do is undertake the work of the sponsoring organisation. So, if a People's Pension Fund was sponsored by an NHS trust to build hospitals in its area then that is what the People's Pension Fund would do, and the contributors to the Fund would have the satisfaction of knowing that they had helped build that facility. It would not, however:

1. provide medical services
2. employ medical staff
3. own the supply of the medical services

All these tasks would remain firmly with the NHS. There is no element of privatisation in the proposal that is being made. In fact, if anything the reverse is true. What a People's Pension Fund would do is demonstrate the support the public have for state provision of public services by investing in that process. And it will involve people in that process as each People's Pension Fund will be managed democratically by its members on a mutual, not for profit basis.

## ■ Getting People's Pension Funds up and running

There would be two critical stages in getting People's Pensions Funds up and running. The first would be getting the necessary legislation through Parliament. The second would be raising the funding so that they could start their work.

1. **Parliament:** Existing pension fund legislation is not adequate to allow for the creation of People's Pension Funds without new laws being passed. One Act of Parliament will be needed to establish them. The critical parts of the new legislation will be:
  - rules to ensure that People's Pension funds are truly independent, and once established are run by their members for their members in democratic, mutual fashion. The history of pension fund management is as much a tale of mismanagement as success, ranging from Maxwell and Equitable Life to the history of employers abusing their employee's pension funds for their own benefit with apparent impunity. This must not be allowed to happen again.
  - provision to ensure that those who are elected by the members to be directors of People's Pension Funds are well trained for the job they do, and are appropriately paid for that part time task. Too often pension funds and mutual companies have fallen under the control of their management rather than their members because the directors, who are elected by the members, have not been able to dedicate enough time to their work because they are insufficiently paid or because they have not had the training to question what has happened in the organisations they are responsible for. Once more, this must not happen again.
  - authorising those pension funds to employ first class managers who ensure that the public infrastructure we need is built to the standard we want. People's Pension Funds will manage large parts of our national spending, and what they will do will have a lasting impact for many years to come, for their members and society as a whole. It is therefore essential that what they do is done well, and that requires high quality thinking by managers dedicated to public service.
  - giving government departments, local authorities, NHS trusts, other statutory authorities and charities undertaking public work the powers to:
    - a. encourage the creation of People's Pension Funds that might support their work
    - b. contract with them to rent the property and other assets they build

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- creating the rules of accountability for the funds so that their financial reporting is transparent
  - creating rules on how People's Pension Funds can charge for the assets they will build and how they transfer them to public ownership at the end of the rental period
  - extending existing tax rules on pension contributions so that they cover People's Pension Funds
  - changing the rules on existing pension funds so that money saved in them can be transferred into People's Pension Funds at the request of the pension fund contributor
  - changing the rules for all employer organised pension funds so that they must provide an option for any employee to have their pension savings invested in a People's Pension Fund of their choice
  - changing the rules on pension annuities so that these can be based on People's Pension Fund investments as well as on government bonds as People's Pension Fund investments should be suited to this purpose
  - establishing the rules on how pensioners are paid by People's Pension Funds, what happens if they want to transfer their funds or die before retirement
  - making provision for there to be special arrangements which some People's Pension Funds might wish to adopt e.g. a fund where no interest is earned for specific use by the Muslim community
  - making provision for there to be a regulator of People's Pension Funds to ensure that the sector is properly managed
2. **Raising money:** People's Pension Funds might be a good idea, but without any cash they will not get off the ground. There are three ways this problem can be overcome:
- an organisation that wished a People's Pension Fund to build an asset for it might lend money to a fledgling fund to enable it to be established
  - existing employer's pension funds will be obliged to offer a People's Pension Fund alternative to their employees and so will need to make funds available to ensure they can be established
  - individuals who seek the benefits that People's Pension Funds will be able to offer will be allowed to transfer their pension savings out of the funds in which they are invested at present, whether those be employer funds or individual funds managed on their behalf by private pension and insurance companies, and into People's Pension Funds without penalty being payable. We anticipate that this option will provide the vast majority of the cash needed to establish People's Pension Funds
- **Making a secure return – an essential part of the plan**

Those who invest in People's Pension Funds would, of course, want a return. That is what pension saving is all about. People's Pension Funds would earn a return in two ways:

1. **By building well:** The People's Pension Fund would actually build the amenities and assets that the department, authority or charity they are linked to want. They would usually sub contract this work, and if they did the benefit of competitive tendering for work would be retained.

If they built the project that has been commissioned for less than the expected cost agreed with the sponsor then the earned surplus could be returned to investors over time.

Of course, if the project cost more than expected and that cost over-run was the fault of the management of the People's Pension Fund then they would have to raise the extra cash to pay that extra cost and that

This appears to be a substantial body of work, but much of it will be developed from existing legislation and so is not an obstacle to progress. The necessary legislation could be presented to Parliament as part of any Queen's Speech and could pass through the entire Parliamentary process quite quickly.

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would reduce the return to investors. There would however be quite different arrangements to those now seen on PFI schemes to make sure that a People's Pension Fund only took on appropriate risks, and so was not excessively paid for taking that risk. Because of the risk element, investing in a People's Pension Fund would not be a loan, but an investment. Money raised in this way could not be considered part of government borrowing since the investor and not the government are taking the risk on it. Government rules on public sector borrowing would not be broken by the use of People's Pension Funds.

2. **By charging an agreed fair rent:** The sponsor (an NHS Trust, for example) and the People's Pension Fund would agree a competitive rent for the resulting asset in advance of construction. This rent would:
- increase over time to ensure it continued to provide a fair return
  - be paid for periods of up to thirty years
  - provide a fair income return on the agreed costs of building the asset
  - return the capital invested over the life of the asset, so that at the end of the period the sponsor would effectively own the asset, as is common with finance leases

At the moment a fair return would probably be between 4 and 7% per annum having made due allowance for the complexity of the project. This is a little more than the government might pay to borrow funds itself but reflects the fact that:

- a People's Pension Fund would have its own costs
- the Fund would have raised cash otherwise unavailable for the government to use

A return of between 4% and 7% may seem limited, but in comparison with the loss of 43% of the value in the UK stock exchange over the last three years it looks very attractive. The rate should also be attractive for the public service that will actually use the asset built by the People's Pension Fund compared to the average 16.5% rate paid on PFI/PPP investment schemes.

## ■ Another perspective

It is important that the whole structure of a People's Pension Fund is understood, both now and in the future if a substantial number of people are to be attracted to invest in them. As a result it is useful to look for suitable metaphors so that People's Pension Funds may be placed within most people's existing experience. A way of doing this is to think of them as:

1. having a structure similar to that of a conventional building society. These are owned by their members. The societies are managed on their member's behalf without a profit being paid to shareholders
2. having provisions in their rules that mean unlike building societies, People's Pensions cannot be turned into private companies
3. using the cash that savers pay to them to fund the purchase, building and renovation of the amenities that people want. In the case of building societies these have been private homes. In the case of People's Pension Funds they could include schools, hospitals, transport systems and so on
4. being like building societies in that they need to take security to ensure they are paid what is due to them over the very long periods that it will be paid over. In the case of a building society this is a mortgage. When a building society takes a mortgage it holds the title deeds to the property that are nominally in the name of the person who has borrowed money from them. It keeps those title deeds to ensure it controls the property, and can legally take ownership of it if the loan is not repaid. In the case of a People's Pension Fund this security is structured slightly differently, in a way that we might call a "social mortgage". The People's Pension Fund will actually own the amenity during the time it is being paid for. The Fund will always then transfer ownership of it to the organisation leasing it when the agreement comes to an end
5. being unlike a building society, which charges interest on the loan of cash until it has been repaid, because a People's Pension Fund will charge rent for the use of a building until the lease agreement has come to an end

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6. taking more risk than a building society because it will actually build the assets that it is going to let, so the rate of return to the saver should be higher
  7. needing a longer term commitment from their savers than a building society because they will actually own the buildings and other assets that will be let and they are very unlikely to be sold on. For this reason they are highly suitable for pension saving, and in exchange for that long term savings commitment the saver gets tax reliefs of the sort now given to people who save for their pensions in the stock market

As with all metaphors, this one is not perfect, but helps communicate the idea of a People's Pension Fund and the "social mortgage" that they will fund to help society enjoy the facilities it needs and to pay a return to their members.

guaranteeing an income for life, which is the principal attraction to many people of saving for a pension

In this way a People's Pension Fund will be able to:

- match all the advantages of existing pension arrangements
- provide a more secure savings environment than most options available under existing private pension arrangements
- let the investor see (and enjoy) the benefits of their investment by way of enhanced public facilities well before the time they might retire. This has the specific advantage of providing a "quality of life" dividend as well as a secure pension

## ■ Tax reliefs and other incentives

The other attractions now offered to encourage pension investment should also be available for an investment in a People's Pension Fund:

1. tax relief would be available at the basic rate in the same way as it is on existing pension funds. Tax relief will be given to the investor's account with the People's Pension Fund to boost the total cash it has available to invest, and this will increase the eventual return to the pension contributor
2. tax relief should also be available at higher rates. At the moment these are given as a discount on a person's tax bill. As these cash discounts do not help fund pensions, but are widely promoted as a means of tax avoidance this is not good use of government cash. As a result it is proposed that this relief will, in the case of higher rate taxpayers also be given within the People's Pension Fund and be used to boost the pension saver's account with it in the same way that basic rate tax relief does
3. when a person retires they will be able to take part of their benefit as a cash lump sum from a People's Pension Fund, just as they can from an existing pension arrangement
4. the People's Pension Fund investment is low risk and will as such be a suitable basis for an annuity, so

## ■ Local investment

The possibility of People's Pension Funds being promoted for separate localities or regions would be strongly encouraged, especially for health, housing and education services. Local People's Pension Funds would increase the identification between the person saving and the asset they had helped fund, and so promote the ideas of:

1. common ownership
2. localisation
3. ethical investment
4. sustainable local communities
5. provision of a resource base that people might need now and in their retirement (such as hospital facilities) from the savings they have made during their working life

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## ■ The People's Pension and the State Second Pension

From 1978 until 2002 the government ran the State Earnings Related Pension Scheme. In April 2002 this was renamed the State Second Pension. The scheme rules changed with the change of name, but none of this affects the substance of this report.

Both SERPs and the State Second Pension pay a pension in addition to the state pension based upon a person's earnings and national insurance contributions paid. The State Second Pension is more generous in some respects than SERPs and reflects time spent on other life commitments such as caring as well as paid work. Some, however, argue that this only replaces the diminishing value of the state pension.

In the case of an employee in work they have a choice about how they want their SERPs fund or State Second Pension contributions to be invested. They can opt to leave it in the government's national insurance fund. In this case it is used by the government to help meet current year pension payments. There is no savings element, and no guarantee that the person making the national insurance contribution will get a pension, although there is an implicit assumption that it will be paid.

The alternative option is for the employee to opt out of the SERPs or State Second Pension systems and to instead have part of their national insurance contributions paid to an employer's pension scheme or to a private pension scheme run for them by a pension company. The amounts involved are quite large, and often exceed £1,000 a year. These sums have been invested in similar fashion to other private pension schemes, and have as a result been put into stock market based pension funds.

This report questions whether the continued availability of an opt out from the state second pension into stock market based pensions is now desirable. The consequences of the availability of the opt out have been:

1. massive pension misselling in the later 1980s and early 1990s as many people were taken advantage of by rogue pension sales people and misguided government publicity
2. reduced security for many low paid employees as their state second pension contributions have been

exposed to risk in their employer's funds or in companies such as Equitable Life (which was widely used for SERPs opt out pension arrangements)

3. a loss of real pension value for many employees as the stock market has fallen
4. a misuse of government finance used by pension funds to support speculation in the stock market; speculation which has now resulted in spectacular losses

Any state second pension must offer:

- security for the pensioner above all else
- good value for the government in that the money spent must definitely be used for the provision of pensions and not for financial speculation
- consistency with broader economic objectives

These objectives can now be best met by withdrawing the opt out choice for an employee to invest part of their national insurance contributions in a conventional stock exchange based pension scheme. Instead all people who are earning an entitlement to a state second pension, whether through national insurance contributions or by way of credit for their caring activities, should have the option to have their state second pension savings invested in a People's Pension Fund of their choice.

The advantages of this recommendation are:

1. it continues to provide choice
2. it provides an undertaking to the person making the national insurance contribution or receiving the credit that cash is being put aside in their name for their benefit, which should increase their confidence in the commitment of the state to make pension payments to them
3. the money credited will come out of the national insurance fund. This will leave that fund apparently short of cash to meet current pension commitments. But, as the cash paid into People's Pension Funds will be available to fund the building of publicly owned assets, otherwise having to be paid for out of tax revenue, that tax revenue can be used to make good the shortfall in the national insurance fund. This would

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ensure that cash is available to meet the needs of current pensioners. The scheme is, in fact, overall cash neutral. This is not true of the existing arrangements where government cash has been, and is, paid out to be lost in stock market speculation

4. each employee and person with a state second pension credit could make a choice as to which People's Pension Fund they would like to have their contributions paid. This has two benefits:

- it provides those Funds with a regular income stream
- it will allow many people to feel that they have some choice over how a tax that they pay (national insurance) is spent for their benefit

5. given that People's Pension Funds will:

- be used entirely to build assets that will be let to fund pension payments
- have a much lower risk than stock market based pension funds

it follows that:

- state second pensioners will face a lower degree of risk if this proposal is adopted than they do under the current opt out arrangements
- the cash invested by the government will be better focussed on pension provision than it is at present because it will not be speculated in the stock market

## ■ Economic benefits of People's Pensions

There are five other major economic advantages to the proposal to create People's Pension Funds. These are:

1. **Increased investment:** The amount of direct investment in the UK economy will be increased by the use of People's Pension Funds. At present it is likely that no more than 15% of the amount paid into pension funds is used to fund new investment in companies<sup>4</sup> or buildings, whether for commercial or

public purpose. The rest is used to fund stock market and other speculation. That speculation is used to fund:

- the City of London
- the financial services industry
- the excessive salaries paid within that industry which has led to the over heating of the economy of the south east of England

What that speculation does not do is provide the goods or services that the public want, whether in the private or public sector. All the cash paid into People's Pension Funds will have to be used to build assets needed by the public or not for profit sectors. These are the areas of the UK economy facing the largest shortfall of investment, and the only area where politicians argue we cannot afford the investment needed to remedy the deficit. The use of People's Pension Fund money in this way will:

- enable a more productive use of our own savings
- enable a new source of funding to be created for the investment in the public sector
- provide a substantial boost to construction and related industries

2. **Reduced risk:** More than 85% of today's pension investment is speculative<sup>4</sup> i.e. it is not used to create new assets needed by either the private or public sector but is instead used to purchase already issued shares with the hope of eventually re-selling them at a profit. Thus institutional gambling underpins the UK's private pension provision. This is:

- irrational in that it places people's long term savings in the hands of those interested in short term market movements
- risky in that savings clearly chase share values to unrealistic levels that ultimately collapse
- inherently unstable
- almost wholly unproductive, as most new saving does not go into new investment in real things

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such as industrial investment but is instead used to purchase existing shares, a process that simply moves money from one financial institution to another, and from which the company that issued the shares does not benefit

The situation would not be quite so bad if the risk taken was small. But it is not. In 2002 alone the UK stock market fell by 24.5%. Virtually no professional pundit working in the City of London predicted this outcome at the start of that year. Almost without exception they predicted a rise in the market over that period. The market lost value of in excess of £350 billion<sup>5</sup>. UK Inland Revenue data suggests that about £50 billion<sup>6</sup> is paid into UK private pensions each year. To put this stock exchange loss in context, in 2002 the equivalent of seven years total pension contributions were lost in a single year. Although most of the public will not have performed this sort of analysis they have an instinctive feeling that it is the case. This is the root of public distrust of pension solutions based on such irrational foundations.

People's Pension Funds will invest in solid, tangible assets that will not disappear in the bursting of a dot.com bubble. By definition these investments are real, can be seen, and be counted. The investment will not be speculative. It will be focussed on addressing real, priority needs within the society in which the pension fund contributor lives. The return will be paid for by lease renting the asset to the state or the not for profit sector of the economy over a defined period of time. Periods of up to thirty years are likely, after which time the asset will belong to the state. This would, in effect, provide an asset that would ultimately always be a public one. The returns to the People's Pension Fund would be sustainable, and reliable rather than spectacular and uncertain. That is exactly the rational, low risk basis for investment that most people are now looking for in their pension investments. Existing pension arrangements cannot provide this sort of security, but a People's Pension could.

The advantages to the UK economy from the certainty that People's Pensions could provide with regard to future pension provision is hard to estimate. There can, however, be little doubt that the return would be real and strongly positive. It is widely recognised by economic forecasters that sentiment is the most powerful of all factors in determining the prospects for an economy. Risk is associated with uncertainty and

once confidence wanes poor demand and a weak economic environment follow. People's Pensions could reduce uncertainty with regard to a major aspect of many people's lives. This would have substantial economic benefits.

- 3. Elimination of the PFI scheme and the impact on government borrowing:** People's Pension Funds would be a massive new source of cash to finance future investment in public sector assets. If half of existing annual private pension contributions were paid into People's Pension Funds then they would receive about £25 billion of pension contributions a year<sup>7</sup>. Over the five years from April 1997 to March 2002 average government capital investment in building schools, hospitals and so on amounted to just over £18 billion per annum<sup>8</sup>. Over the coming five years it is forecast to average just over £36 billion<sup>8</sup> per annum. In other words, had they existed and secured 50% of the total market for private pension contributions over this period People's Pension Funds:
  - could have paid for all the UK government's public investment programme over the last five years and so would have reduced national debt by over £18 billion per annum or over £90 billion<sup>9</sup> over the period. The interest saving on this reduction in debt would probably have been enough to have paid the entire rent returns due to People's Pension Funds, and would in the process have been focussed upon a clear social goal of meeting the needs of people in old age, rather than supporting the banking system by the payment of interest on the national debt
  - there would have been no need for any PFI schemes. More than enough cash would have been available at lower cost from People's Pension Funds
  - there would be no need for any new public borrowing over the next five years. This sum is forecast to be about £90 billion<sup>7</sup>, again substantially less than the £125 billion<sup>10</sup> potentially available from People's Pension Funds in this period, with the net benefit in debt repayment resulting in reduced interest costs providing the Government with the means to pay the rents due to People's Pension Funds on the assets they will have built

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If People's Pension Funds had been in operation already Gordon Brown would not have faced the difficulties that he did with regard to new borrowing when making his pre-Budget statement in November 2002. The Labour Party could have entirely avoided defending PFI proposals at the 2002 party conference. The PFI / privatisation threat to public ownership of the health service and the London underground could be entirely avoided.

In making these observations we reiterate that People's Pension Funds would play no part in the management of the services supplied by the public sector, all of which remain firmly under public control. They would merely build the assets the public sector need and would be paid a fair rent for them. The most unacceptable elements of PFI schemes - such as the enforced transfer of employment to the private sector, the loss of public control of key services, and the excessive charges paid to private sector consortia and consultants - are entirely avoided by the creation and use of People's Pension Funds.

4. **Restoring the basic state pension:** The basic state pension has been a foundation stone of pension provision in the UK since its introduction almost a century ago. It became the centrepiece of pensions policy after being made a universal entitlement at the end of the Second World War. This foundation stone has, however, been weakened since the decision by a Conservative Government in 1980 to break the link between earnings inflation and pension increases (increasing the basic state pension only in line with prices). The cost of fully restoring the link now, based on data from the National Pensioner's Convention, would be approximately £16 billion per annum. The basic state pension would rise by 40% as a result.

The People's Pension provides a means of financing the restoration of the link between pensions and earnings. This is the result of two elements within it:

- tax relief is given on the private pension contributions paid into a People's Pension Fund. In existing private pension arrangements this tax relief is either paid to the private pension fund (primarily to fuel stock market speculation) or to the person who makes the contribution (who therefore sees it as a way of avoiding tax). In either case the government has suffered a real cost but the economy has obtained little direct

long-term benefit. In the case of a pension contribution to a People's Pension Fund the tax relief would always go to the contributor's account within the People's Pension Fund and so would be used to help pay for their pension. That means that the cash is always used for the purpose the government intends, i.e. pension provision, which is the first benefit of the arrangement.

The second is even more significant. Because the People's Pension Fund will use the cash to fund investment in the public sector (otherwise having to be paid for out of taxation) the tax relief does, in effect, go straight back into the public sector pot. The government will no longer need to fund such investment itself. This means that the tax relief given will effectively be available for alternative immediate use within the public sector. The Inland Revenue estimated that in the year to March 2002 the cost of tax relief for pension contributions amounted to at least £16.5 billion. If People's Pension Funds secured 50% of the pensions market the tax relief that would be available for re-use in the public sector would be about £8.25 billion, or half the cost of restoring the earnings link for the basic state pension.

- People's Pension Funds will on the basis of our assumptions provide new options for the government to fund its capital spending and will as a result allow it to increase the total proportion of revenue spending within its budget. Any government will have substantially increased freedom to set priorities for current spending.

The data used consistently in this report would suggest that over the next five years People's Pension Funds could reduce government borrowing by at least £90 billion. Part of this sum, when combined with the savings in benefits paid to meet the Minimum Income Guarantee for pensioners, should be used to fund the remaining cost of restoring the value of the old age pension to a level that should ensure all pensioners can live in dignity in their retirement.

5. **Employer contributions to pension funds:** The number of employers who have either closed final salary pension schemes or reduced their commitment to making contributions to employee's pensions has increased dramatically over the last year. This fails to

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recognise that employers' contributions to occupational pensions are, in effect, deferred wage payments. However successful People's Pensions might be, if the necessary levels of saving required to meet future pension obligations are to be achieved, the government will have to define a statutory obligation for employers to contribute to sustainable pension arrangements. If such contributions were based solely on wages paid, or a head count, as employer's national insurance contributions are at present, this may be counter productive. As a result, a new basis of contribution is needed based on ability to pay. This report is not the place to explore those ideas in more depth.

What is clear is that People's Pensions should provide employers with a secure framework in which to meet their obligations. The investments a People's Pension Fund makes will not be as risky as those made by existing occupational pension funds. Today's risks have made it rational, even if undesirable, for employers to withdraw from such funds.

## ■ Further issues

There are, naturally, other dimensions to People's Pensions that it has not been possible to explore in a report of this length. The report has, necessarily, focussed on the key aspects of the proposal to create People's Pension Funds. Deliberately, and in the interests of brevity, it has not detailed:

1. the specific mechanism for their operation
2. theoretical reasons why People's Pensions are substantially more likely to meet their obligations to pensioners than existing pension funds
3. the local and regional benefits that People's Pension Funds might provide
4. consideration of the impact of future demographic change changes on pension funding

The recommendations made do, however, take these issues into account.

## ■ Final considerations

The People's Pension that this report proposes is a radical departure from all previous ways of providing pensions in the UK. But it makes complete sense if you can answer "yes" to the following questions:

1. do you wish your pension fund to be invested securely?
2. do you want your pension fund to be used to create real jobs and real assets for the benefit of local communities and society at large?
3. do you want to see an improvement in public services in your community, such as better local hospitals, schools, transport facilities and housing?
4. would you rather your pension fund wasn't gambled on a daily basis in the stock exchange?
5. do you want the security that having a State Second Pension, invested in your name in a People's Pension Fund of your choice could provide?
6. do you want to see an end to the PFI scheme and a reduction of government debt?
7. do you want the basic state pension to be restored to the value it had in 1980, and to re-establish the previous link to earnings?
8. do you want to be able to choose where in the country and in what public services you would like your money to be invested?

Most people will answer yes to these questions. This is the strength of its appeal. Existing pension arrangements offer few of the same certainties. For many the choice between the two will be easy to make.

Given that this would still be a choice rather than an obligation we recommend the early introduction of People's Pensions as the way to solve the UK's pension crisis, and much more besides.

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## Notes

1. National Association of Pension Funds estimate based on UBS Global Asset Management estimate of value of £1,000 billion in May 2002
2. A second pension is any pension over and above the basic pension. It can, therefore, be:
  - a state second pension
  - a SERPs (State Earnings Related Pension)
  - a pension made out of a former employer's pension fund
  - a privately funded pension, such as a personal pension, stakeholder pension or one paid for by a retirement annuity contract
3. Data from UBS Global Asset Management report "Pension Fund Indicators" May 2002 available from their web site.
4. It is widely presumed that all money paid to pension funds is used by them to buy shares issued by companies to fund investment in the real economy. This is not true. Data supports this.

In 2002 the total value of UK shares traded on the London Stock Exchange amounted to £1,815,034 million. The total value of new UK shares issued in the same twelve-month period was just £17,391 million. In other words, just 0.95% of all shares traded were new shares from which the company issuing the shares could get any cash benefit at all.

The other 99.05% of share dealings were in what we call "second hand" shares i.e. they had been issued some time previously by the company after which they are named and were being traded speculatively by someone other than the original subscriber. The original issuing company gets none of the cash from such a trade and as such that cash cannot fund its commercial activities. (All data quoted is from the London Stock Exchange.)

This data shows that most shares bought by pension funds are not new shares. In this case it is important to estimate just what value of new shares are subscribed for by pension funds. At the end of 2002 a best estimate suggests that about 30% of the London Stock Exchange may have been owned by UK pension funds. In that case it is likely that they bought 30% of all new shares issued in 2002. These shares would have cost them £5,220 million.

The London Stock Exchange represents about 65% of pension funds' total shareholdings, the rest being held through other stock exchanges, such as New York. Currently such overseas shareholdings have a probable value of about £188 billion. The New York Stock Exchange was worth about £6,100 billion in December 2002. This means UK pension funds might own 3% of that market. The total value of new share issues in New York in 2002 was about £17,700 million. In that case it is probable that the number of overseas shares acquired by UK pension funds was no greater than £530 million by extrapolation.

Of the non-share assets held by pension funds, cash is by definition not invested in new productive assets. Over the last five years the government has steadily repaid gilts. As a result pension fund investment in them has not created real investment in the economy in that period. Since property only accounted for 6% of investment value in pension funds in 2002 then it is unlikely that more than 6% of the total pension contributions in the year will have been invested in property. That means property investment would not have exceeded £3,000 million in 2002. Of this sum it is unlikely that more than half i.e. £1,500 million will have been invested in newly built property.

In consequence funds actually invested by UK pension funds in productive economic activity probably did not exceed £7,250 million in 2002. When compared to total contributions into pension funds of £50,000 million this amounts to fewer than 15% of all contributions, and may have been somewhat less given the generous estimate made with regard to property investment.

5. London Stock Market fact sheets November 2002, extrapolated.
6. There has been some dispute as to the amount paid into UK pension funds. The Office for National Statistics originally calculated that the figure for the year to March 2001 was £86.4 billion but under challenge from the Opposition revised that sum to £43.7 billion. Due to the obvious risk that both estimates are materially misstated we have used Inland Revenue data published at [http://www.inlandrevenue.gov.uk/stats/pensions/p\\_t09\\_1.htm](http://www.inlandrevenue.gov.uk/stats/pensions/p_t09_1.htm) in January 2003 for the year to March 2002. This suggests the cost of pension reliefs given on contributions is £16.51 billion. The same site suggests the underlying average tax rate for these contributions is 30%. This suggests contributions of £55 billion. For safety's sake we have, in broad terms, used a figure of £50 billion that broadly splits the difference between these official estimates.
7. In 1962 51% of all pension cash was invested in UK government bonds (source: UBS Global Asset Management report noted above). The suggested 50% market share for People's Pension Funds is based on this data.
8. HM Treasury, November 2002 data published in support of the Pre Budget Report.
9. £90 billion is five times £18 billion, being the average borrowing each year over that period, none of which would have been needed if People's Pension Funds had financed asset building instead of government borrowing.
10. £125 billion is five years of People's Pension Fund contributions if they secured a 50% share of the UK pension contribution market, which share would be worth £25 billion a year. Government borrowing in this period is forecast to be £90 billion. The difference between the £125 billion of potential People's Pension Fund contributions and £90 billion of borrowing should more than eliminate PFI borrowing in the period. In the last year that amounted to £2.6 billion according to the HM Treasury run Office of Government Commerce.

## People's Pensions - new thinking for the 21<sup>st</sup> Century

There is a pension crisis in the UK. This paper proposes an entirely new arrangement for the provision of second pensions in the 21<sup>st</sup> century. This is called the "People's Pension". It is not a tinkering with the rules as, for example, stakeholder pensions were.

The People's Pension is different because it looks at the pension crisis as one part of a range of problems affecting the UK economy, and creates a solution that solves both the pension crisis and many of those other problems as well. And, as fundamental elements in that solution:

- it includes the explicit assumption that the basic state old age pension must be sufficient for a person to live on with dignity and without the need for means testing, and releases
- finance to assist this. It also incorporates the assumption that this pension will increase in line with earnings
- it substantially improves the State Second Pension which will mean that this scheme will be much more attractive than it has been
- it creates an entirely new investment framework, completely free of the stock market, to provide a secure and safe place in which an individual or company pension scheme can invest
- and it provides funds to build the new schools, hospitals and public transport that we need whilst eliminating the need for PFI or new government borrowing.



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### **The New Economics Foundation (NEF)**

NEF works to construct a new economy centred on people and the environment. NEF has a wide programme of work on local economies, and on economic globalisation ranging from corporate accountability to climate change.

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