THE DAVID HUME INSTITUTE

THE POLITICAL ECONOMY OF PENSION PROVISION

ALAN PEACOCK
NORMAN BARRY

Hume Occasional Paper No. 2

ALAN PEACOCK is Research Professor in Public Finance, The Esmee Fairbairn Research Centre, Heriot-Watt University, and Chairman of the Committee on Financing the BBC, and was a member of the Secretary of State for Social Services' Committee on Retirement Provision, 1984-85, which advised on pensions reform.

NORMAN BARRY is Professor of Politics at the University of Buckingham. He is a well-known political theorist and philosopher with a particular interest in the links between economics and politics.

THE POLITICAL ECONOMY OF PENSION PROVISION

ALAN PEACOCK
NORMAN BARRY

THE DAVID HUME INSTITUTE
1986

The David Hume Institute
Belwood House
Glencorse
Midlothian EH26 0NL
Scotland

© The David Hume Institute, 1986

ISBN 0 9510122 3 1

Printed in Scotland by
Macdonald Printers (Edinburgh) Ltd

CONTENTS

Preface v

The Political Economy of Pension Design 1
Alan Peacock

Pensions and Policy-making in Great Britain 11
Norman Barry

PREFACE

These papers were first presented at a Conference on Pensions arranged by The David Hume Institute which took place in Edinburgh in June 1985 but have been modified in the light of the government's White Paper which appeared in December 1985. The Conference was opened by the Minister of State for Social Security, Mr Tony Newton, and also included papers on the problems created for the pensions industry by the proposed reform.

Professor Peacock's paper argues that the debate has concentrated too narrowly on the provision of pensions rather than on the provision for retirement and that the government's own arguments point towards the complete abolition of the State Earnings Related Pension Scheme (SERPS) coupled with the raising of the basic pension. Professor Barry's paper argues that the 'consensus' over SERPS is a convenient myth perpetuated by the interest groups seeking to maximise the utility of their members by an ever-growing public sector. The fact that the British system of government helps to create such groups results in a legacy of problems, such as the burden of pensions, which are virtually insoluble for any major changes in policy impose significant costs on those affected by such changes.

The papers are essentially complementary, but it will be noted that the authors take different views of the necessity of funding state pension schemes.

The fact that both contributors are closely connected with The David Hume Institute must not be taken to mean that the Institute's members are in any way committed to their views.

THE POLITICAL ECONOMY OF PENSION DESIGN

by
Alan Peacock

Introduction

In this paper I would like to consider pension *design* rather than pension *reform*, that is to say I would like to use an old trick used by economists and assume a *tabula rasa*. This is purely an expository device but I believe that in asking how one might design a pension system from scratch one offers a useful way of commenting on the government's actual proposals.

I shall first of all ask the question: why have a state pension system at all? Then I shall ask the further question: given that there is to be a state pension system, what principles should govern its operation? Finally, I shall relate my analysis to the actual proposals which are to be found in the recent Green and White Papers.[1]

The rationale of state intervention

As a community we might have some broad agreement about the distribution of income and capital, though that is a large assumption, and seek to achieve the pattern of distribution required by government intervention. Why go any further and stipulate how individuals should allocate their resources between the present and the future? Surely there are sufficient incentives for individuals to save to cover the period when they no longer have any earning capacity?

There are two answers to this question. The conventional answer is given in the form of the 'moral hazard' argument. If the individual makes no provision then he may assume that *some* provision will be made for him or her. The more people who base their decisions on this proposition, the less incentive the community as a whole will have to save for the future. In an extreme situation, the community would not be able to supply the resources to look after the improvident aged. The second answer is the complement of the first. I may be willing to pay more to the government than the perceived value to me of the services I receive so that I can help those less fortunate than myself, but only on condition that the redistribution takes *specific forms* which ensure that the moral hazard problem is avoided. So far as provision

for retirement is concerned, I may be willing to be taxed more per £ than others, provided that the money received by the less fortunate is compulsorily invested in provision for their future.

It is to be noted that so far a reason has been given why there could be strong support for compulsory provision only for retirement. Nothing in what has been said offers any guidance on either how this is to be achieved or what level of provision is to be made. I have not even used the word 'pension' in the argument.

Do we need a state pension scheme?

Assuming that some compulsory provision has to be made, what is the role of the state?

So far a case has been made only for state *regulation*. Everyone would have to make provision for old age, or have provision made for them. Why not simply lay down that every person has to provide his or her own retirement cover, *by law*? After all, this is what is done in the case of motor insurance. The individual would then have to show that he/she was making provision to a certain standard by some form of saving.

Now, in practice, this is done by a large proportion of the working population in a variety of ways. It is worth making the point that provision need not take the form of a pension only. It could mean buying a house on the 'never-never'—a large proportion of house property today is owned by those over sixty years of age. Those who have reached official retirement age may be fit enough to go on working full- or part-time. They may have stocks, shares, unit trust holdings. It is perfectly true that the proportion of income which those of pensionable age derive from earnings and investment is likely to decline under present pension arrangements, but it is interesting, if such arrangements did not exist or were to be changed substantially, to speculate about how individuals would save for retirement. It should also be noted that a capital asset such as a house can be turned into income by mortgage arrangements with insurance companies. Still, if we ignore wealth as a source of protection in retirement, there is a firm expectation that, given present state pension arrangements, pensioners' disposable income per head relative to non-pensioners should rise considerably over the next twenty-five years or so—on one set of assumptions from 69 per cent to 77 per cent between 1984/5 and 2015/16. In 1951 it was barely 50 per cent.[2]

The above analysis suggests that all that is necessary to meet the state 'rule' would be accumulation of sufficient saving *in any form* by a certain date in the individual's life span. (This is the basis of the argument that the tax system should be broadly 'neutral' with respect to the different forms of saving.) This would be a necessary condition but, so it is argued, not a sufficient condition. People might not spread out their savings throughout retirement, and protection would have to be assured to dependants.

We have reached the stage now when we can say that a case has been made for a 'pension test', and not simply an 'accumulation of wealth' test, but this only takes us to the point where the individual would have to save *in a particular form*, e.g., a personal pension. We are still left with a host of unanswered questions, but the main ones can be considered in examining some of the doubts and reservations about personal pension provision (PPP).

The first point to be made is that the 'pension test' must embody at least some *minimum pension* (in *real terms*?). How many suppliers of personal pensions would be willing to specify a real income guarantee for customers when there cannot be a real guaranteed return on their own investment? (The position is altered somewhat by the existence of index-linked 'gilts'.) PPP, it is claimed, can only operate on the basis of a contribution test and not a 'final benefit' test. This may not be so much of a problem if the 'pension test' is not too severe, and particularly if it does not have to be related to *earnings*.

The second point made about PPP arrangements stresses the imperfection in the pensions market. There is much argument about this matter. It is claimed that individuals can be too easily pressured into making wrong choices, whereas the counter-argument is that competition between pension providers offers sufficient protection and the individual need not deal exclusively with one company all his working life. He can also subscribe to non-profit advice-giving services such as consumer associations. It is also claimed that administrative costs of private schemes are high compared with a national state pension scheme, whereas it is simultaneously claimed that competition between private companies helps to keep costs down and enables companies better to meet the very different circumstances in which individuals find themselves in respect of the 'cover' they seek. I shall not seek to resolve these arguments, which are perennial ones and in the end can only be settled by agreement about the empirical evidence. The Sub-Group of the Fowler Inquiry on Portable Pensions, upon whose work the previous recommendations on PPP were based, did suggest that, at the very least, some form of *regulation* of the pensions market would be necessary, perhaps self-regulation, in order to protect the consumer. They also indicated that if personal pensions were to be a substitute for occupational pensions within the contracting-out system available under the SERPS scheme, then there would be major administrative problems associated with monitoring individuals' compliance with a contribution test designed to produce pensions over and above some minimum standard.

It is a fair question to ask me, where do you stand on all this, and this is a good point at which I should declare my hand, because I believe I have reached the point where, in an ideal world at least, I would want to stop any further state intervention. Provided, and it is a major proviso, there are no major inequalities of income and wealth and that any necessary corrections in income and wealth can be undertaken by government in ways which do not simply increase the size of government, I believe that the state's function

is simply to lay down a minimum pension standard, and to see that the pensions market is not rigged against the consumer. My view is based on a value judgment which nobody is obliged to accept, namely that I believe that to insist on a dynamic pension test, i.e., a final salary-related pension standard, is to support an unwarranted interference in the individual's right to allocate his income between present and future uses as he pleases.

I would go somewhat further than this. One way in which the state could monitor the private pension system would be to set up in competition with the private sector, but under regulations which did not result in 'unfair competition' from the state scheme. It might also be necessary for the state to subsidise the contributions of those persons for whom the meeting of the pensions test was an onerous burden. In other words, certain risks such as poverty, disability and longevity would be partly borne by the community. I do not deny that there are further monitoring problems, given the prospect of evasion of contribution obligations, but I remain to be convinced that these would be any more difficult than the problems already encountered by the existing state pension arrangements.

The design of the state pension system

A good case can be made out, even in terms of the 'liberal' argument which I have deployed, for a state pension scheme with flat-rate pension provision, and along the lines set out many years ago by William Beveridge. It is probably administratively easier, though not necessarily less costly, to take account of the collectivisation of certain risks by operating a state pension scheme. Apart from important issues which I do not have space to deal with—pension rights of men and women, pension age, early-retirement provisions, taxation of pensioners, and limitations on pensioners' earnings—economists concentrate on two issues. The first is whether it is necessary to have a separate insurance system at all and, if so, whether or not the state insurance system should be funded.

In my salad days I wrote a strong critique of the National Insurance system, arguing that the insurance element was a myth and that the preservation of a separate system merely created a duplicate tax administration. So, along with others—and our views now seem very modern alongside the present discussion—I proposed an amalgamation of the income tax and social security administration and the relief of poverty, including the poverty of the old, by a system of universal benefits.[3] The trouble with a negative income tax scheme of this kind was its cost, and, in consequence, the relatively high tax burden on even modest income levels. At the time, little attention was paid by the supporters of the scheme to the 'moral hazard' problem, it being assumed that growth in the economy would create a growing gap between the level of universal allowances and the lower ranges of earnings. Since those days, our ideas of minimum levels of subsistence have been raised

substantially, but the rate of economic growth has been lower than expected. Hence the emergence of the 'poverty trap' problem whereby high marginal rates of tax beset those who consider moving out of a means-tested benefit régime into employment.

Fortunately I do not have to consider the complications associated with the whole range of social security benefits. If we cannot assume that the large bulk of the working population could not under any conceivable circumstances save for their old age an amount sufficient to cover basic subsistence levels, then no amount of fiscal juggling could create a pension scheme.

Assuming that the bulk of the working population can do so, then some form of contribution test must operate, and there must be some link between contributions paid and benefits received. I now see much more clearly than I did thirty years ago why Beveridge was so anxious to 'take pensions out of politics'. Unfortunately, that is rarely, if ever, possible. The government can find all kinds of policy reasons for severing the nexus between contributions and benefits.

The case I have made so far for a separate state pension scheme, assuming that it is necessary to have one in the first place, implies some kind of scheme which would be roughly equivalent to a private scheme, though some allowance could be made, as with a state-regulated private scheme, for 'contribution abatement', either temporarily or permanently to deal with low-income contributors. If such a scheme were to be funded, there is no reason why the government should operate the scheme itself, but could enter into a franchise arrangement with private operators. Alternatively, if the government were to continue to run the scheme as a pay-as-you-go (PAYG) system, it may be claimed that not enough saving is being generated by present contributors to pay for their own pensions.

The cardinal point to be made in this debate is that whatever title to resources pensioners may claim under either scheme, what pensioners in aggregate will be able to consume in real terms will depend on the productivity of the working population. However, the growth in GDP need not depend in any crucial way on methods of funding. Let me explain why.

The most plausible argument for funded schemes is that they could increase aggregate net saving of the community above what it would otherwise be, thus releasing resources for increasing the country's capital stock and thus encouraging higher growth. This is not necessarily the case. In the case of private funded schemes, for example, an increase in contributions may improve the title to resources of those who will eventually receive pensions, but if contributions are tax deductible, this means that government saving will be reduced or private saving reduced as a result of the extra revenue which the government has to raise to cover its expenditure commitments. Moreover, if contributions are income-related, then the growth in pension rights may be at the cost of acquiring other assets, such as

property or stocks and shares, so that aggregate saving may not be increased. It is possible that a publicly funded scheme which did not allow tax relief on contributions might increase net aggregate saving, but one can hardly imagine a government reverting to a funded scheme without some form of relief, as a substitute for the existing PAYG scheme. This would mean from now on either that present contributors would have to fund not only their own pensions but those whose pensions were not supported by accumulated funds or that the government would have to pay lower benefits to those who were not subscribers to the funded scheme. One cannot see the powerful pensioners' lobby letting that happen!

I am bound to conclude, if only for pragmatic reasons, that there would be no particular economic advantage in designing a state pension scheme which would be funded. In any case, the government can by suitable fiscal arrangements encourage the growth in net saving either by itself or, preferably, in my view, by the private sector.

The government's proposals

The government's initial proposals have been widely discussed.[4] I shall concentrate on the question as to how far the government's reforms approach the 'pension design' which I have put forward in previous paragraphs.

First, my approach emphasises, implicitly at least, that government commitments to paying pensions must take account of cost. The Green Paper (volume 2, chapter 1) lays stress on the progressive rise in state pensions costs which follow not only from the maturing of SERPS itself but from relating the basic pension to the projected growth of earnings. This is contrasted with the fall in the ratio of National Insurance contributors to pensions from 2.3 in 1985 to 2.0 in thirty years' time and to 1.6 by 2035. This is a dramatic way of displaying the growing burden of pensions. Let me heighten the drama by another method of calculation. In 1984 John Hills of the IFS records funded public debt liabilities (net of government lending) at £100b but the unfunded liability represented by state pensions (including public service pensions but net of deferred tax liabilities) at about £300b![5] Credit must be given to the government for acting responsibly by looking at these long-term effects well beyond the normal time horizon of politicians. The government claims that its proposals to modify the SERPS scheme will halve its cost from £25.5b to around £13b in the year 2033.

Second, the proposed government reforms certainly move in the right direction of the 'pension design' that I have put forward by opening up the pensions market. However, in one important respect it has retreated from a position previously held in the Green Paper by not proposing to abolish SERPS completely. The argument used to support compulsory additional provision over and above a basic pension is that 'otherwise we should perpetuate "two nations" of those with and those without additional

pensions' (Green Paper, vol 2, p 4). It rests on the assumption that individuals will not in fact make provision for their old age unless forced to do so. This is at least a disputable proposition. It assumes that the main cause of 'divisiveness' originating from an unequal distribution of income and wealth is to be found in pension provision, which is highly questionable, and also that individuals cannot make provision for old age other than through accumulation of pension rights. It is not even consistently applied, for self-employed people will continue to be exempted from participation in SERPS. Only they, so it is assumed, should be allowed to have the freedom to make flexible arrangements for retirement provision, so that they can build up their business capital first and then turn their minds to making retirement provision in later life; and can be trusted to make such provision. But many employed persons could reasonably suppose that they should be allowed the same flexibility, paying less towards pension provision when they are financing house purchase and supporting their family and more when they may have fewer family commitments and have paid off the mortgage.

Third, the government has gone a long way towards meeting the requirements which follow from the pension principles laid down in this paper by its support for personal pension provision. This has been made possible by scrapping a 'final salary' test for pension provision and substituting a 'contributions' test and by the various provisions making it possible for the employee to contract out of an employer's occupational scheme. There will obviously be some regulatory problems. In order to make the personal pension market less imperfect it is sensible to extend the list of institutions allowed to provide pension schemes to banks, unit trusts and building societies with which individuals are already familiar. At the same time, the plethora of institutions able to offer personal pensions requires the setting up of a rather complicated regulatory régime.

Fourth, there is the question of the level of the basic pension. The government has accepted that it will be in a better position to deal with the lot of the poor pensioner if resources can be moved away from a SERPS-type commitment towards finding finance for up-rating the basic pension. However, it does not intend to raise the basic pension now, presumably on the grounds of cost. The question of cost draws attention to a major problem confronting responsible discussion of the new pension plans, namely that of the dimension of the social security budget and its finance. The Green Paper, for example, draws attention to the improvement in the condition of the elderly, relative to that of the working population. The evidence it provides is incomplete, and not only probably seriously underestimates the relative position of pensioners but also ignores the distribution of real disposable income among the retired themselves. Thus no account is taken of the incidence of owner occupation and mortgage debt by age group. Already 50 per cent of households headed by pensioners are owner-occupiers with all the advantages of an imputed rental income which is not subject to tax. A large

proportion of these households must own their own homes completely. Those of pensionable age receive a whole range of tax concessions, such as the old-age allowance and tax-free lump sums on retirement, and price concessions, e.g., travel on trains and buses, prescriptions. There is a presumption that not only are those of pensionable age as a group relatively better off than the data accompanying the Green Paper suggest, but also that the various benefits that are missing from the calculations are skewed in favour of the better-off elderly. If I am right in this, then perhaps there is room for an increase in the basic pension that could be financed not solely by cutting other kinds of government expenditure but also by reducing tax and other concessions to the better-off elderly *now* and using the proceeds to finance the worse-off elderly largely dependent for their standard of living on the basic pension. I cannot be sure of this, but as I have kept emphasising in this paper (and as I did as a member of the Inquiry) the pension is only one factor, albeit of increasing importance as one moves down the elderly's income scale, governing the economic condition of the retired.

Conclusions

I have argued that a government commitment to see that individuals provide a basic pension for themselves can be derived from a 'moral hazard' argument, namely that if society makes a commitment to support the improvident, then there is a danger that such a policy would be self-defeating. To argue that governments should do more than this and insist on some earnings-related pension standard and on a SERPS scheme as the *modus operandi* is to argue that individuals are not competent to make decisions about the allocation of income between the present and the future and that financial markets do not or cannot be made to work in the interests of consumers. In short, to resolve disagreements about the design of pension schemes for all citizens does not call simply for technical knowledge of the pensions market. It involves agreeing about values and this is not something that can be resolved by scientific analysis. It calls for agreement about how the economy works, and particularly how the capital market functions. It calls for agreement about how the working of the economy might be improved in the light of policy objectives and the instruments for promoting those objectives.

I support the government's value judgment that social policy should be 'targeted' to those who need help, but I believe that this judgment does not call for the retention of even a vestige of a SERPS system. On the other hand, I believe it calls for serious consideration to be given to the raising of the basic pension now.

I share the government's confidence in the benefits accruing from a more competitive capital market, buttressed by the supply of loanable funds for pension provision coupled with much greater freedom of access to suppliers

of pension services. I would nevertheless be the first to admit that a precondition of obtaining these benefits is a general improvement in the understanding of all of us how this market works or could be made to work.

As on many occasions, I am indebted to Professor Jack Wiseman for stimulating discussions on the subject of this paper.

References

1 *The Reform of Social Security*, volume 1 (Cmnd 9517, 1985), and volume 2 (Cmnd 9518, 1985), Her Majesty's Stationery Office, London. *The Reform of Social Security: Programme for Action* (Cmnd 9691, 1985), HMSO, London.
2 See Department of Health and Social Security, *Population, Pension Costs and Pensioners' Incomes*, Part II, Her Majesty's Stationery Office, 1984.
3 See Alan Peacock, *Economics of National Insurance*, William Hodge and Co., Edinburgh and London, 1952.
4 For discussion of the economic aspects of these proposals, see, for example, *Catalyst: A Journal of Policy Debate*, volume 1, no. 3, Autumn 1985 (articles by Alan Maynard, John Ermisch and Michael Pich); and Evan Davis, Andrew Dilnot and John Kay, 'The Social Security Green Paper', *Fiscal Studies*, volume 6, no. 3, August 1985. For further background, see A. W. Dilnot, J. A. Kay and C. N. Morris, *The Reform of Social Security*, Institute of Fiscal Studies, Clarendon Press, Oxford, 1984, and the bibliography therein.
5 See John Hills, 'What is the Public Sector Worth?', *Fiscal Studies*, February 1984, and my own comments on unfunded obligations of government in 'Is There a Public Debt Problem in Developed Countries?', Proceedings of the 1984 International Institute of Public Finance Congress (forthcoming, 1986).

PENSIONS AND POLICY-MAKING IN GREAT BRITAIN

by

Norman Barry

It has become readily apparent that the British political system is no longer the model of stability that it was. That once-valued consensus about economic and social goals known as 'Butskellism' which characterised British political life in the 1950s, '60s and early '70s has truly disintegrated: the resulting political vacuum has been filled by an ideological fervour perhaps unparalleled in twentieth-century British history. I wish to show that the problem of pensions,[1] and more especially the state's role in the provision of pensions, is deeply embedded in the prevailing crisis of British politics and must not be seen merely as an actuarial conundrum. For in many ways the State Earnings Related Pension Scheme (SERPS), soon to be substantially modified, was a product of that consensus; indeed, perhaps its last desperate act.

What I shall attempt to show is that the apparent consensus that spawned SERPS, and other welfare policies, was a spurious one: it had no basis in genuine public approval (least of all in 'reason') but was entirely a product of the fanciful schemes of politicians. It is because the British 'constitution' is so permissive, embodying as it does a sovereign parliament and an electoral system that allows a party to use that sovereignty as it pleases with the flimsiest of support from the voters, that such harmful exercises in the creation of happiness by law are allowed to take place. It is now conceded that the basic structure of SERPS is seriously flawed but what is not realised is how such obviously dubious policies can be implemented in a democratic society. It seems to me that SERPS is rather like inflation: it can only emanate from a lax constitutional system that tempts political parties into vote-catching policies, the malign consequences of which they will not have to endure, and encourages behaviour on the part of the electorate, which although 'rational' in the present circumstances, is ultimately self-destructive.

In fact, the British constitution encourages the gradual and seemingly ineluctible 'politicisation' of economic life, i.e., the tendency for individual decision-making to be replaced by collective decision-making (emanating either from parliamentary majorities or interest groups acting on executive government). The welfare state, for example, has ceased to be a 'safety net' for particular individuals in distress. It is now a complex set of transfer

payments by which everyone is affected. Payments are often made irrespective of need, and there is growing evidence that the whole system produces a redistribution from the poor to the better off.[2] The fact that people are unavoidably locked into this system means that the welfare state is unlikely to 'wither away' no matter how prosperous society may become.

Strictly speaking, there is no reason at all why pensions should be subject to political or collective decision-making. Pensions are simply deferred payments and in a free economic system their level will depend entirely on the time preferences of individuals, i.e., the rate at which they discount the future. It seems fundamentally illiberal for the state, through compulsory pensions schemes, to decide individuals' saving and consumption patterns over their lives. This does not, of course, exclude a welfare role (in its original form) for the state, but this has nothing necessarily to do with retirement pensions. There is now a decreasing connection between being old and being poor; whatever the situation might have been in 1908, when the state first got involved in the pensions business.

The role of the state in pensions, and especially in the delivery of *earnings-related* pensions, represents a classic example of the confusion of the welfare principle with the insurance principle. There is (rightly or wrongly) a consensus that the state should have a welfare role but there is surely no consensus that it should take upon itself to decide how everyone should determine his or her (financial) future. The present system produces inadequate welfare for those in genuine need and poor insurance for those well able to take care of themselves. The only justification for state involvement in compulsory pensions would be if it were the case that most people were too myopic to plan for their old age, leaving the state a massive welfare bill for the elderly. This is the problem of 'moral hazard'. But this is surely, on empirical grounds, quite false: there is no evidence of 'market failure' here. Indeed, as I shall show below, it is *political* actors who have short time horizons, preferring the pleasures of vote-catching now at the cost of creating massive welfare (and other) bills for the future.

This is well illustrated by SERPS, established by statute in 1975. This statute provided an earnings-related pension to be paid in addition to the normal flat-rate benefit. The scheme is extremely complicated but basically SERPS provides a pension equal to one-quarter of average qualifying earnings (there is a floor and a ceiling to qualifying earnings) in the best twenty years of a person's working life-time. The system is fully indexed in that qualifying earnings are revalued in line with average earnings before the pension is calculated. The first beneficiaries of the scheme will not be eligible until 1998. However, unlike its American counterpart (see below), an element of freedom was preserved by permitting 'contracting out': private occupational schemes, if they met certain requirements, e.g., that of providing a guaranteed minimum pension (GMP), would not have to participate. There is a consequent reduction in state contributions from

employers and employees and a chance for private plans to improve on the state. Nevertheless, the state is deeply implicated even in the private occupational schemes since it is committed (financially) to the guarantee of a basic level of earnings-related benefit if the funded part fails to generate sufficient income.

The problem with SERPS is that it is a 'pay-as-you-go' (PAYG) scheme; the retired are to be paid pensions by direct transfers from those in employment. The process is 'validated' by an intergenerational 'promise' that is to be honoured indefinitely. In effect, what is known as the 'pensions time bomb' is passed from the lap of one generation to another.

But why should there be a 'time bomb'? The usual answer is that the keeping of the promise depends on a level of economic growth to pay for the commitment and this projection must in the nature of things be highly speculative. The problem is highlighted by demographic predictions that in the next century the number of workers will fall so that the commitments to existing beneficiaries can only be paid by ever-increasing contributions from those still in employment. The alternative is, of course, the great 'unmentionable', a lowering of the benefits, i.e., a breach of the intergenerational promise or contract.

Now, of course, great fears are being expressed about the future costs of the scheme for generations of workers yet unborn. The statistical predictions have been well documented and there is no need to repeat them here.[3] The most important point here is the 'support ratio', i.e., the number of workers available to finance each SERPS claimant. At present the support ratio is 2.76, and this improves to 3.08 in 2006. Thereafter it is predicted to fall until it reaches 2.40 in 2033. The cost of SERPS starts to rise dramatically in the second quarter of the next century. Now that everyone (except the Labour Party) is trying to get out of the mess it is worth inquiring how we got into it in the first place.

The 1975 Act followed two previous attempts at earnings-related pensions which were thwarted by general elections: these were Richard Crossman's almost completely state-based scheme of 1969 and Sir Keith Joseph's two-tier proposals of 1973. The latter is more interesting. In it every employee had to qualify for a second pension (in addition to the flat-rate entitlement) by either belonging to an approved private scheme or by joining the (less beneficial) 'State Reserve Scheme'. This, however, was intended to be fully funded and would not therefore (in theory) have involved the ethical and economic problems that stem from intergenerational contracts implied by PAYG schemes. In fact, the present government's proposals are not unlike the Joseph scheme.

Now, if we look at Barbara Castle's diaries (she was the minister responsible under the Labour Government of 1974-79) for the period we find an instructive example of the motivations of politicians and of Cabinet decision-making. Mrs Castle, oblivious of the drawbacks of PAYG schemes, was

openly contemptuous of the ill-fated Joseph measure. She wrote: 'One of the most obnoxious features of the Reserve Scheme was that it was to be "funded" . . . instead of current pensions being financed out of the current contributions, plus an Exchequer contribution. . . .'[4] She seemed quite unaware that the viability of PAYG schemes is totally dependent on highly speculative predictions about future economic growth rates, demographic changes and improvements in medicine that lower mortality rates. Indeed, in a volume of nearly 800 pages it is quite remarkable that the issue, potentially the most significant of the Wilson government, is discussed (with no analytical acumen at all) on a mere handful of occasions.

Furthermore, from the same source we learn that the proposal received only desultory consideration in full Cabinet before it became official government policy. Mrs Castle wrote: 'One thing that interested me was the total lack of interest in Cabinet in discussing the scheme.'[5] It was too complex; and the general sense of *ennui* among politicians with regard to pensions no doubt contributed to its easy passage.

It was no doubt this same feeling of *ennui* that led to the alleged all-party consensus about SERPS once the legislation had been passed. However, it is worth pointing out that at first Sir Geoffrey Howe called the scheme 'flat-footed and doctrinaire' and that Mr Hardiman Scott of the BBC asked Mrs Castle the question: 'Isn't this all just an electoral bribe?'

In fact, it was an electoral bribe on the grand scale since it imposed costs on generations not yet born, let alone on the electoral register.

Britain is not alone in passing legislation almost by accident which has far-reaching implications, neither foreseen nor possibly intended by its authors. Similar problems exist in the American system (inaugurated in the Social Security Act of 1935). This was intended by Franklin Roosevelt to be a fully funded pension scheme with benefits closely tied to contributions. However, within twenty-five years the scheme was virtually PAYG and the fund gradually became technically insolvent.

If anything, the implications for freedom in the American system are much worse there since there is no provision for contracting out. Furthermore, since the scheme has been going much longer, the deleterious effects of its unsound financial base are much more clearly visible. There is constant talk now in academically respectable American welfare circles of an impending pensions 'catastrophe'.

The American social security system (it includes other things as well as retirement pensions, but the latter are by far its most expensive commitment) is a perfect example of the ills of an unfunded compulsory state scheme, subject to political controls rather than impersonal economic forces. Its economic and other deficiencies may be summarised as follows.

The most obvious economic deficiency is its cost. The estimated unfunded liability is about 8 trillion dollars and this can only be paid for by ever-increasing payroll taxes on employees and employers (a combined figure at

present of about 13 per cent of taxable income). Indeed, some American householders are now paying more in social security tax than federal income tax. As a PAYG system matures, more people become beneficiaries and the cost rises. This can only be paid for in higher rates of tax—in America the suggestion is that to fulfil the obligations being created by the system will require payroll taxes of up to 40 per cent. This means that as tax rates rise, the value of the benefits eventually received must fall. While in the past successive indexing of benefits has protected their real value, this cannot go on indefinitely under present actuarial calculations. Later generations are therefore bound to lose out under the system. As Weaver puts it: 'A decision to increase the tax rate represents a collective decision to alter the distribution of rates of return between generations.'[6]

The salient question is: how do these things happen? It cannot be simply the ignorance and lack of interest of the politicians. For one thing, the number of workers contributing to the system will always outnumber the beneficiaries, so why do they not outvote them and end the scheme? Even if one allows for the fact of higher turnout of older voters compared to younger voters this would not be significant enough a difference to explain the persistence of the phenomenon.

Undoubtedly, there is a strong element of 'fiscal illusion' in the process. To most voters, at least in the early states of a PAYG scheme, the costs in terms of contributions may seem relatively low compared to the benefits that are promised. Furthermore, voters can hardly be expected to know the opportunity costs involved in their tax 'investments' in terms of foregoing income from the capital market. However, it is worth pointing out that the academic research indicates that had these taxes been invested on the capital market they would have yielded a considerable *increase* in net investment.[7]

Of more significance is the fact that the 'median voter' model, associated with the economic theory of democracy, is inapplicable to situations in general elections where voters choose from rival policy packages (on the assumption that preferences are not 'single peaked'). Voters do not vote on the single issue of pensions but on a whole range of policies. The incentive therefore is for party leaders (political entrepreneurs) to put together packages of policies that favour a coalition of interests that may not represent genuine consensus at all. Furthermore, since each elector has only one vote, which he has to spend on one package, he has no rational self-interest in becoming fully informed of the likely consequences of all the policies. It is for these reasons that certain policies may persist even though there may be no consensus in their favour. Indeed, it is difficult to know in democratic voting systems what a consensus is.

What is particularly striking is that while there may be some incentive for political leaders to moderate their 'bribes' in terms of favourable public policies because they have to be paid for more or less immediately by higher taxes ('paying' for them by inflation is no longer electorally attractive) and

taxation is a vote-loser, this cannot be so in relation to pension schemes such as SERPS. This is because the bill is not picked up until twenty or thirty years later. Political parties think and behave only in terms of periods between elections—no more than five years. This should give the lie to the claim that it is individuals and not political leaders that are short-sighted. In general, an extension of state activity into areas such as pensions is likely to lead to an investment in political activity rather than production and to the domination of interest groups over any genuine public interest—'like wrestlers struggling over the contents of a china shop'.[8]

What is worse, there is the plausible argument of Edgar Browning[9] that suggests that there is not only an inexorable tendency for spending in a PAYG social security system to rise in a majority-rule democracy, but that this eventuates in a *stable* equilibrium. The stable equilibrium rate of tax determined by majority vote is always higher than the preferred rate of tax of each individual taken separately; but according to the argument, every participant has an interest in maintaining it.

As Browning puts it, the key to understanding why this should be so is the differential impact of the system on those older when the system begins (or is changed in size). Thus, older people in the system have an incentive to vote for higher social security taxes to finance higher returns since they will pay these for a shorter length of time: the pension of an individual depends only on the tax rate operative when he retires. Thus, at any point in time, rational self-interest will drive those about to retire to press for an enormously high tax rate while only those about to start work will opt for a rate consonant with a preferred rate of saving for their life-time. But the actual rate of taxation will be determined by the median voter.

In Browning's highly abstract and simplified model, it is assumed that the voting community consists of people aged twenty to seventy, with an equal number of persons of each age and a population of constant size over time: they have identical preferences for rate of taxation at alternative rates of return. The retiring age is sixty-five. He assumes that they all *prefer* a 3 per cent tax rate of return on taxes paid at 10 per cent tax rate. But, in any given year, this does not produce (as one might expect) a 10 per cent tax rate. All the twenty-year-olds would indeed vote for the 10 per cent tax but those, say, aged sixty gain from a much higher increase. For example, if the rate were 20 per cent they would only pay this for five years yet enjoy a higher return. In fact, anyone over twenty gains from a higher than 10 per cent tax rate, so that this cannot be the equilibrium rate. The actual rate will be determined by the median voter (aged forty-five); and this will persist through time if the essentials of the model remain unchanged.

This is, of course, a highly abstract model that assumes away many of the salient features of the real world. But one can profitably speculate on the differences they make to the model. One fact is demographic variation. Will not an increase in population lower the tax rate, since the numbers of younger

age groups will increase and therefore lower the age of the median voter? This is true, but it is quite likely to be offset by increased longevity of older age groups (a problem noted in the discussion of the British SERPS system). Furthermore, as we have already noted, there is a marked tendency for a higher turn-out at elections by older voters in a democratic society. But a larger proportion of younger voters must surely eventually pose some threat to the stability of the system.

The point of Browning's model is that it is a 'one-issue' model and therefore his prediction that a PAYG system is in a theoretical sense 'stable' might well hold. But as we observed earlier, in real world elections voters do not decide on single issues but on policy packages. It is this fact that makes the outcomes of elections indeterminate. In such circumstances we can make no predictions about the fate of PAYG pension schemes in a competitive democracy.

One fact that normally supports the argument that public spending tends to rise in a democracy is the existence of sovereign parliaments, such as that of Great Britain. If there are no formal constraints on what a government may do once it has a parliamentary majority (although, of course, this is highly unlikely to be an electoral majority) then there are few limitations on how it constructs its package of vote-winning policies. Indeed, it is this that makes the 'British disease' peculiarly British.

Yet by a curious irony it is this very sovereignty that enables mistaken policies to be reversed since no one parliament can bind another. This is precisely what is happening to SERPS at the moment. But there is little comfort to be derived from this 'happy' state of affairs since the resolution of the problem depends entirely on the goodwill of politicians rather than on strict constitutional rules. One constitutional rule which could be added to an hypothetical 'economic constitution', that now includes a monetary control rule and a 'balanced budget' rule, would be one strictly limiting the imposition of costs on unborn generations.

It is therefore only by chance that Britain can extricate herself from the pensions imbroglio. Under the present constitutional arrangements there is no guarantee that similar mistakes will not be made in the future if our system of parliamentary sovereignty persists in its present form, as it is likely to do.

The argument that the British policy-making process generates problems that are virtually insoluble (in the sense that past errors cannot be corrected without imposing significant costs on people) is nicely illustrated by the Conservative Government's attempt to get off the SERPS hook. All that has been achieved by the White Paper on the welfare system, *The Reform of Social Security: Programme for Action* (Cmnd 9691), is a modification of the details of the SERPS system and not the killing-off of SERPS itself as proposed in the Green Paper which preceded it.

It has long been a truism of British political science that interest groups are a valuable adjunct to parliamentary democracy in the mobilisation of consent to our political arrangements and decisions. Following on from this

it is argued, especially by Bernard Crick in his *In Defence of Politics*,[10] that in normative terms *political* decisions, which reflect the strengths of the various interest groups in society, are preferable to those taken either in the *anonymous* market or by personalised centralised rulers. It is some stable equilibrium of group activity that is said to constitute consensus.

However, it is just the view that such activity is benign that is under attack at present. For, as each pressure group makes demands on government so this produces a state of fiscal anarchy, with precious little constraint on the levels of public expenditure rising. Parties tend to represent organised coalitions of groups, each driven to seek more state privileges by the mechanics of the system; and with Parliament organised on strict party lines it can do little more than formally validate substantive decisions taken elsewhere. The difficulties involved in ending SERPS show how governments *create* interest groups which have no alternative but to make escalating demands on the public purse.

In relation to unfunded pension schemes it could well be argued that the passing off of their cost onto the future indicates that a certain level of *exhaustion* with regard to taxation by the present generation has been reached. The electoral system does, in a very inefficient way, check ultimately the demands of groups but what it cannot do is protect generations yet unborn.

While there is undoubtedly a consensus that the state should have at least a minimum role in welfare there is little agreement on what that role should be above this. Furthermore, such a consensus is less likely to emerge the more British politics operates in the manner described.

References

1 For a detailed analysis of the philosophy, economics and politics of state pensions schemes, see Norman Barry, 'The State, Pensions and the Philosophy of Welfare', *Journal of Social Policy*, October 1985.
2 See J. Le Grand, *The Strategy of Equality*, Blackwell, Oxford, 1982.
3 See R. Hemming and J. Kay, 'The Costs of the State Earnings Related Pension Scheme', *Economic Journal*, 92 (1982), pp. 300-19.
4 Barbara Castle, *The Castle Diaries 1974-76*, Weidenfeld & Nicolson, London, 1980, p. 53.
5 Ibid, p. 158.
6 Carolyn Weaver, 'The Economics and Politics of the Emergence of Social Security', *The Cato Journal*, 2 (1983), p. 304.
7 See Martin Feldstein, 'Social Security, Induced Retirement and Aggregate Capital Accumulation', *Journal of Political Economy*, 82 (1974), pp. 905-26.
8 Mancur J. Olson, *The Decline of Nations*, Yale University Press, New Haven, 1982, p. 44.
9 Edgar Browning, 'Why the Social Security Budget is too Large in a Democracy', *Economic Inquiry*, 13 (1975), pp. 377-88.
10 Bernard Crick, *In Defence of Politics*, Penguin, Harmondsworth, 1964.

THE DAVID HUME INSTITUTE

HONORARY PRESIDENT (1984-87)

Professor George Stigler, Nobel Laureate in Economics

HONORARY VICE-PRESIDENTS

Professor James Buchanan, Fairfax, Va
Professor David Edward, CMG, QC, Edinburgh
Professor Francesco Forte, Rome
Lord Grimond of Firth
Professor Neil MacCormick, Edinburgh

BOARD OF TRUSTEES

Mr Gerald Elliot (Chairman)
Mr Hugh Hunter Gordon
Lady Mackenzie Stuart
Dr Walter Scott

EXECUTIVE DIRECTOR

Professor Alan Peacock, FBA, Edinburgh

DIRECTORS

Professor Norman Barry, Buckingham
Mrs Catherine Blight
Mr Peter Clarke
Professor Richard Dale, Edinburgh

SECRETARY TO THE INSTITUTE: Mr H. L. Snaith

ADVISORY COUNCIL

Professor Bruno Frey	Zürich
Professor Brian Griffiths	London
Professor Keith Lumsden	Edinburgh
Professor Donald Mackay	Edinburgh
Professor Anthony Ogus	Newcastle-upon-Tyne
Professor Charles Rowley	Fairfax, Va
Professor Pedro Schwartz	Madrid
Professor Andrew Skinner	Glasgow
Mrs Linda Whetstone	
Professor Jack Wiseman	York

REGISTERED OFFICE

Belwood House, Glencorse, Midlothian EH26 0NL
Tel: Penicuik (0968) 77517