Pensions and the age-old crisis

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Abstract The paper suggests that there is a 'cold war' in welfare between different ideas and geographical regions concerning the funding of pensions and the role of the state. Many emotional concepts are used such as 'crisis' and 'dependency'. But the private funding of pensions provision does not produce the economic results and 'rates of return' which are commonly assumed, and many concepts need to be reviewed. Funding is linked to a broader stock market and corporate culture which produces activities which we should examine more closely in terms of 'rate of return', 'investment', corporate structures and economic welfare.

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Many books, academic articles, newspaper articles, reports, mimeographs, pamphlets and conferences in recent years have pressed for pension 'reform' throughout most of the world.¹ This usually means increasing or establishing pension provision through funding, or investment, and private management. The arguments for reform are variously based on concerns about demographics, public expenditure, savings rates, personal choice, investment returns, promoting stock markets, enhancing an equity culture, increasing institutional investment, limiting the ability of governments to 'change their minds' or renege on pension promises, restricting corrupt or inefficient governments which use pension reserves for their 'own' purposes, or governments that interfere with the market allocation of savings.

A colourful language has developed. We have 'creaking' welfare states, 'burdens' of old people, demographic 'timebombs', 'looming' crises, 'implicit public debts', a universal old-age 'crisis',

rising old age 'dependency ratios', 'saving' social security (US pensions), pensions 'fraud', 'crumbling' finances of state welfare systems, 'shrinking' the welfare state, potentially 'bankrupt' national economic and social institutions, 'deplorable' states of affairs, need for 'fundamental' reform, 'crises of confidence', 'crises of social security', 'crises' of this, that and the other.

Furthermore it is generally assumed, even taken for granted, that the private sector makes a better 'return' for contributors on a nation's potential retirement capital than the state (privately managed and funded as opposed to pay-as-you-go). Conversely, raising state pay-as-you-go pensions across the board is said to be wasteful because much of the increase goes to pensioners who do not 'need' it (*viz.* the earnings-related debate in the UK), and anyway this will only aggravate the financial 'crisis'. A broader economic argument, popular with the World Bank and advisers in the USA, is that privatisation (funding under

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private management) increases savings, which in turn increase investment enhancing the nation's 'capital stock', thereby enabling the rising pension claims to be met.

But it has to be *private* management. *Public* management is tantamount to the 'nationalisation' of industry (see the World Bank and Feldstein in footnote 1). Other work decries the role of political 'interference' in pensions management, producing figures of lower 'rates of return' where politicians are involved or where 'social' investment (or ETI — 'economically targeted investment') is introduced.

In other words we have a fairly formidable barrage of arguments, theories, allegations and metaphors in support of the privatisation case.

There have been some interesting responses. The demographic argument about old age 'dependency ratios' and 'crises' is wearing a bit thin and, in any case, different definitions of 'dependency' (general dependency, total dependency) produce different results and implications for public policy.² Next, the arguments about social investment and rates of return beg many questions rather than providing definitive answers to serious points about welfare, the productive use of capital, social and environmental issues, and whether financial returns to shareholders are a reliable measure of all these.

There is also no convincing evidence that privatisation increases savings (even the World Bank is ambivalent on this), and there is no clear case that productive investment and economic growth follow from private savings — nationally from domestic 'investment' or internationally from foreign 'investment'. This is discussed further below. Furthermore, if many old people do not 'need' increases in state pensions then they will surely save them (as they would the higher

private pensions they will apparently receive) — just what some of the privatisers desire in their arguments about increasing the rate of saving.

Old people also contribute to civil society and the economy in all sorts of other ways (free grand-child care, charity, church and political/campaign work, free neighbourhood-watch for their local communities, all of which never figure in the 'national accounts') and many continue to work, on one basis or another. This should surely at least qualify some of the emotional language about 'dependency' and 'burdens'. Indeed, the real social and economic contribution of old people is an issue much in need of research in its own right. 'Old', 'retired', 'pensioned-off' (terms virtually synonymous with 'finished') are concepts defined by legislation, myth and popular imagery, not by actual experience.

The private sector itself can be 'corrupt' or negligent — the personal pensions mis-selling scandal in the UK was not so insignificant to be dismissed as some small historical aberration (5 million cases). Major financial institutions were subject to financial penalties, including the Prudential, the largest UK insurer. I also note the Department of Trade and Industry report of its enquiry into the Maxwell affair and its criticism, not just of the Maxwells but of key City institutions such as Goldman Sachs. And this just relates to pensions' corruption and negligence.

The private sector can also 'change its mind' or renege on 'promises'. There is no 'guarantee' from the market. The dependence on variable stock market returns and the inability to make adequate private pension contributions because of interrupted employment or low wages should be a reminder of this (defined-contribution pensions may be 'fully-funded' by definition, but so

what?). The Equitable Life debacle in the UK is also an example of failed market pension 'guarantees'. The seemingly endless crashes and crises of financial systems stretching back a hundred years or more (many bailed out by the profligate state) also suggest that there is indeed substantial financial market risk, as opposed to what the World Bank calls 'political risk'.

In addition, pensions, whether pay-as-you-go or funded, are only worth what the economy can provide at the time of retirement. Pensions can only buy what is available, at the prices prevailing (unless, one supposes, future pensioners pile up a mountain of tinned food, tea bags, coffee, beer and dried milk while they are still working). Additionally, public expenditure on pensions in the European Union is forecast to increase by less than three per cent of GDP over the next 50 years, assuming no increase in productivity or other positive macro-economic or social factors.

Many private pension systems are also underpinned by tax allowances. Yet no-one appears to have calculated the cost to public exchequers and the rising proportion of GDP over the next fifty years incurred by the increase in subsidised private provision which the privatisers advocate. But privatisation and talk about 'crises' persist — in the UK, USA, continental Europe, Central and Eastern Europe, South America, from the World Bank, academics, the financial press, financial institutions and elsewhere. Why is this?

This paper suggests that the privatisation of pensions through funding, investment and private management is part of the promotion of a much broader model of finance, corporate structures and economic organisation. This model includes the promotion of a 'shareholder culture', 'rolling back' the state, and

increasing the importance of capital markets — no more 'cosy' bank-corporate structures, 'crony' capitalism, 'sclerotic' European conglomerates, 'dinosaurs', 'sleepy' companies, state 'protectionism', 'coddled' workers — more colourful language, this time on the other side of the welfare/corporate equation. Academics and other commentators may think they are writing solely about pensions, welfare and old age 'crises', but they are not.

Private pensions have become an important mechanism in cementing or transforming whole corporate and economic structures. Where there are large private funded/managed pension assets (perhaps a figure equivalent to 40 per cent or more of GDP as a working guideline) there are also large stock markets as a proportion of GDP (over 50 per cent), relatively smaller public expenditure on state pensions, and a primacy of 'shareholder value', 'equity culture' and the virtues of hostile takeovers in which pension funds play a key role. Elsewhere, as in most of continental Europe, the opposite is generally the case.

But the situation is changing in many countries, as we constantly read in the press and journals. In 'crisis-ridden' continental western Europe there have been serious debates or proposals about 'reform', both to the pensions and the corporate structure, one linked to the other.

Germany, the largest member of the European Union in terms of population and GDP, is a prime example. There we have the proposed introduction of private pension plans akin to the US 401(k) plans, or UK personal pension and stakeholder plans, and the increased funding of the 'book reserve' system as companies seek international stock market quotations.³ A 'revolution' is

apparently taking place in German corporate and financial structures too (the concept of 'revolution' in this context is used by *The Financial Times* and *The Wall Street Journal*). The takeover of Mannesmann (Germany) by Vodafone (subsequently the UK's largest company by market capitalisation) and the bid for Dresdner Bank by Allianz (Germany's largest insurer), both have important implications for corporate restructuring and for the role of pensions; Anglo-American in the case of the former, and the new German private plans in the latter.⁴

In central and eastern Europe, pension 'reforms' favour the model advocated by proponents of, what this paper shall refer to as the Anglo-American bloc. Accession to the EU by some of these countries is even seen by one commentator from the World Bank⁵ as a means of encouraging more private provision within many current members of the Union — the European bloc — whether they need it or not. Another driving force for privately invested pensions, especially in eastern Europe, is the privatisation of state industry; shareholders are needed to buy the assets. The Chairman of the Warsaw stock exchange is reported as commenting that this is *the* reason for setting up private pensions.⁶

In South America there are similar arguments. The much plauded Chilean pension scheme has been examined many times with inconclusive proof about its effects on pensions, savings, welfare and economic growth. But the same commentator from the World Bank suggests that 'proof may not be necessary'.⁷ Other countries, including central and eastern Europe, should go down a similar path because it helps to develop their financial sectors.

I call this 'the cold war in welfare'. The old cold war was a global conflict

between competing 'blocs' about social and economic ideas and territory, and about the role of the state versus the market. So is the new one. This new one centres around the enormous expenditures and business of pensions, the role of capital markets, the role of the state and the structure of the corporate and financial sectors — which are all interlinked.

The general point is that the 'welfare blocs' are comprehensive pension and corporate/financial systems. It seems almost impossible to have one model of pensions and welfare alongside another model of finance and corporate control. Each has far-reaching implications for the other because pensions have become so important in terms of finance and the economy. Previous work on the classification of welfare states, welfare 'worlds', welfare regimes, welfare systems and so on, does not take this into account.⁸ The organisation of the corporate system, markets and, most important, the role of the financial sector are all unimportant for the assessment and classification of the welfare system in previous analyses; some leave out private provision altogether. But through the nature of the financial sector, the two sides of welfare and corporate structures are inextricably linked and influence one another, as well as jointly influencing economic and social benefits. Let us consider this, nationally and internationally.

It was mentioned above that countries in the bloc with large private pension funds or plans have large stock markets. There is obviously a connection between the two, especially when pension funds are equivalent to over 40 per cent of GDP, stock markets are equivalent to over 50 per cent of GDP, and pension funds, insurance companies and mutual funds are the largest stock market investors. But what does all this stock

market and pensions 'investment' actually do? Improve and increase the 'capital stock'? The supporting evidence is not very compelling. In the UK only about 3 per cent of stock market turnover, even in good years, goes towards 'new' investment, which is defined here as new issues and rights issues. Of this small percentage, a major part goes towards financing takeovers and mergers. Examination of takeovers suggests that the arguments for their economic benefits leave much to be desired.⁹ Much of the rest of the figure goes toward debt restructuring. The 3 per cent is also a gross figure. If we include redemptions of stock, the net contribution to new activity is much less, even negative.

Colin Mayer¹⁰ found that, between 1970 and 1985, in the UK and the USA new issues actually made a negative contribution to investment — there were net redemptions of stocks due to takeovers and mergers and the consequent buying of stock by acquiring companies. For the USA, Robert Wade and Frank Veneroso found that net savings transferred to the corporate sector through the equity market averaged less than one per cent of GDP over the decade to 1998, and were often negative.¹¹ Doug Henwood calculates that between 1981 and 1997, US non-financial corporations paid back \$813bn more in stock than they issued, due to takeovers and buybacks.¹² Ajit Singh also quotes data which show that between 1970 and 1989 the contribution of equity markets to the investment requirements of the corporate sector in the USA and the UK was negative.¹³ His review of the literature shows no correlation between stock market development and economic growth.

If there was a logical connection between the size of private pension assets, stock markets and economic

growth, one would expect economic growth in the USA and UK to have been many times that of crisis-prone continental Europe. The evidence does not support this; see Table 1. When we compare the Anglo-American bloc with the Asian-Pacific bloc, where there is a much larger role for the state in the direction of investment and management of retirement 'provident funds', the balance of advantage in terms of economic growth favours the latter. Essential ingredients in economic growth appear to stem from factors which have little or nothing to do with private pension funds and stock markets. There is no correlation between size of stock markets and economic growth. But there is a connection between pension funds, stock markets and financial/corporate structures — or the market in corporate control.

Next, let us consider the international dimension. Over 12 per cent of pension fund assets (total assets around \$12,000bn world-wide) are invested outside their country of origin. In G-10 countries the figure is 17 per cent. The UK and Netherlands have around 30 per cent invested outside their home countries. Australia has 24 per cent. Again, as with domestic investment, this private capital is not for the most part 'direct investment' — the provision of finance for new infrastructure, production or services, or the promotion of productive investment in companies outside the domestic economy — or foreign 'capital stock'.

In any case, foreign direct investment is smaller as a proportion of world output than before the First World War, whereas gross international financial flows are much larger. Capital flows were long-term one hundred years ago. Now they are dominated by short-term flows.¹⁴ Foreign direct investment has shown stability in financial crashes.

Table 1: The world's welfare blocs; Anglo-American, European, Asian-Pacific; (selected statistical details)

Country	Public expenditure on state pensions (%GDP) various years 1985–92	Supplementary pensions' coverage (% labour force) various years 1989–96	Funded pension assets (%GDP) mostly 1996	GDP growth 1985–95 (average annual)
United States	6.5	55	58.2	2.5
UK	9.5	75	74.7	2.3
Switzerland	9.9	100	117.1	1.6
Netherlands	9.8	82	87.3	2.6
Ireland	6.1	52	45.0	4.2
Australia	3.9	60	42.0	2.9
Chile	5.7	55 (unoff)	40.0	6.8
		86 (off)		
South Africa		70	57.0	1.0
Japan	5.0	38	41.8	3.1
Canada	4.2	45	43.0	2.2
<i>Anglo-Am. Ave.</i>	6.7	66	60.6	2.9
Austria	14.8	10	1.2	2.6
Belgium	11.0	5	4.1	2.2
Denmark	9.9	80	23.9	1.7
France	11.8	90	5.8	2.2
Finland	10.3	0	10.0	1.0
Germany	10.8	46	5.8	2.8
Greece	12.3	5	12.7	1.4
Italy	14.4	5	3.0	2.0
Luxembourg	12.0	30	19.7	5.9
Portugal	7.7	15	9.9	3.2
Spain	7.5	15	3.8	2.9
Sweden	11.6	100	32.6	1.0
Norway	10.1	25	7.3	2.5
<i>European Ave.</i>	10.8	27	10.4	2.4
Singapore	2.2	90	73.0	8.2
Malaysia	1.6	49	40.8	7.6
Fiji	8.5		43.9	
<i>Asian-Pac. Ave.</i>	4.0		51.5	7.9

Taken from the book, *The Cold War in Welfare*, listed in the References

Portfolio and bank credit flows, in 'stark contrast', have not.¹⁵

The size of these global portfolio financial flows is unprecedented and they are increasingly unpredictable in their activities. It is unnecessary to dwell on the stock market manias and panics of the last five years. The crucial point is that they are now augmented by the way we pay for retirement. But we fail to make the link between the promotion of private pensions and the economic implications for broader financial market and economic activities, nationally and internationally.

This brings us to the famous rate of return argument. All this may be all very

well, some may argue. But it misses the point. The funds secure good rates of return for pensioners and that is enough. They cannot be responsible for running the domestic or world economy. They can only secure the maximum financial return for beneficiaries and, *en route*, promote 'shareholder value' and good 'corporate governance'. This is an interesting reversal of the economic growth argument and it means that the 'financial' rate of return is clearly different from the 'economic' rate of return and may arguably even worsen it. Our use of the 'rate of return' concept surely needs further sophistication when we consider the links between the

pension system and the corporate/financial/economic structure (perhaps a 'Human Development Index' for pension investment in the book listed below). Even the narrow financial rate of return is heavily dependent upon the macro-economic policy of the much maligned state.

In the cold war in welfare there are financial interests with their fees for management, stock market issues and takeover advice (estimated fees for investment banks from the restructuring of continental European companies could amount to \$60bn in a couple of years according to *The Financial Times*,¹⁶ with substantial fees for the management of funded pensions as well, along with corporate interests in takeovers and their doubtful economic gains. There are government interests in demonstrating 'responsibility and restraint' (where the financial implications of continuing state provision in pensions are not so dramatic as many maintain, and in broader economic terms arguably positive), and an Anglo-American movement of academics and reformers who argue for 'responsibility' in the face of demographic pressures, crises or the failure of the state (with considerable lack of evidence).

Furthermore, there are 'new equity culture' lobbyists, international pressures from the World Bank about the link between privatisation and economic growth (confusing increased holdings of equities by pension funds and increases in stock markets with 'long-term capital' and 'productive investment'), and relentless use of emotional and tendentious language from all of the above. We have unproven economic gains from promoting 'shareholder value', and a doubtful ability to create a bigger cake for all by the privatisation of pensions.

All this leads to conclude that there is

something far more fundamental about the 'old age crisis' than is commonly assumed or admitted. Providing security in old age, unfortunately, is not by any means the whole story.

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The article is based on some of the arguments and research in the new book, *The Cold War in Welfare: Stock Markets versus Pensions*, by Richard Minns and published by Verso.

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- 4 See *The Wall Street Journal*, 30th March, 2001, pp. 1 and 4, ('Allianz-Dresdner Deal May Trigger Business Revolution'). For the Vodafone deal, *The Financial Times*, 4th February, 2000, p.1, ('Triumph for Vodafone as Mannesmann Gives In', plus Comment and Analysis, 'Whirlwinds of Change', which discusses the role of pension funds). The former

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