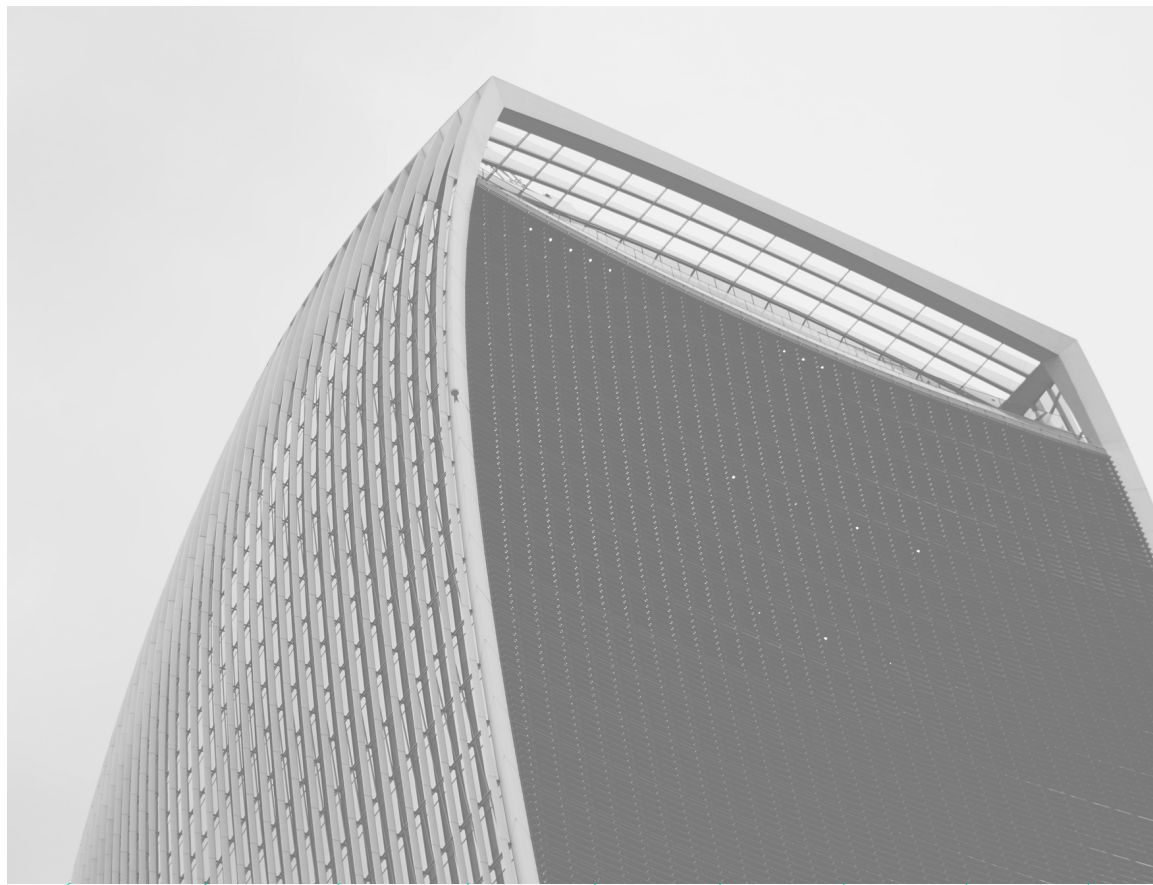


# Undefined Benefit: Fixing the UK Pensions System

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# Executive Summary

Is the UK welfare system skewed toward its oldest citizens? It would not be unreasonable to think so. Analysis shows pensioners<sup>1</sup> were the only group to gain from the changes to working-age benefits and the state pension made by successive governments in the last decade.<sup>2</sup> Compared to 2010, pensioners now receive around £500 more per year in benefits, while £1500 per year has been cut from support for infants and children.<sup>3</sup> At the same time, policies with the potential for wide societal benefit and progressive distributional outcomes, such as windfall taxes, are often challenged, weakened or altogether abandoned on the basis that they will harm pension funds and pensioners' incomes.<sup>4</sup> Importantly, these trends are more than just electorally motivated cynicism. They are also a result of the unique dysfunction built into the design of the UK's pension system.

Far from gilded support, most people in the UK have very poor pension cover, and the distribution of pension assets is steeply unequal, with lower average cover for women and other disadvantaged groups. The vast, state-subsidised private pension assets built up by a rich minority are increasingly invested via globally diversified financial portfolios managed by third-party asset management firms, which invest on behalf of asset owners such as pension funds and charge often substantial fees for the service. In the process, these firms capture substantial rewards for themselves, boasting average profit margins of 35 per cent despite regularly failing to outperform market benchmarks.<sup>5</sup> The result is that rather than pensions investing directly and/or wholly into the UK economy — a concern the Chancellor has recently committed to address through the Mansion House Reforms<sup>6</sup> — this pool of money is distributed in pursuit of higher returns throughout the global economy, to the benefit of large investment firms. Indeed, far from simply allocating investment resources to maximise returns for members, asset managers impose a heavy cost on the pensions system. The large volumes and concentration of pension assets under management in the industry have also enabled leading asset management firms to accumulate significant

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1. Defined here as individuals currently in receipt of pension payments following retirement.

2. Molly Broome, Sophie Hale, Nye Cominetti, Adam Corlett, Karl Handscomb, Louise Murphy, Hannah Slaughter & Lalitha Try, "An intergenerational audit for the UK", Resolution Foundation, 2022, p.38.

3. Ibid.

4. Adrienne Buller and Chris Hayes, "Perspectives: Will Restraining Corporate Excess Harm Pensioners?", Common Wealth, 23/05/23, <https://www.common-wealth.co.uk/perspectives/will-pensioners-suffer-if-we-restrain-corporate-excess>

5. Asset Management Market Study, Financial Market Authority, 2017, MS15/2.3, p.34.

6. "Chancellor's Mansion House Reforms to boost typical pension by over £1,000 a year", HM Treasury, 10/17/2023, <https://www.gov.uk/government/news/chancellors-mansion-house-reforms-to-boost-typical-pension-by-over-1000-a-year>

influence over investment allocation, corporate governance, and even politics.<sup>7</sup>

Finally, the UK's increasingly financialised pensions system reinforces financial instability and short-termism. By trying to fund pension provision through investments in financial markets, pension funds must prioritise the extractive principles of shareholder primacy and maximum returns while at the same time generating new risks, such as the "LDI crisis" that followed the UK's Autumn 2022 mini-budget. Through this system, the wellbeing of pension holders — both those in receipt of payments and those still paying in — has become tethered to financial returns, placing both real and political restrictions on policymakers and pressure on firms and infrastructural projects to maximise profit and shareholder payouts, potentially to the detriment of service quality, real investment, wages, sustainability or other urgent demands.<sup>8</sup>

Resolving these problems means reckoning with two essential points. First, all pensions entail a cross-generational social and economic contract between employers, workers, residents and government to distribute money from those who currently work to those who no longer do so. How long people live after retirement, what costs people face as they age, and how well an economy performs over generational stretches all involve deeply uncertain projections about the long-term future and involve society-spanning challenges. There is nothing individualistic about these processes, which raises the second essential point about pensions: the risks associated with providing them are inherently collective, and therefore easiest to manage when shared collectively. As scholar Craig Berry states, "all forms of pensions provision are collective in practice"; our pensions system should reflect this.<sup>9</sup>

The incremental reformist agenda that has defined pension policy debate for the last three decades has failed to adequately engage with these two critical points. Decisions regarding distributional choices — which should be as transparent as possible, not least for the sake of democratic legitimacy — have been lost in the complexity of modern financial solutions. As key economic indicators have lagged — namely business investment, profitability, productivity and wages — asset managers have stepped forward as modern-day alchemists to promise the production of return from nothing. And critically, the narrative of "personal responsibility" has undermined the social contract, and in so doing has created serious problems concerning distributional justice.

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7. Adrienne Buller and Benjamin Braun, "Under New Management: Share Ownership and the Rise of UK Asset Manager Capitalism", Common Wealth, 09/07/2021, <https://www.common-wealth.co.uk/publications/under-new-management-share-ownership-and-the-growth-of-uk-asset-manager-capitalism>; Adrienne Buller, "The Limits of Privatized Climate Policy", Dissent Magazine, 2022, <https://www.dissentmagazine.org/article/the-limits-of-privatized-climate-policy>

8. Adrienne Buller and Chris Hayes, "Perspectives: Will Restraining Corporate Excess Harm Pensioners?", Common Wealth, 23/05/23, <https://www.common-wealth.co.uk/perspectives/will-pensioners-suffer-if-we-restrain-corporate-excess>

9. Craig Berry, *Pensions Imperilled: The Political Economy of Private Pensions Provision in the UK*. Oxford University Press: 2021, p.37.

This report explores several critical challenges gripping the UK pensions system and problems in its design, before making a series of recommendations for addressing these. With respect to more moderate and readily implementable incremental changes, these include:

- Eliminating or significantly reducing the contribution threshold for accessing the full state pension.
- Reducing or eliminating tax relief on pension contributions and reinstating the lifetime limit.
- Increasing and reforming required contribution rates for employers to address gaps and in-built inequalities.
- Consolidating individualised DC pensions into collective schemes.

More fundamentally, however, we question the justifications for and underlying principles of our prevailing approach to providing economic security and dignity in old age. In place of the inadequacy, instability and financialisation that defines the current model, we argue for a radical reimagining to build a system that is fit for purpose.

## 1 Introduction: The Current UK Pensions Landscape

In the UK, the pensions system has three “pillars”: the state pension, occupational (or workplace) pension, and private personal pensions, each potentially providing the individual with a distinct stream of retirement income. As a baseline, the state provides a basic “poverty avoidance” benefit, typically referred to as the state pension, to which is added an earnings-related stream organised through a workplace pension scheme. Finally, these two streams can be augmented by private pensions: policies that individuals hold directly with financial companies, rather than through a workplace pot.

The state pension is financed on a pay-as-you-go (PAYG) basis: the government receives inflows in the form of National Insurance contributions and other taxation, while the state pension payments represent government outflows. Several public sector workplace pensions, such as teachers’ pensions, are financed in a similar way, with current contributions from those in the workforce financing current pension expenditure.

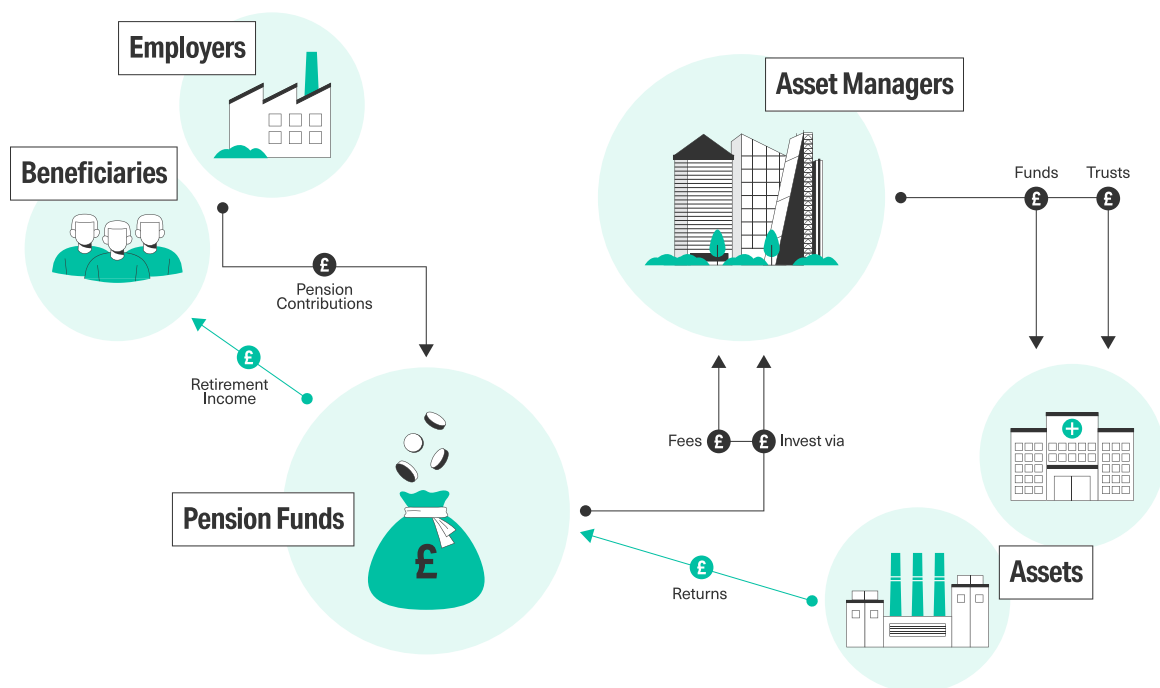
Relative to international peers, the state pension in the UK is very low (explored in Section 3, below),<sup>10</sup> with the result that adequate retirement income frequently hinges on having access to an occupational pension. Since the advent of auto-enrolment in the

10. “Pensions at a Glance 2021: OECD and G20 Indicators”, OECD, 2021, <https://doi.org/10.1787/ca401ebd-en>

UK, which came into force in 2012, most workers have been automatically enrolled into occupational pension schemes. With respect to increasing numbers of participants in such schemes, the policy has been a success: as of 2021, 79 per cent of the active workforce (22.6 million employees) were members of a pension scheme, up from 47 per cent in 2011.<sup>11</sup> However, while auto-enrolment has significantly increased the number of participants in pension schemes, contribution levels remain quite low, the implications of which are examined in Section 3, below.<sup>12</sup>

In contrast to the PAYG method, in the private sector, occupational pension schemes are more likely to be “funded”. Under this approach, pension contributions are taken from the pay of workers in the form of deductions (visible on pay slips) before tax. Employers make additional contributions on top of salaries, set at an agreed percentage of a worker’s salary. Rather than using these income streams to directly finance pensions for retirees, these contributions enter a pooled fund which is used to purchase financial assets. These assets then generate inflows to the fund, for example through dividend payments from shares and interest payments on bonds. In addition, capital gains can be made from re-selling financial assets. In this way, the fund assets are used to finance pension payments.

Figure 1 How Funded Pensions Work



11. “Pension participation at record high but contributions cluster at minimum levels”, Office for National Statistics, 08/05/2018, <https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/workplacepensions/articles/pensionparticipationatrecordhighbutcontributionsclusteratminimumlevels/2018-05-04>

12. Ibid.

Occupational pensions can be divided into two distinct approaches with respect to how pension benefits are determined. Defined Benefits (DB) pension schemes contractually commit to provide members with a specific retirement income based on salary and years of membership. Defined Contributions (DC) schemes, by contrast, guarantee only the rate of contributions to be paid in by employees and employers, with the end benefit depending on the financial performance of the pension fund, thereby closely tying benefits to the performance of financial markets. The differences between and distributional impacts of various types of pension scheme are discussed in detail in the Appendix.

As of 2021, the Office for National Statistics estimates that 22.6 million individuals, or 79 per cent of the eligible workforce, are active members of occupational pension schemes.<sup>13</sup> The collective contributions by employers and workers into these schemes mean that UK pension schemes collectively have assets worth £2.24 trillion.<sup>14</sup> Finally, though there are tens of thousands pension schemes operating in the UK (Table 1), the vast majority are small, which has prompted much recent debate among experts about whether these funds lack the scale to generate sufficient returns or accommodate the risk level associated with investment in assets such as UK infrastructure or firms.<sup>15</sup>

Table 1 Number of UK Pension Schemes and Active Members

	Defined benefit	Hybrid: mixed benefit	Hybrid: dual-section	DC (trust)	DC (workplace contract)
Schemes	4,740	240	600	26,390	1,830
Open Schemes	640	20	260	22,750	1,450
Total membership	5,913,000	1,105,000	4,298,000	24,789,000	N/A
Total active members	440,000	238,000	889,000	10,474,000	5,566,000

Source: The Pensions Regulator<sup>16</sup>

13. "Employee workplace pensions in the UK: 2021 provisional and 2020 final results", Office for National Statistics, 20/04/2022, <https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/workplacepensions/bulletins/annualsurveyofhoursandearningspensionables>; "Occupational pension schemes in the UK", Office for National Statistics, 13/01/2021, <https://www.ons.gov.uk/peoplepopulationandcommunity/personalandhouseholdfinances>

14. "Financial survey of pension schemes", Office for National Statistics, March 2023, <https://www.ons.gov.uk/economy/investmentpensionsandtrusts/datasets/fundedoccupationalpensionschemesintheuk>

15. See Harriet Agnew and Katie Martin, "Britain's 'capitalism without capital': the pension funds that shun risk", *The Financial Times*, 19/04/2023, <https://www.ft.com/content/03280cd7-8013-4212-a98e-e0c35194d009>; Paul Brandily et al., "Beyond Boosterism: Realigning the policy ecosystem to unleash private investment for sustainable growth", The Resolution Foundation, 22/06/2023, <https://www.resolutionfoundation.org/publications/beyond-boosterism/>

16. "DC Trust: scheme return data 2022 to 2023", The Pensions Regulator, 2022, <https://www.thepensionsregulator.gov.uk/en/document-library/research-and-analysis/dc-trust-scheme-return-data-2022-2023>

## 2 How Did We Get Here? A Brief History of UK Pensions

There is a consensus emerging that the UK pension system is heading towards “crisis”.<sup>17</sup> An ageing population, changing economy and patterns of work, slowing productivity, insufficient personal saving, slowing real economy investment, and unequal pensions coverage are generating a perfect storm that, for some, threatens to “wreck the UK economy”.<sup>18</sup> Nearly twenty years ago, and for many of the same reasons, the Pensions Commission (2005) reached a similar conclusion. In response they promised “a new settlement for the twenty-first century”. Yet even then the problem was not new: nearly fifty years prior, British politicians confronted a crisis of pensions, again with similar problems: an ageing population, unequal coverage, and an industrial economy that stood to benefit from potential investment by pension funds.<sup>19</sup>

Throughout this cycle of realisation and failed reform, the UK pensions system has never fully succeeded in three key areas despite repeated commitments to do so: first, establishing generous (or indeed, adequate) pension provision across the population; second, embracing a redistributive system of pension provision; and third, channelling pension fund capacity toward societally beneficial or public purpose investment.

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Instead, the UK has until relatively recently relied primarily on occupational defined benefit (DB) pensions which, faced with increasing funding pressures and crises, are now increasingly closed to new entrants and supplanted by individualised defined contribution (DC) occupational pensions. Perhaps owing to these ongoing failures, pension provision and pension investment have been sites of intense political contestation and relentless reform.

Pensions in the UK originally formed around workplace schemes,<sup>20</sup> which emerged in the late nineteenth century but only grew significantly to include an important share of the workforce in the decades following the Second World War.<sup>21</sup> In 1948, the post-war Labour government introduced a flat-rate state pension to broaden coverage; however, it was provided at levels that, like today, were below subsistence.<sup>22</sup> By 1957, there was already growing recognition that an ageing population threatened

17. See Paul Johnson, “We must act now to prevent a real pensions crisis developing in future”, *The Times*, 16/06/2023.

18. See Melissa Lawford and Szu Ping Chan, “Britain’s retirement crisis threatens to wreck the economy”, *The Telegraph*, 25/05/2023.

19. Hugh Pemberton, “‘What matters is what works’: Labour’s journey from ‘national superannuation’ to ‘personal accounts’”, *British Politics*, 2010, 5 (1), pp. 41–64, p. 42.

20. Berry, *Pensions Imperilled*, p. 39.

21. Aled Davies, “Pension Funds and the Politics of Ownership in Britain, c. 1970–86”, *Twentieth Century British History*, 30 (1), 2019, pp. 81–107, p.83.

22. Pemberton, “‘What matters is what works’: Labour’s journey from ‘national superannuation’ to ‘personal accounts’”, p. 46.



a future “crisis” of pension provision, and that the inequity between those with good occupational pensions and those on the state pension was producing “two nations” in retirement.<sup>23</sup> Thus, contemporary claims that demographic shifts — in other words, an ageing population — which have made or are making pensions unsustainable were unforeseen or “shock” changes do not hold water.<sup>24</sup>

To address the projected crisis identified by the Phillips Committee’s 1954 report<sup>25</sup> into old age provision, the Labour opposition in 1957 proposed a new earnings-related state-run pension scheme. The aspiration was to solve two problems at once: the scheme would channel funds into British corporate equity (specifically, the equity of publicly listed companies) to promote economic growth, and at the same time provide generous provision on a redistributive basis. Within the scheme, higher earners would make larger contributions, which would be invested into UK firms to generate returns for all.<sup>26</sup>

In their early years, occupational pension funds typically invested in the fixed-income bonds of their sponsoring employees, but the Second World War and period immediately following saw funds invest more in government debt securities.<sup>27</sup> Much like today, the push then was for a shift toward greater investment in UK listed equities. These proposals, however, were resisted not only by opposition parties, but also higher paid workers and trade unions.<sup>28</sup> Higher-paid workers, for their part, were not keen on the redistributive element of the proposals, while the Trades Union Congress feared that forcing new workers to enter the new state-run pension scheme, rather than existing occupational schemes, could threaten the sustainability of the latter and potentially undermine the pensions of existing workers.<sup>29</sup>

With Labour’s radical proposals blocked, workplace pensions continued to grow instead. Between 1957 and 1978, the total market value of pension fund assets grew from £8.3 to £31 billion (in 1978 prices), making this a significant financial force in the UK economy.<sup>30</sup> This vast pool of long-term savings made pension fund investments highly politicised. From as early as the mid-1950s, reformers were already seeing pension funds as a source of potentially patient capital that could be used to jump-start a modernisation of the UK industrial sector<sup>31</sup> which meant that by the mid 1970s those

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23. Ibid, p. 42.

24. Berry, *Pensions Imperilled*, p. 11.

25. Phillips Committee, Report of the Committee on the Economic and Financial Problems of the Provision for Old Age (Cmd.9333). London: HMSO.

26. Pemberton, “What matters is what works’: Labour’s journey from ‘national superannuation’ to ‘personal accounts’”, p.47.

27. Berry, *Pensions Imperilled*, p.220.

28. Pemberton, “‘What matters is what works’: Labour’s journey from ‘national superannuation’ to ‘personal accounts’”, p. 48.

29. Ibid.

30. Davies, “Pension Funds and the Politics of Ownership in Britain”, p.83.

31. “National Superannuation: Labour’s Policy for Security in Old Age”, Labour Party, 1957, p. 101.

around the more radical parts of the Labour party were proposing a “state investment agency” to allocate “a very large part of the institutionalised savings of the community”.<sup>32</sup>

Over the same period, there was a movement among prominent financiers who saw the potential of institutional investors to act as a disciplinary force on inefficient managers and drive what would come to be known as a “shareholder revolution”.<sup>33</sup> In this way, pension funds came to be seen as both the drivers of, and a possible solution to, the “financialisation” of the firm.

Pension funds have also played a key role in the financialisation of the state, manifesting in ideas such as “asset-based welfare”,<sup>34</sup> wherein pension fund holdings and home ownership were directly encouraged as an alternative to dependency on state welfare. In his conceptualisation of “pension fund capitalism”, Gordon L. Clark noted that pension funds had a dual role to play in reducing the state: pension funds could hold assets in privatised infrastructure — both built, such as transport or water systems, and social, such as care — thereby reducing both capital and revenue expenditure for states. As such, privatisation not only raised funds for the state but also created investible assets for funds.<sup>35</sup>

As the size of pension portfolios grew, they were increasingly turned over to specialist intermediaries — asset managers — who would invest on their behalf for a fee charged in proportion of the value of the asset pool. By 1981, one third of all UK pension fund assets were delegated to insurance companies in this arrangement.<sup>36</sup> This trend to the concentration of investment power among a few asset managers generated repeated calls for reform of pension fund governance. In 1976, the then Labour government published a white paper proposing that trade union members should make up 50 per cent of the membership of any body in control of a pension fund, as part of a broader movement for industrial democracy.<sup>37</sup> The response from opponents centred on fears that trade unions and government would use their position for “political investment” instead of to comply with their fiduciary duty, understood as maximising returns for beneficiaries.<sup>38</sup> The corollary of this concern was that pension members’ interests were best served by ostensibly apolitical professional asset

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32. James Reveley and John Singleton, “Labour, Industrial Revitalization, and the Financial Sector, 1970–79”, *Twentieth Century British History*, 2016, 27 (4), pp. 599–620, p. 607.

33. Samuel Knafo and Sahil Dutta, “The myth of the shareholder revolution and the financialization of the firm”, *Review of International Political Economy*, 2020, 27 (3), pp. 476–499, p. 477; Charles Raw, Slater Walker, 1977, Andre Deutsch; David Kynaston, *City of London Volume 4: Club No More, 1945–2000* v. 4., Pimlico, 2002, p. 374.

34. Christian Lennartz and Richard Ronald, “Asset-based Welfare and Social Investment: Competing, Compatible, or Complementary Social Policy Strategies for the New Welfare State?”, *Housing, Theory and Society*, 2017, Volume 34 Taylor and Francis.

35. Gordon L. Clark, “Pension Fund Capitalism” Oxford University Press, 2000.

36. Aled Davies, “Pension Funds and the Politics of Ownership in Britain, c. 1970–86”, *Twentieth Century British History*, 30 (1), pp. 81–107, 2019, p. 90.

37. *Ibid*, p. 89.

38. *Ibid*, p. 90.

managers. The so-called “shareholder value” revolution of the 1980s made rhetorical use of this to further empower a tranche of asset managers who would use pension funds resources as part of a strategy of leveraged growth.<sup>39</sup> Pension funds were mobilised to finance hostile takeovers and asset-stripping and though they benefited from higher returns, it was the buyout firms that swallowed the vast profits made<sup>40</sup>—a pattern that continues today.<sup>41</sup>

Throughout this period, the comparative de-industrialisation and falling profitability and growth of the UK economy left firms reluctant to support growing pensions provision. Those with existing DB schemes began to close to new members and employers took contribution “holidays” when they were allowed to by reforms made by the Thatcher government.<sup>42</sup>

As part of the pushback against “industrial democracy” and the risk that pension savings concentrated in institutions risked “pension fund socialism”, the Thatcher government promoted personal pensions.<sup>43</sup> In the name of personal freedom, these reforms prevented employers forcing workers onto occupational schemes and discouraged schemes from running surpluses.<sup>44</sup> Partly as a consequence of these reforms (and the cyclical realisation of the demographic “shock” and the dot.com stock market crash) by the early 2000s existing DB schemes were instead building up projected deficits that looked unsustainable.<sup>45</sup> In response, rather than renewing a push for expanded state pension or enforcing stronger contribution requirements, policymakers continued the push for individualisation of pensions through occupational DC pensions.<sup>46</sup> The Pensions Act of 2004 reversed the rules against running surpluses and eventually the promise of a new pensions settlement for the twenty-first century culminated in the auto-enrolment policy developed by New Labour and eventually implemented under the Coalition government.

Unfortunately, despite being sold as a vital and successful solution, auto-enrolment in DC pensions has done, and will continue to do, comparatively little to secure decent provision for most workers, nor will it redress inequalities inherent to the pension system as currently designed. What it will continue to do, however, is support third-party asset managers who, according to the Investment Association now manage

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39. Julie Froud, Sukhdev Johal, Adam Leaver, Karel Williams, *Financialization and strategy: narrative and numbers*, Routledge, 2006; Knafo and Dutta, “The myth of the shareholder revolution and the financialization of the firm”.

40. Knafo and Dutta, “The myth of the shareholder revolution and the financialization of the firm”.

41. Brett Christophers, *Our lives in their portfolios: why asset managers own the world*, Verso, 2023.

42. Berry, *Pensions Imperilled*, p. 65.

43. Aled Davies, *The City of London and Social Democracy: The Political Economy of Finance in Britain, 1959-1979*, Oxford University Press, 2017.

44. *Ibid.*

45. Berry, *Pensions Imperilled*.

46. *Ibid.*

approximately two thirds of UK pension fund assets,<sup>47</sup> controlling the allocation of investment resources and by doing so reinforcing the pressure on firms to maximise investor returns.

Importantly, while the politics of pension fund investment strategies are often separated from the politics of pension provision, the push for individualisation since the early 1980s should be understood as part of both the growing power of leveraged financial intermediaries, and the broad pushback against the potential of “political investment” — that is pension funds making investment decisions according to collectively decided principles, rather than purely optimising returns.

Today, the UK’s funded pension schemes now have assets worth around £2.24 trillion, and the debate over where these investment resources should go rages on. As we explore in the following sections, over the last two decades investment has turned away from UK corporate equities, contributing markedly to the ongoing decline of UK plc,<sup>48</sup> such that once again politicians from all parties are pushing for rules that force pension funds to invest according to domestic priorities.

## 3 Why UK Pensions Are Not Working

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### Problem one: inadequate pension cover

The UK is an international outlier in terms of the responsibility it places on the individual to secure income for their retirement. While many countries also share the “multi-pillar” approach that mixes state benefits with occupational and private pensions, the UK stands out with respect to the very low level of the state pension, and thus comparatively high dependence on other pillars.

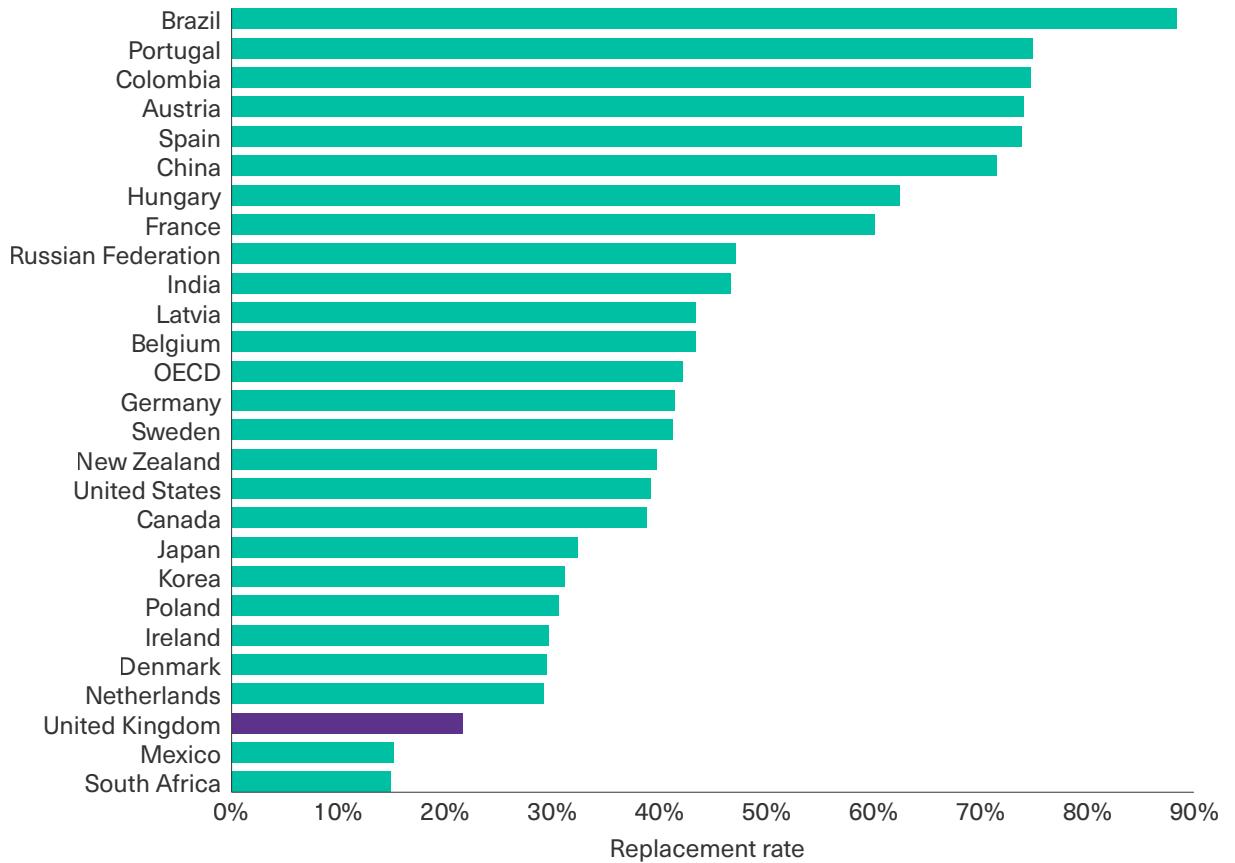
The full UK state pension for 2023/24 is £203.85 per week, or just over £10,600 per year. To place this in context, the adequacy of retirement income can be measured in terms of a “replacement rate”, which compares a year of pension income with a year of average working age gross income prior to retirement.

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47. “Investment Management in the UK 2021-2022”, The Investment Association, 2022, <https://www.theia.org/sites/default/files/2022-09/Investment%20Management%20Survey%202021-22%20full%20report.pdf>

48. “Britain’s stock market has languished. Its gilt market may be next”, *The Economist*, 02/03/2023, <https://www.economist.com/britain/2023/03/02/britains-stockmarket-has-languished-its-gilt-market-may-be-next>

Figure 2 The UK Has One of the Lowest Replacement Rates Among Peer Countries



Source: OECD<sup>49</sup>

Note: Figures measured by the OECD as basic pension income as a proportion of average working income.

To qualify for this full state pension, an individual needs to have made 35 years of National Insurance contributions or have equivalent credits.<sup>50</sup> To qualify for *any* fraction of the state pension, an individual must have made at least ten years of contributions or have equivalent credits. Thus, even the UK’s first pillar, the state pension, is to a degree contribution based. This stands in contrast with countries such as Canada, Mexico, the Netherlands and New Zealand, which have adopted a residence-based, non-contributory basic pension.<sup>51</sup> Residency-based pensions increase coverage and seem to be effective in reducing poverty rates in old age.<sup>52</sup>

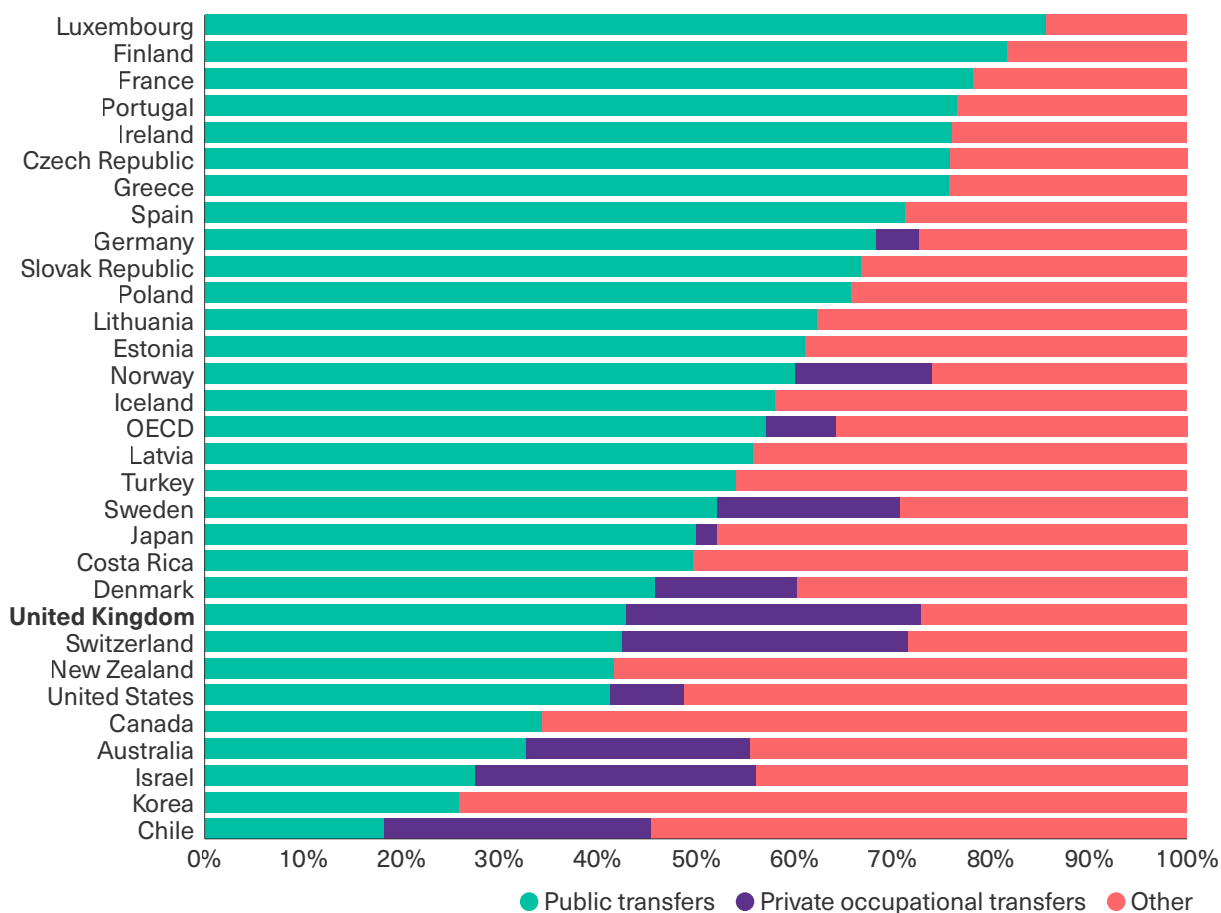
49. “Pensions at a Glance 2021: OECD and G20 Indicators”, OECD, 2021, OECD Publishing, Paris, <https://doi.org/10.1787/ca401ebd-en>

50. “The basic State Pension”, HM Government, <https://www.gov.uk/state-pension>

51. “Pensions at a Glance 2021: OECD and G20 Indicators”, OECD, 2021, OECD Publishing, Paris, <https://doi.org/10.1787/ca401ebd-en>

52. Armando Barrientos, “Cash transfers for older people reduce poverty and inequality” in Anthony J. Bebbington, Anis A. Dani, Arjan de Haan and Michael Walton (eds.) *Institutional Pathways to Equity: Addressing Inequality Traps (New Frontiers of Social Policy Series)* World Bank, 2008.

Figure 3 UK Pensioners Receive Less Retirement Income from Public Transfers



Source: OECD<sup>53</sup>

Note: 2018 data.

The Department for Work and Pensions (DWP) has recently analysed the adequacy of the current UK pensions system (that is, comprising all three pillars), making projections of retirement incomes for current workers.<sup>54</sup> Adequacy was considered both in comparison to a tiered replacement rate measure, allowing for differences in income prior to retirement (Target Replacement Rate, TRR), and on an objective expenditure-based measure, looking at the living standards afforded by different levels of income.

The data show that higher earners are less likely to meet the TRR of 50 per cent. It should be noted, however, that many in the higher income bracket have other forms of non-pension wealth which they may use to supplement their pension, such as buy-to-let properties or private investments. Those on the lowest incomes prior to retirement tend to have higher TRRs, but this could simply reflect an income prior to retirement is already inadequate.

The Pensions and Lifetime Savings Association documentation on retirement

53. "Pensions at a Glance 2021: OECD and G20 Indicators", Figure 7.1, OECD, 2021, OECD Publishing, Paris, <https://doi.org/10.1787/ca401ebd-en>

54. "Analysis of future pension incomes", DWP, 3 May 2023, <https://www.gov.uk/government/statistics/analysis-of-future-pension-incomes/analysis-of-future-pension-incomes>

living standards offer more insight.<sup>55</sup> Just over half (51 per cent) of current workers (aged between 22 and retirement age) are not projected to achieve even a “moderate” retirement living standard, as defined in Table 2 below. Over four million of those currently working are projected to fall below the minimum living standard.

Table 2 Retirement Living Standards and Sample Criteria

Minimum	Moderate	Comfortable
A minimum income of £12,800 a year for a single person is expected to cover needs and allow a small amount in reserve. Needs would include a budget of £54 a week for food. Housing costs are expected to be zero, with money only for minimal DIY. There is no budget for a car, and holidays are UK based.	For some level of security, an income of £23,300 is required. This allows for the upkeep of a car, a two-week holiday in Europe, and more money for food, etc.	£37,300 a year allows for significant expenditures (a new kitchen for example), more for holidays, clothes, gifts etc.

Source: PLSA<sup>56</sup>

Importantly, it should be noted that these projections are based on very optimistic assumptions. For example, the study assumes that on retirement people will use the entire value of their pension pot to buy an annuity, therefore guaranteeing an income until death. In reality, many will choose (or be forced) to take a significant part of their pension as a lump sum, which reduces the income that can be derived from annuities.

The study also assumes that the state pension will continue to be uprated in line with the “Triple Lock” principle, according to which the state pension will be increased each April by whichever is the highest of: CPI in September of the previous year, average increase in wages over the previous year, or 2.5 per cent. However, this policy is vulnerable to “suspensions”, as happened in 2021.<sup>57</sup> Critically, at a time when wages are failing to keep up with inflation, the Triple Lock becomes politically vulnerable, as it raises questions of distributive fairness between older and younger generations. For example, this year the increment rate for the state pension is ten per cent, in line with inflation, while pay growth in the public sector has been under seven per cent, and in the public sector under 5.5 per cent.

55. These standards were developed by Loughborough University on behalf of the Pensions and Lifetime Savings Association (PLSA), working from principles developed by the Joseph Rowntree Foundation. See “Picture Your Future: Retirement Living Standards”, Pensions and Lifetime Savings Association <https://www.retirementlivingstandards.org.uk/>; “Minimum Income Standards”, Joseph Rowntree Foundation <https://www.jrf.org.uk/living-standards/minimum-income-standards>

56. “Picture Your Future: Retirement Living Standards”, Pensions and Lifetime Savings Association <https://www.retirementlivingstandards.org.uk/>

57. Kevin Peachy, “Triple lock pension pledge suspended for one year”, *BBC News*, 07/09/2021, <https://www.bbc.co.uk/news/business-58476547>

Costs of retirement living standards are calculated on a national average, meaning that those living in more expensive areas (e.g., London) will in fact be poorer in real terms. Crucially, in determining adequate standards of income, the assumption is also made that all people in retirement will be living rent and mortgage free. The actual picture is very different, and housing tenure is a key indicator in the likely adequacy of retirement income: one in four renters are projected to not meet minimum retirement living standards, compared to only eight per cent of owner-occupiers.<sup>58</sup>

Thus, even when making highly optimistic assumptions, the DWP's projections point to a future (and present) of insecurity in old age for millions across the UK. The state pension both has poor coverage due to its contribution-based design, and payments fall significantly below the accepted minimum income for those who do fully qualify. Occupational schemes (to be explored further below) are failing by some margin to make up the short-fall, due to inadequate contribution rates and again, poor coverage.

### **Box 1: Case Study**

#### **Lynda Collins, Occupational DC Pension**

Lynda is a 38-year-old retail worker at her local supermarket outside of Leicester. She has worked in different retail jobs since finishing her A-levels in 2002. Until auto-enrolment she was not a member of a pension scheme. She now earns the average (pre-tax) UK income of £33,566. Prior to being auto-enrolled, Lynda had six years out of work while she cared for her two children until they reached school age, as childcare costs were more than she earned from work. She also opted out of pension contributions for five years to try to save for a deposit for a house. She now makes tax deductible contributions of £139.86 per month, with her employer contributing £83.19. By the time she reaches the state retirement age of 68 in line with recent policy changes, absent any further pauses in contributions Lynda will have contributed around £57,000, and her employers £34,200. If the scheme earns a consistent four per cent annual return, she will have around £191,750, enough to purchase an annuity with an annual income around £7,670. This would then be topped up by the state pension, currently £10,600, to make a total of £18,270, £5000 below the "Moderate" income standard of £23,300, though this is reliant on Lynda no longer needing to pay rent or make mortgage payments. Lynda would also gain access to a free TV licence, subsidised travel, and the Winter Fuel Payment.

Assumptions: Yearly income does not change. Minimum legal contribution rate (5 per cent contribution by Lynda, 3 per cent by employer). Annual 4 per cent return. Auto-enrolment in 2015, with no contributions between 2017 and 2021.

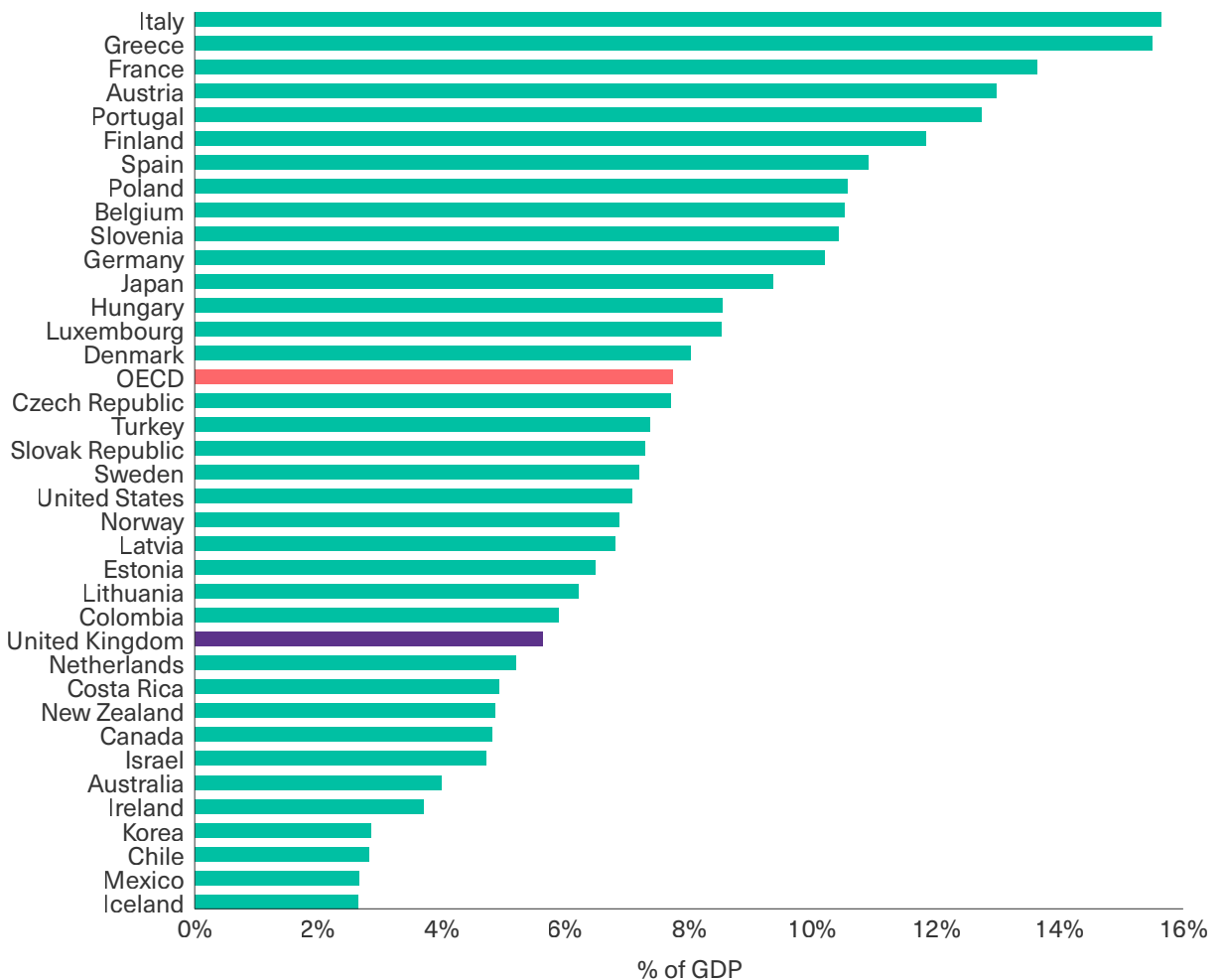
58. "Analysis of future pension incomes", DWP, 03/05/2023, <https://www.gov.uk/government/statistics/analysis-of-future-pension-incomes/analysis-of-future-pension-incomes>



## Problem two: major hidden costs

As Figure 4, below, shows, when compared with peer countries, the UK's direct government expenditure on pensions in 2019 was relatively low at just over six per cent of GDP. However, rather than a reflection of cost-efficiency, these figures obscure several other public expenditures required to sustain decent standards of living for many in retirement age. As measured by the Office for Budget Responsibility (OBR), these include Housing Benefit for those in post-retirement age, Pension Credit and Winter Fuel Payments.<sup>59</sup>

Figure 4 The UK Spends Comparatively Little on the State Pension as a % of GDP



Source: OECD<sup>60</sup>

Note: Comparative government expenditure on basic state pension (2019).

Pension Credit is a benefit for qualifying recipients who fall below a poverty line (for example because they do not qualify for full state pension). Expenditure on Pension Credit in 2021 added a further £5 billion to the £104 billion in direct pension

59. "Welfare Spending: pensioner benefits", OBR, 24 April 2023, <https://obr.uk/forecasts-in-depth/tax-by-tax-spend-by-spend/welfare-spending-pensioner-benefits/>; people over 60 in the UK also receive a number of non-means tested benefits in kind, ranging from free prescriptions to bus passes and TV licences, which can total several hundred pounds annually per recipient.

60. "OECD Social Expenditure Database (SOX)", OECD, <https://www.oecd.org/social/expenditure.htm>

expenditure, while Housing Benefit for those over 65 was £6 billion, and Winter Fuel Payments £2 billion. Expenditure on Housing Benefit is expected to rise due to changing trends in housing tenure among younger groups, with substantially fewer households at retirement age anticipated to be outright owners of their homes.<sup>61</sup> However, by far the most significant government expenditure in addition to the state pension is the tax relief paid on pension contributions. In 2020/21, the net cost of this tax relief was estimated at £48.2 billion,<sup>62</sup> with the cost substantially increasing after the 2023 March budget.

The level of tax relief an individual receives is higher for higher income taxpayers and is therefore distributionally regressive by default. In a 2016 report, the Resolution Foundation<sup>63</sup> calculated that 63 per cent of relief went to the top fifteen per cent of tax earners. In the past, defenders of this preferential tax treatment justified it on the grounds that pension savings had to be used to secure retirement income, and such savings needed policy encouragement. However, policy reforms in 2015 subsequently relaxed the rules regarding what can be done with pension savings. From the age of 55 those in DC schemes can now withdraw cash lump-sums or purchase other pension products.<sup>64</sup> While these changes led to some more sensational claims at the time that pension savings might be spent on “Lamborghinis”,<sup>65</sup> arguably the most significant impact of this policy change is that the distinctiveness of pension savings used to justify their special tax treatment — and therefore the legitimacy of that treatment — is being increasingly undermined.

Thus, while claims are often made about the cost efficiency of the UK pension system for the state, any headline savings associated with the basic state pension must be placed in the context of substantial and often fluctuating costs elsewhere in the system.

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61. Angele Storey, Ngaire Coombs and Rose Giddings, “Living longer: changes in housing tenure over time”, ONS, 10/02/2020, <https://www.ons.gov.uk/peoplepopulationandcommunity/birthsdeathsandmarriages/ageing/articles/livinglonger/changesinhousingtenurevertime>

62. “Private pension statistics commentary: September 2022”, HM Revenues and Customs, 30/11/2022, <https://www.gov.uk/government/statistics/personal-and-stakeholder-pensions-statistics/private-pension-statistics-commentary-september-2022#the-estimated-cost-of-pension-relief>

63. Adam Corlett and Matthew Whittaker, “Save it for another day: pension tax relief and options for reform”, Resolution Foundation, March 2016, <https://www.resolutionfoundation.org/publications/save-it-for-another-day-pension-tax-relief-and-options-for-reform/>

64. Amy Austin, “Pension freedoms: were they really a good idea?”, *The Financial Times*, 08/02/2022, <https://www.ftadviser.com/pensions/2022/02/08/pension-freedoms-were-they-really-a-good-idea/>

65. Nicholas Watt and Larry Elliott, “Pension pots ‘can be used to buy Lamborghinis’”, *The Guardian*, 20/03/2014, <https://www.theguardian.com/money/2014/mar/20/pension-pots-used-lamborghini-minister>

## Problem three: large inequalities in pension wealth

A significant consequence of relying on occupational pensions to “top up” basic state pension provision is that occupational schemes reproduce and even exacerbate the income inequalities that exist between working-age people.

The state pension is by nature highly redistributive. It does not attempt to replace earnings, and therefore the link between contribution and benefit is loose, with the replacement rate higher for those who were on lower incomes prior to retirement. It has a credit system that allows those working outside the formal labour market on qualifying caring activities to build up national insurance contributions. National Insurance contributions go into the National Insurance Fund and must be used for specified social insurance and health care expenditure. This fund can be topped up by a Treasury Grant — i.e., through general income tax receipts, which further strengthens its progressivity since higher earners pay a higher rate of tax.

By contrast, there is a much tighter link between contributions and benefits for occupational pensions, whether DB or DC. In short, those with higher incomes will make higher contributions, receive higher contributions from employers and have higher benefits. Embedded social structures in the labour market, such as differences in pay between gendered and or racialised groups, are therefore recreated at the level of retirement income. Time out of the formal labour market is an even larger problem. Indeed, the “parenting penalty” is one of the largest factors in the gender pensions gap,<sup>66</sup> stemming from a combination of factors, including the fact that even after the point of parental leave, women are far more likely to adopt part time working arrangements and re-join the labour market through taking jobs below their level of education and experience.

The nature of engagement with the formal labour market also affects access to occupational schemes. Employers only have to auto-enrol workers above a minimum level of pay.<sup>67</sup> Workers who engage in low pay work across several different jobs can therefore miss out and not receive employer contributions. Finally, those who are self-employed lose out on employer contributions, adding an extra dimension of concern for the growing adoption of “gig economy” norms across many sectors.<sup>68</sup>

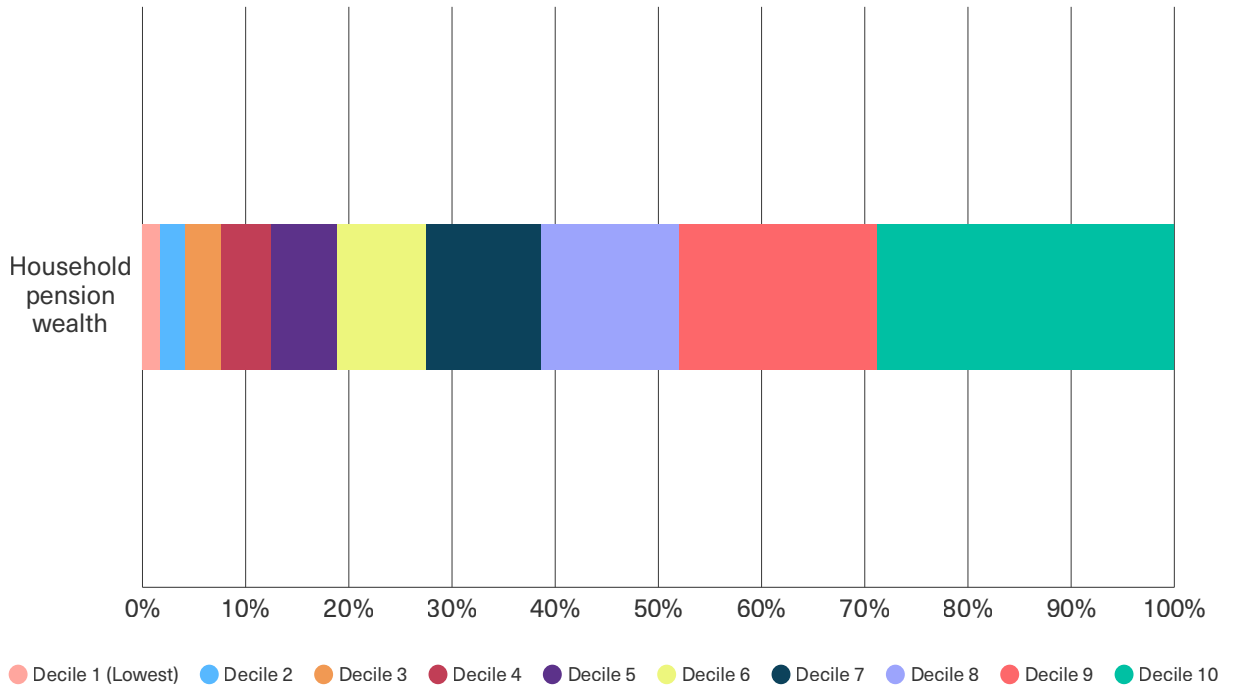
Thus, the current occupational pension system directly reproduces inequalities. These inequalities cut across different categories, including income, occupational social class, gender and, of course, age. The distributions of pension wealth by overall wealth and income deciles provide a particularly striking insight into this reproduction of inequality, as seen in Figures 5.1 and 5.2.

66. “The gender pensions gap”, Trades Union Congress, 29/05/2023, <https://www.tuc.org.uk/research-analysis/reports/gender-pensions-gap>

67. See <https://www.gov.uk/workplace-pensions/joining-a-workplace-pension>

68. Delphine Strauss, “Gig economy workforce hits 4.5m in England and Wales”, *The Financial Times*, 05/11/2021, <https://www.ft.com/content/0db4979c-df93-434c-b931-77179ed5cc99>

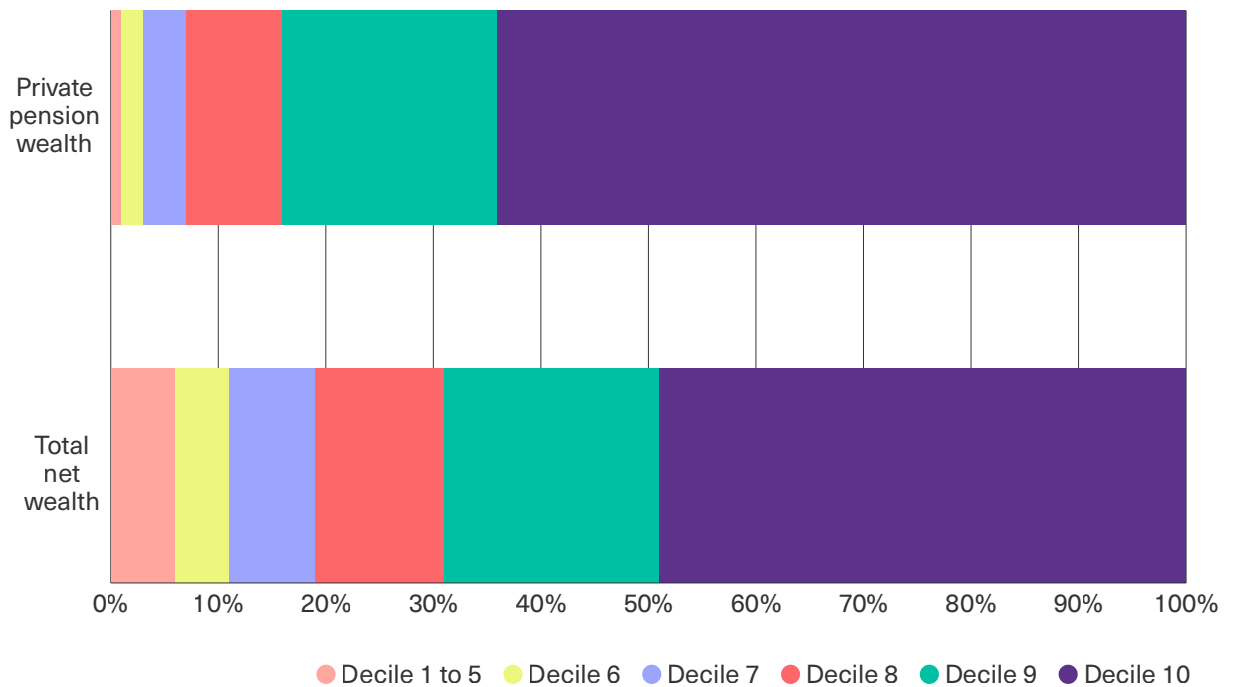
Figure 5.1 UK Pension Wealth Is Very Unequally Distributed (Distribution by Income Decile, 2018)



Source: Common Wealth based on ONS<sup>69</sup>

Figure 5.2 UK Pension Wealth Is Very Unequally Distributed (Distribution by Wealth Decile, 2020)

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Source: Common Wealth based on ONS<sup>70</sup>

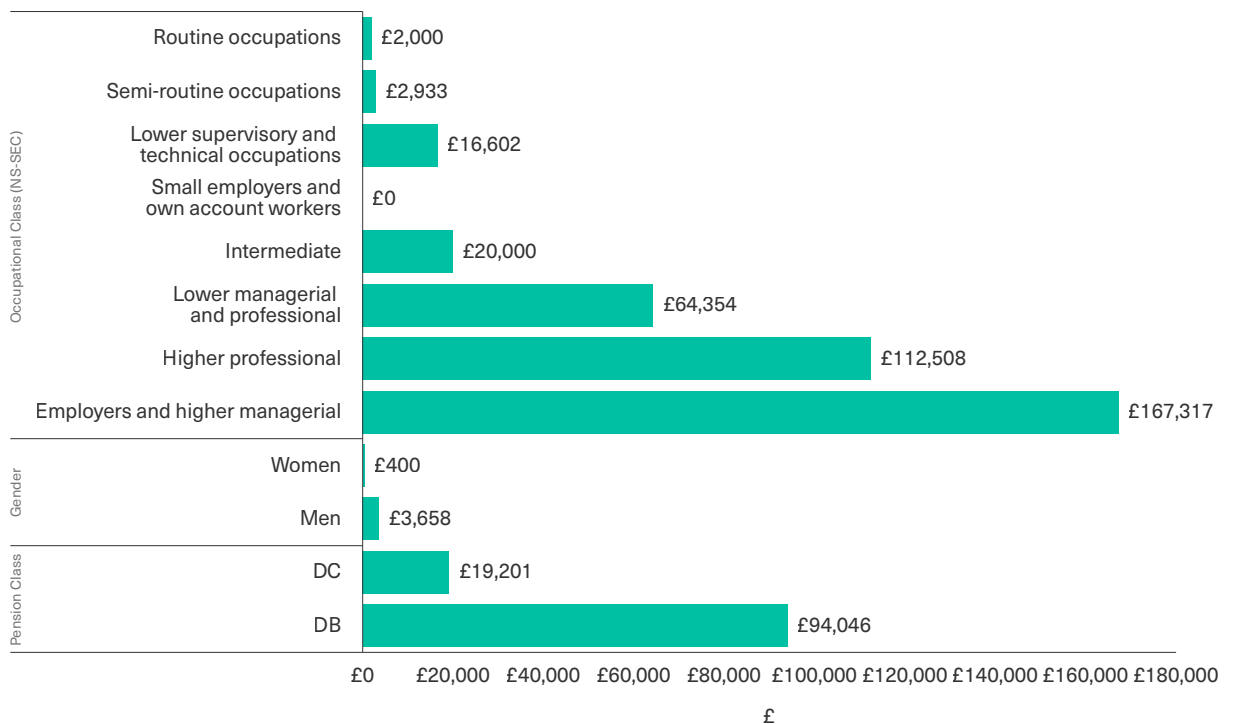
69. "Saving for Retirement in Great Britain: April 2018 to March 2020", Office for National Statistics, 17 June 2022, <https://www.ons.gov.uk/peoplepopulationandcommunity/personalandhouseholdfinances/incomeandwealth/bulletins/pensionwealthingreatbritain/april2018tomarch2020>

70. "UK shares and private pension wealth by household income: Great Britain, July 2010 to June 2016 and April 2014 to March 2018", Office for National Statistics, 04/2021, <https://www.ons.gov.uk/peoplepopulationandcommunity/personalandhouseholdfinances/incomeandwealth/adhocs>

Occupational pension wealth is very unequally distributed. As figure 5.2 highlights, median pension wealth for the top ten per cent (tenth decile) is about £550,000, with this decile owning around 60 per cent of the total. The corresponding figures for the middle (fifth) decile of the distribution are just £550 and three per cent. Even more strikingly, deciles one through four have zero median pension wealth and 0 per cent of the total. In other words, almost 40 per cent of the population has no (occupational) pension wealth at all.

This already stark distribution is stratified in different ways, which partly reflect the inequalities of occupational arrangements. Figure 6 shows a breakdown across several key categories.

**Figure 6 Major Inequalities in Pension Wealth Persist Between Different Groups**



Source: Authors' elaboration based on ONS<sup>71</sup>

Note: The figures show the median pension wealth for workers with current or retained rights in DC or DB pension schemes, by gender and by occupational social class (NS-SEC). Data for the latest round (2018-2020) in £.

Within this figure, several contrasts stand out. First, there is a clear discrepancy in median pension wealth between members of DB schemes — most of which have closed to new members and/or new accruals — and DC schemes. Additionally, though median wealth is relatively low among both genders surveyed, wealth is higher among men compared to women (See Box 2: The Gender Pension Gap in Europe for further detail). Levels of pension wealth are also strikingly unequal when it comes to occupational status: higher managers and professionals have median pension wealth levels above £100,000, while the corresponding level for routine and semi-routine occupations is

71. Ibid.

under £3,000, and zero for the self-employed and small employers.

Therefore, despite the increase in the number of people enrolled in pension schemes, there remain significant gaps in terms of ensuring financial security for many in retirement. This is true both in terms of the social groups less likely to be enrolled into a pension scheme, such as women and self-employed workers,<sup>72</sup> and in terms of the adequacy of the pensions income that people can expect to have.<sup>73</sup>

## Box 2: The Gender Pension Gap in Europe

The low level of basic expenditure on pensions in the UK and other similar countries has drawn attention from reformists since the late 1990s seeking to emulate the UK system by pushing responsibility for the provision of retirement income onto the individual, using a variety of mechanisms to tighten the connection between contribution and benefits.<sup>74</sup>

Where such measures have been taken across member states of the European Union, they have proven to be controversial, not least because of their impact on gender equality. As noted by the European Commission:

“Women (particularly migrant women and women heading single-parent households) still generate a much lower proportion of income on the labour market than men. Women in employment, especially mothers, are much more likely to work part-time and are paid on average 16 per cent less than men per hour of work. As a consequence, the gender overall earnings gap during active years has reached 41 per cent and leads to a very wide gender gap in pensions, which today stands at 40 per cent. Older women are much more at risk of poverty and social exclusion than older men and no mitigating trends have been observed in recent years.”<sup>75</sup>

At a similar time, the UN was also pointing to changes in pensions across Europe (and elsewhere) as a key area of concern, stating:

72. Lauren Wilkinson and Jethwa Chetan, “The Underpensioned Index”, Pension Policy Institute, 2022, <https://www.pensionspolicyinstitute.org.uk/sponsor-research/research-reports/2022/2022-12-07-the-underpensioned-index-2022-edition>

73. David Finch and Cara Pacitti, “Building a living pension: Closing the pension savings gap for low to-middle income families”, Resolution Foundation, 2021, <https://www.resolutionfoundation.org/publications/building-a-living-pension>

74. See, for example, “A Concerted Strategy for Modernising Social Protection”, European Commission, Communication to the Council, the European Parliament, the Economic and Social Committee and the Committee of the Regions, COM (1999) 347, <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=URISERV:c10618>

75. “Strategic Engagement for Gender Equality 2016-2019”, The European Commission Directorate General for Justice and Consumers, 2016, <https://op.europa.eu/en/publication-detail/-/publication/24968221-eb81-11e5-8a81-01aa75ed71a1>



The shift from social insurance to individual capital accounts has had detrimental effects, specifically on women's income security in old age. This is both because benefit levels are directly based on past contributions and because the benefit formula usually considers the number of years during which the person is expected to collect benefits, penalising women for earlier retirement and, in some cases, their greater average longevity through the use of gender-specific actuarial tables.<sup>76</sup>

In response to this problem, it was the conclusion of the Portuguese Presidency of the EU in 2007 that new gender-related indicators for pensions should be considered. To this end, a study was undertaken by the Expert Group on Gender Equality and Social Inclusion, Health and Long-Term Care Issues (EGGSI) on the gendered impact of pension reforms.

The conclusion of the EGGSI study is unequivocal: to address gender disparity in pensions, it will not be sufficient simply to meddle with existing pension design. Rather, the problem needs to be addressed at source. Per the report: “[p]ension policies alone cannot...reduce gender differences in pension income, as they largely reflect gender gaps in the labour market, with women tending to have lower wages than men and interrupted employment histories, and in the home, with men taking little part in household and care activities. To reduce gender gaps in pension income it is thus necessary to improve women's access to the labour market and equal pay”.<sup>77</sup>

The study's proposals for addressing the gender pension gap include: “active labour market policies, care services and reconciliation policies between work and private lives to support women's continuous labour participation and employment careers in the formal labour market; anti-discrimination and employment policies to eliminate gender pay and career gaps and support employment in old age; policies to encourage men to increase their role in the household with appropriate paternity and parental leave and awareness-raising measures”.<sup>78</sup>

76. “Progress of the World's Women 2015-16”, United Nations, 2016, p. 150, [http://progress.unwomen.org/en/2015/pdf/UNW\\_progressreport.pdf](http://progress.unwomen.org/en/2015/pdf/UNW_progressreport.pdf)

77. “The socio-economic impact of pension systems on the respective situations of women and men and the effects of recent trends in pension reforms”, Expert Group on Gender Equality and Social Inclusion, Health and Long-Term Care Issues (EGGSI) 2011 Synthesis Report, p. 10, [http://ec.europa.eu/justice/gender-equality/files/equal\\_economic\\_independence/pensions\\_report\\_en.pdf](http://ec.europa.eu/justice/gender-equality/files/equal_economic_independence/pensions_report_en.pdf)

78. Ibid, p. 160.

## Problem four: (un)productive investment in the broader economy

The largely funded nature of occupational pensions has driven a significant accumulation of wealth in pension funds. Currently, there is approximately £2.24 trillion invested into occupational pension funds — roughly the same size as UK GDP.<sup>79</sup> UK pension funds are, collectively, the second largest in the world after the United States. The immense size of this pool of capital means pensions' investment choices are not only an issue of retirement provision, but also have major implications for financial markets and firms' access to capital. The scale of the sector, alongside concerns about the adequacy of returns for DC funds, has led many prominent voices including the *Financial Times*' Editorial Board to call for changes to the UK pension system to “unlock” this capital and provide “long-term” investment in the domestic economy.<sup>80</sup> In July this year, the Chancellor introduced the “Mansion House Reforms” for pensions in an effort to address these dual concerns. The Reforms aspire to “increase pensions by over £1000 per year in retirement for an average earner”, and intend to do so in part by heeding calls to “unlock” pension allocation to new or under-exposed areas.<sup>81</sup> Among the key aspects of the Reforms is the establishment of an agreement among several of the larger financial services firms to allocate 5 per cent of their default DC fund assets to private (unlisted) equities by 2030.<sup>82</sup>

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However, the above arguments, and the policies stemming from them, rely on several assumptions about the nature of pension investment, discussed below.

As Figure 7 highlights, UK pension fund asset allocation has evolved substantially since 2000. Until relatively recently, UK pension funds were a major source of investment for companies listed on the London Stock Exchange. Indeed, the boom in stock prices in the 1990s can be partly attributed to the growth of pension funds' investment in listed UK equities.<sup>83</sup> However, since the 2000s, direct equity investments have dramatically fallen, with a corresponding growth in exposure to gilts (UK government bonds) and funds (pension funds' investment into pooled vehicles). There are several reasons behind this shift, from risk-related regulation, the closure of many Defined Benefit schemes, and the progressive transformation of financial markets towards increasing

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79. ONS, “Financial survey of pension schemes”, Office for National Statistics, March 2023, <https://www.ons.gov.uk/economy/investmentpensionsandtrusts/datasets/fundedoccupationalpensionschemesintheuk>

80. The editorial board, “How to make Britain’s pensions assets work harder”, *The Financial Times*, 04/06/2023, <https://www.ft.com/content/e56525a8-875f-42b4-a257-2a619863e49a>

81. “Chancellor’s Manion House Reforms to boost typical pension by over £1,000 a year”, HM Treasury, 10/07/2023, <https://www.gov.uk/government/news/chancellors-mansion-house-reforms-to-boost-typical-pension-by-over-1000-a-year>

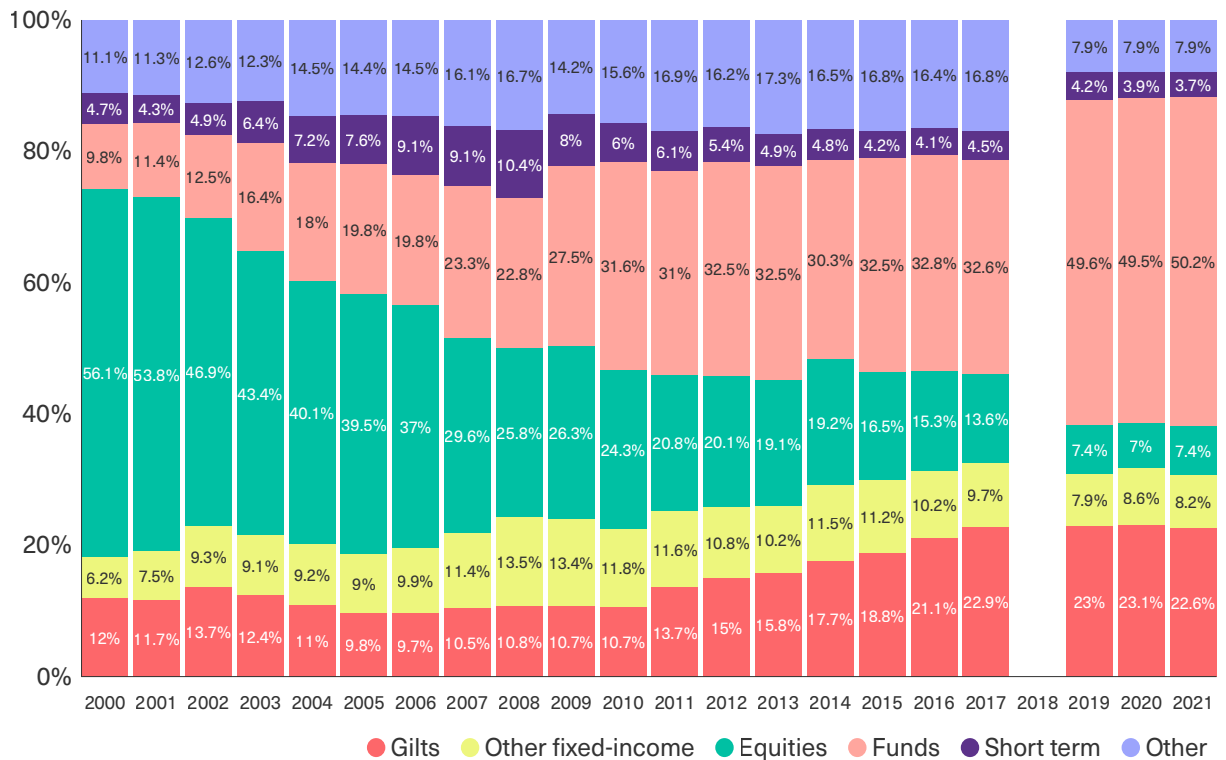
82. Toby Nangle, “UK pension reform push relies on a big bet”, *The Financial Times*, 17/07/2023, <https://www.ft.com/content/ed4d0611-4d2c-405d-98cb-b71352f0d2f5>

83. Jan Toporowski, *The Ends of Finance*, Routledge, 2000.



use of collateral: in other words, an increasing need to hold gilts as a guarantee for borrowing and derivatives.<sup>84</sup>

Figure 7 UK Pension Fund Allocation Has Moved Substantially Over Time Away From Equities



Source: Author's elaboration<sup>85</sup>

Note: Figures are expressed as percentages of total assets (net of derivatives). The 2018 gap and jump to subsequent years reflects a change in the survey methods by the ONS.

One consequence of this process is the greater importance of the asset manager industry for pension funds and, by extension, asset managers' much greater influence in the economy. Indeed, the chart above shows only pensions' direct investments in equities; while these have fallen substantially, pensions today are increasingly exposed to equities through pooled funds, with asset managers directly holding the securities instead. Over time, the launch of practices such as Liability-Driven Investment (See Box 3: "Liability-Driven Investment"), products such as Diversified Growth Funds,<sup>86</sup> and the offer of opportunities to increase international portfolio diversification have driven an explosion in the proportion of pension money invested via asset managers rather than directly by pension funds themselves. Even large pension schemes, such as the government-backed DC pension provider NEST, use a suite of external asset managers

84. See Berry, *Pensions Imperilled* and Bruno Bonizzi, Jennifer Churchill and Annina Kaltenbrunner, "UK pension funds' patience and liquidity in the age of market-based finance", *New Political Economy*, 2023.

85. Figures based on ONS, "Financial survey of pension schemes", Office for National Statistics, March 2023, <https://www.ons.gov.uk/economy/investmentpensionsandtrusts/datasets/fundedoccupationalpensionschemesintheuk> and ONS, "Investment by insurance companies, pension funds and trusts (MQ5)", Office for National Statistics, 2019. <https://www.ons.gov.uk/economy/investmentpensionsandtrusts/datasets/mq5investmentbyinsurancecompaniespensionfundsandtrusts>

86. These funds contain a wide range of assets, such as equity, different types of bonds, property, hedge funds and commodities. See PLSA, "Diversified Growth Funds: Made Simple Guide", 2015.

and pooled fund products.<sup>87</sup> This has meant a significant expansion in fees paid by pension funds to the industry (See Box 4 “Pension Funds and Asset Managers”), which increases costs for pension beneficiaries.

Because it is a comparatively high-yielding asset class, private equity investment has already begun to grow in popularity among pension funds globally.<sup>88</sup> Private equity investments often offer substantially higher returns than other assets: the measured internal annual rate of return in the UK since 2012 is reportedly 22.6 per cent.<sup>89</sup> In the UK, private equity investments are the primary route through which pension funds have gained access to outsourced local government service provision, particularly social care and services for looked-after children (foster care and care homes). These investments have often proven profitable but politically contentious, as practices such as high leverage and property sell-and-rent-back schemes have increased precarity in provision in sectors like care, without obvious value-for-money advantages.<sup>90</sup> Many stakeholders, policymakers and civil society organisations also increasingly call for pension funds to provide critical capital for investment in infrastructure projects, particularly those relevant to decarbonisation such as clean energy. Perceived as inherently long-term in their strategies, claims are often made that unlocking pension assets is key to delivering the transition to a low-carbon economy.

However, examples such as private-equity-backed care homes in crisis<sup>91</sup> or even the recent turmoil at Thames Water, in which both UK and Canadian pension schemes are top investors (alongside the Abu Dhabi Investment Authority and China Investment Corporation),<sup>92</sup> should sound alarms about the logic of relying on pension schemes to invest in areas such as social (e.g. care) and physical (e.g. utilities) infrastructure, including through private equity. Indeed, the critical challenge for this popular argument is that pension fund investment is not as long-term and patient as many might assume or hope it to be. On the one hand, regulatory pressures give most DB pension funds a short-term horizon, as they are heavily focussed on maintaining a stable funding

87. See <https://www.nestpensions.org.uk/schemeweb/nest/investing-your-pension/how-nest-invests/our-investment-team.html>

88. Jonathan Ford, “Pension funds and private equity: a puzzling romance”, *The Financial Times*, 02/02/2020, <https://www.ft.com/content/fc16cdec-45ba-11ea-ae2-9ddbdc86190d>

89. “Performance Measurement Survey 2021”, BVCA (British Private Equity and Venture Capital Association), <https://www.bvca.co.uk/Research/Industry-Performance>

90. Gill Plimmer, “Private equity and Britain’s care home crisis”, *The Financial Times* 09/02/2020, <https://www.ft.com/content/952317a6-36c1-11ea-a6d3-9a26f8c3cba4>; Gill Plimmer, “Children’s care triggers bumper returns for private equity owners”, *The Financial Times*, 17/06/2021, <https://www.ft.com/content/c39e8f95-fb25-42f0-8f89-b7525ec64e69>; Grace Blakeley and Harry Quilter-Pinner, “Who Cares? Financialisation in social care”, IPPR, 2019, <https://www.ippr.org/research/publications/financialisation-in-social-care>

91. Tim Jarrett and Rachael Harker, “Four Seasons Health Care Group – financial difficulties and safeguards for clients”, House of Commons Library, 05/11/2019, <https://commonslibrary.parliament.uk/research-briefings/cbp-8004/>

92. Ewan McGaughey, “Repairing English Water in the Wake of the Thames Water Crisis”, Common Wealth, 04/07/2023, <https://www.common-wealth.co.uk/publications/repairing-english-water-in-the-wake-of-the-thames-water-crisis>

ratio in preparation for a triennial regulatory evaluation (See Box 3: Liability-Driven Investment). More broadly, both DB and DC pension funds are highly concerned with the liquidity of their investments due to the uncertain liquidity needs arising from the use of derivatives and in some cases increasing leverage. In the case of DC schemes, flexibility of investment is in-built in the system, which prompts a need to keep their investment liquid on a daily basis. This need stands in direct conflict with investment in long-term illiquid assets such as infrastructure projects.

Additionally, as Brett Christophers notes, approximately three quarters of pension funds' investments in infrastructure are made through unlisted investment funds offered by third-party asset managers.<sup>93</sup> Critically, as Christophers argues: "most asset manager investment in infrastructure occurs through closed-end funds with fixed lifespans (normally of ten-twelve years), which necessitate asset disposal before the end of the fund's life."<sup>94</sup> This approach thus calls into question the framing of pensions as inherently patient investors whose money should be channelled toward vital long-term infrastructure, particularly when this investment continues to be made through third-party funds.

Relying on financial markets to provide for retirement also makes pension funds vulnerable to fluctuating asset prices and interest rates. A key problem in the decade following the 2008 financial crisis and before the Covid-19 pandemic was a chronic low-yield environment, which hurt pension funds by lowering the returns on the bonds to which they were increasingly exposed (as well as increasing the value of their liabilities — see Box 3). This pushed pension funds to experiment with investing in high-return collective funds in the hope of enhancing returns while retaining some liquidity. The problem is that such investments are highly pro-cyclical, and even their liquidity is questionable during crises — precisely when pension funds need it.

Acute attention to liquidity and search for yield ultimately constrain the ability of pension funds to make "good" or "productive" investments. Despite repeated attempts, it remains very hard to direct pension fund investment into projects with high uncertainty but potentially very positive socioeconomic impacts.<sup>95</sup> Indeed, while some pension funds have committed to divestment and most rely on ESG metrics, they remain widely invested into the fossil-fuel industry.<sup>96</sup> Finally, as former fund manager Toby Nangle recently outlined in *The Financial Times*, compelling pensions to allocate more to private equity in order to increase their returns is a considerable gamble, relying on recent trends in the sector as a basis for a long-term policy, where private equity and

93. Brett Christophers, "The dangers of asset managers when it comes to long-term infrastructure", *The Financial Times*, 16/04/2023, <https://www.ft.com/content/0cbd8878-1de1-4f73-8e87-73e1dafad1f2>

94. Ibid.

95. Productive finance working group, "A Roadmap for Increasing Productive Investment", Bank of England and Financial Conduct Authority, 2021, <https://www.bankofengland.co.uk/-/media/boe/files/report/2021/roadmap-for-increasing-productive-finance-investment.pdf>

96. UK Divest, "Polluted Pensions? Clearing the air around UK pensions and fossil fuels", 2021 <https://www.divest.org.uk/wp-content/uploads/2021/10/Polluted-Pensions-Final-1.pdf>

other areas like venture capital have returned highly varied results.<sup>97</sup> Nangle notes that academic studies “almost universally” find that once fees are deducted, returns from private equity don’t beat public markets.<sup>98</sup>

### **Box 3: Liability-Driven Investment**

After the Truss “mini-budget”, the UK briefly teetered on the edge of a crisis related to a peculiar investment strategy among UK pension funds: liability-driven investment (LDI). As the name suggests, this strategy implies that the primary goal of pension fund investment is to meet a fund’s liabilities. For DB pensions, these consist of the future retirement income that must be paid to scheme members. In practice, for regulatory and accounting purposes, pension funds calculate the present value of future pensions to be paid through a process of mathematical discounting. Pension funds then compare the value of their liabilities with the market value of their assets. When the former is greater than the latter, pension funds are said to be “underfunded”. The same considerations do not apply for DC pensions, as these do not generate fixed benefits and therefore the value of the assets determine the possible value of the pensions.

Underfunding implies costs for employers, which typically need to pay higher contributions to fill the gap. Pension schemes therefore actively try to reduce the risk of finding themselves underfunded. One key source of this risk is interest rate risk, because the yields on UK gilts are used as the base for the discount rate to calculate pension liabilities, as they arguably represent a benchmark for safe returns because government debt is the most likely of all to be repaid (it should be noted that using a mark-to-market discount rate is controversial, with some arguing for alternatives e.g. taking a ten year average). When interest rates fall, the present value of the future liabilities of the fund is discounted at a lower rate, and the liabilities of the fund therefore increase in value.

LDI has emerged primarily as a strategy to reduce such interest rate risks. The strategy involves increased allocation to gilts, as well the use of interest rate swaps and repo-based leverage to hedge against interest rate declines and counter any increase in liabilities with a similar increase in assets. Using swaps and repos also frees up financial resources that can be invested in other asset classes that might hold the promise of higher returns. LDI has become a popular and rapidly growing segment of UK asset management (see Box 4),

97. Toby Nangle, “UK pension reform push relies on a big bet”, *The Financial Times*, 17 July 2023, <https://www.ft.com/content/ed4d0611-4d2c-405d-98cb-b71352f0d2f5>

98. Ibid.

with a total of up to £1.6 trillion in assets under management.<sup>99</sup>

However, while LDI can be used to mitigate interest rate risks, it can also generate liquidity risks for pension funds. Derivatives and repos require pension schemes to have “collateral” — assets pledged to cover their exposure to banks and financial intermediaries. An increase in interest rates can force pension funds to pledge additional collateral to protect their investments. When interest rates rise quickly, pension funds can struggle to meet such demands. Between Friday 23 September and Wednesday 28 September 2022, as interest rates on long-term gilts rose by more than one percentage point following the “mini-budget”, pension funds had to either sell financial assets to generate cash or lose their LDI investments. By selling gilts, pension funds themselves contributed to rising interest rates. Only intervention by the Bank of England was able to stop this episode of financial instability.

Unsurprisingly, after these events, LDI became a contentious approach to investing, sparking debates among policy makers including an inquiry by the Department for Work and Pensions. So far however, there do appear to be signs that LDI will be abandoned.

#### **Box 4: Pension Funds and Asset Managers**

The relationship between pension funds and asset managers in the UK is tight. According to data by the Investment Association, pension funds are the single largest client of the UK asset manager industry, accounting for about 40 per cent of the £10 trillion of the industry’s assets under management in 2021.<sup>100</sup> This mainly comprises occupational pension funds in both the private sector and the public sector.

These relationships can take different forms. An asset manager might manage a particular portion of a pension funds’ portfolio, which remains segregated with a clear mandate in terms of asset class and/or risk. Alternatively, pension funds can invest in pooled funds offered by asset managers, where their assets are joined with those of other institutional investors.

99. “Investment Management in the UK 2021-2022”, The Investment Association, 2022, <https://www.theia.org/sites/default/files/2022-09/Investment%20Management%20Survey%202021-22%20full%20report.pdf>

100. “Investment Management in the UK 2021-2022”, The Investment Association, 2022, <https://www.theia.org/sites/default/files/2022-09/Investment%20Management%20Survey%202021-22%20full%20report.pdf>

Pooled investment funds have grown significantly over the past two decades. Investment in these funds is particularly common among smaller pension funds, which do not have the scale to directly invest a broad range of assets directly. Many pooled investment vehicles may invest in more “traditional” and comparatively lower risk and lower yield assets such as corporate and government bonds and publicly listed equities. However, they are not limited to traditional asset classes, with “mixed-strategy” funds comprised of several asset classes as well as “alternatives”, such as private equity assets and hedge funds. These assets promise a higher rate of return and/or diversification benefits, for which pension funds have been searching desperately over the past decade of very low interest rates.

These increasingly sophisticated strategies generate significant revenue for the asset manager industry. A report by Hymans Robertson estimates the collective annual fees for asset managers by DB pension schemes to be £5-7 billion.<sup>101</sup> DC Schemes, which have been under significant “value for money” scrutiny, have an average annual charge 0.48 per cent of total assets, suggests roughly annual flow of £1 billion paid to pension providers.<sup>102</sup> These fees benefit mainly a concentrated industry, with the top three managers (Legal and General, Insight and Blackrock) managing about 70 per cent of total assets.<sup>103</sup>

## 4. Charting the Alternatives

A pension system largely based on funded occupational pensions takes a long time to change. Most private sector DB schemes have been largely closed to new members for over a decade,<sup>104</sup> and there has been a significant growth of workers enrolled into DC schemes. Despite these gradual shifts, however, corporate DB pension schemes still represent the lion’s share (over 80 per cent) of UK pension assets.<sup>105</sup> While the

101. Hymans Robertson, “Maximising Value in DB”, 2018, [https://www.hymans.co.uk/media/uploads/Maximising\\_Value\\_in\\_DB\\_FINAL.pdf](https://www.hymans.co.uk/media/uploads/Maximising_Value_in_DB_FINAL.pdf)

102. This charge however covers all running costs of DC pension funds, not just investment management. See DWP, “Pension charges survey 2020: charges in defined contribution pension schemes”, 2021, <https://www.gov.uk/government/publications/pension-charges-survey-2020-charges-in-defined-contribution-pension-schemes/pension-charges-survey-2020-charges-in-defined-contribution-pension-schemes>

103. Nick Reeves, “Chart of the Week: The UK’s biggest asset managers”, Investment and Pensions Europe, 30/8/2019, <https://www.ipe.com/chart-of-the-week-the-uks-biggest-asset-managers/10033048.article>

104. The Pension Regulator, “Annual landscape report on defined benefit and hybrid schemes 2020”, March 2021, <https://www.thepensionsregulator.gov.uk/en/document-library/research-and-analysis/db-pensions-landscape-2020>

105. “Purple Book 2022: DB Pensions Universe Risk Profile”, Pension Protection Fund, November 2022, [https://www.ppf.co.uk/-/media/PPF-Website/Public/Years/2022-11/PPF\\_PurpleBook\\_2022.pdf](https://www.ppf.co.uk/-/media/PPF-Website/Public/Years/2022-11/PPF_PurpleBook_2022.pdf)

direction of travel toward a DC-based system is clear with respect to participation, the next decades are likely to see the broad configuration of occupational pension left unchanged. Thus, in the medium-term, a progressive policy agenda should try to tackle the pension system's current shortcomings in terms of adequacy, inequality and the allocation of investment.

We identify four key areas where policy changes could improve the adequacy and fairness of pensions, whilst encouraging more productive use of pension assets: first, state pension provision and taxation of pension contributions; second, extending coverage and increasing contributions into occupational pensions; third, the redesign of pension schemes to move away from individualisation and towards forms of collective risk sharing; and finally, the question of directing pension investment into productive areas for the economy and society at large.

## Improving the state pension and reforming tax benefits

It is increasingly clear that auto-enrolment in DC schemes is unlikely to provide sufficient retirement income for most workers. Thus, it is paramount that the state pension is both protected and extended. Because of the Triple Lock, pension expenditure in relation to GDP in the UK will automatically increase in the near-term owing to prevailing conditions of low GDP growth and high inflation. Importantly, while the OBR projects spending will be five per cent of GDP by 2027-28,<sup>106</sup> this remains significantly below the OECD average of eight per cent. The Triple Lock could thus be expanded to include some commitment not to fall below the eight per cent mark, or a higher target.

However, pension expenditure as a proportion of GDP is clearly a limited measure, as it tells us nothing about the distributional implications of this spending and their relations to other forms of welfare expenditure. The OBR forecast for UK state pension expenditure in 2023/24 is £123 billion, or approximately ten per cent of total government expenditure of £1189 billion. Given this high expenditure relative to government spending overall, one important question is whether additional spending should be targeted, for instance to those in the lowest income and wealth deciles, to ensure "best value". However, as a word of caution, any advantages that might be gained from targeting support must be balanced against any losses to the universalism within the current state pension design, given that progressivity can be maintained elsewhere through the tax system.

Perhaps most important in designing and determining the appropriate scale of state pension expenditure is the need to holistically consider total pensioner benefits (that is, the combination of state pension, pension credit, pensioner housing benefit and winter fuel payment), and ongoing trends related to each element. With the above

106. OBR, "Welfare spending: pensioner benefits", April 2023, <https://obr.uk/forecasts-in-depth/tax-by-tax-spend-by-spend/welfare-spending-pensioner-benefits>

in mind, there are several relatively modest and implementable changes that could improve the outcomes and equity of the existing state pension system.

### → **Recommendation 1: eliminate or significantly reduce the contribution threshold for accessing the full state pension**

The current requirement for thirty-five years of contributions to access the full state pension is relatively extreme compared with many peer countries where retirement income is based on residency, serving almost as a universal basic income for those of retirement age. Some of these countries, also have a large occupational pension pillar, similarly to the UK, including Canada and the Netherlands. Eliminating the contribution threshold would reduce inequalities by boosting the pension income of those with a more irregular contribution history. At the very least, there is considerable scope for reducing the number of years of contributions required to access the full pension, which could be undertaken as a first step toward a residence-based system.

### → **Recommendation 2: reduce or eliminate tax relief on pension contributions and reinstate the lifetime limit**

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The most obvious area for reform with respect to public expenditure is the tax treatment of pension contributions. Tax rebates, which in practice represent a large net transfer of £48 billion per year,<sup>107</sup> were meant to encourage saving in a climate where workers had to take the active choice of saving towards retirement through either a personal or occupational pension. After the UK adopted auto-enrolment, this incentive became redundant, with membership based on an opt-out scheme.

Moreover, the system as it is currently designed disproportionately benefits higher earners who, paying more tax, receive a higher relief. In light of the regressive redistributive impacts of existing tax relief and its substantial cost, there is a clear need to radically reduce the tax relief available on pension contributions and reinstate the lifetime limit, which placed a cap on the maximum amount of tax-free pension contributions an individual could receive over a lifetime. Additionally, the higher rates of tax relief available for those on higher income-tax rates could be eliminated, setting the tax relief rate at a fixed level of twenty per cent.<sup>108</sup> Ultimately, the pension tax relief could be entirely abolished, and the additional revenue used to increase the state pension.

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107. "Private pension statistics commentary: September 2022", HM Revenues and Customs, 30/11/2022, <https://www.gov.uk/government/statistics/personal-and-stakeholder-pensions-statistics/private-pension-statistics-commentary-september-2022#the-estimated-cost-of-pension-relief>

108. Currently everyone automatically receives 20% on contributions if they pay the basic tax rate of 20%. However, those paying higher income-tax rates (40% and 45%) can claim extra tax relief. See <https://www.gov.uk/tax-on-your-private-pension/pension-tax-relief>



## Adequacy and equality: increasing coverage in the current pensions system

The success of auto-enrolment in extending pension coverage should not lead to complacency. Access to and the distribution of occupational pension entitlements remains enormously unequal, and there are considerable risks surrounding the long-term inadequacy of DC schemes with respect to retirement income. While mitigating these risks is a significant challenge, it is also vital to avoid a future of insecurity in old age for a substantial portion of the population.

### → **Recommendation 3: increase and reform required contribution rates for employers to address gaps and in-built inequalities**

Increasing mandated contribution rates by employers can not only help to ensure sufficient retirement income, but can also be targeted to reduce inequalities, for instance by increasing employer contribution rates for those on lower incomes. The current minimum employer contribution rate to DC pensions is three per cent. By contrast, those employers sponsoring DB schemes pay in much more than this, with contributions over fifteen per cent not unusual.<sup>109</sup> Indeed, despite the number of participants in DC schemes having recently overtaken those contributing to DB schemes,<sup>110</sup> DC pensions account for just thirty per cent of employer contributions.<sup>111</sup> Contribution rates should therefore increase on average, to ensure “minimum” retirement living standards as defined above in Table 2 are met as an immediate and absolute baseline target, with a baseline of “moderate” living standards considered substantially more appropriate as a basic standard. The Resolution Foundation has offered one estimate for raising contributions, calculating that to reach their Living Pension target, which is based on an estimation of minimum retirement living standards, would require an increase of eight percentage points in contribution rates for a Living wage earner.<sup>112</sup>

Urgent issues regarding gaps in coverage also need addressed: the obligation to enrol employees into a scheme will need to be extended to those categories that are more likely to be excluded, particularly self-employed workers and those working multiple jobs, which may lead them to fall below the auto-enrolment threshold. Plugging these gaps is key to addressing inequalities, as women and minority ethnic groups

109. See for example the Universities Superannuation Scheme, the largest DB scheme in the UK, where members' contributions are 9.8% and employers' contributions at 21.4%.

110. Hilary Mainwaring, “Saving for retirement in Great Britain: April 2018 to March 2020”, Office for National Statistics, June 2022, <https://www.ons.gov.uk/peoplepopulationandcommunity/personalandhouseholdfinances/incomeandwealth/bulletins/pensionwealthgreatbritain/april2018tomarch2020>

111. “UK pension surveys: redevelopment and 2019 results”, Office for National Statistics, June 2020, <https://www.ons.gov.uk/economy/investmentpensionsandtrusts/articles/ukpensionsurveys/redevelopmentand2019results>

112. Finch and Pacitti, “Building a living pension”, 2021.

are more likely to be excluded on this basis. Measures could include eliminating the minimum income requirement for auto-enrolment to help low-income workers building up pension pots, as well as incentivising self-employed workers (a category unaffected by auto-enrolment) to set up workplace pension accounts.

## Rethinking risk: towards collectivisation

The UK pensions system has been designed to increase “individualisation” — tightening the link between contributions and benefits, making each individual responsible for their own retirement income. This approach pushes systemic risks in terms of economic performance and financial stability onto those least able to cope, and worsens inequalities in pension accumulation, as workers with lower incomes are more likely to contribute less and inconsistently. While any contribution-based system is bound to reproduce labour market inequalities, individual DC pensions do so to a larger and more direct extent.

Policy action should thus be taken to protect DB schemes by ensuring existing schemes remain open and do not reduce the level of commitment towards their members. Action should also be taken to further promote Collective Defined Contributions pensions.

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### → Recommendation 4: consolidate DC pensions into collective schemes

Collective DC (CDC) schemes offer a potential solution to certain challenges of individual DC schemes. In the UK, these are being pioneered by Royal Mail — whose CDC scheme was authorised in April 2023 — with significant direct support from the Communication Workers Union, which represents postal workers.<sup>113</sup> CDC schemes reduce the uncertainty about pension income that is caused by market volatility and longevity risk. In an individual DC, each member has an individual account. On retirement they can buy an annuity or choose to draw-down from the account gradually or as a lump sum. An annuity insures against the risk of living more years than expected after retirement (longevity risk), but the price and therefore return on annuities varies with market conditions (market volatility risk), meaning that a person retiring one year might end up much worse off than a colleague retiring a year later. In a CDC, members receive a pension until they die (similar to a DB scheme) meaning there is no longevity risk. In addition, any corrections in value up or down for the assets of the collective fund are shared between current and prospective members, with current and future benefits being adjusted. Therefore, whilst there is still some market volatility risk, individuals are cushioned from the impact. Overall, CDCs are seen as yielding better and more equitable pension outcomes than individual DCs. Of course, they are not as good from

113. CWU, “Royal Mail CDC pensions – another big step forward”, 17/02/2022, <https://www.cwu.org/news/royal-mail-cdc-pensions-another-big-step-forward>

a member perspective as DB schemes, where pension benefits are defined in advance and are guaranteed by employers. Collective DC should be seen as an improvement upon existing DC pensions rather than a way to further erode DB pensions.

DB and collective DC pension should be designed to secure the benefits of risk sharing. Notably, schemes must remain open to new workers to ensure a balanced proportion between active and retired members, and thereby promoting intergenerational risk-sharing. Consolidation between existing schemes into larger ones could also help achieve this objective to help maintain a more stable demographic profile and generate economies of scale. Ultimately, so long as the UK remains reliant on occupational pension schemes for retirement income, the creation of one or more large national occupational pension funds, collectively managing the risks of ageing and investment into long-term productive and socially beneficial assets, should be explored.

Steps to enhance risk-sharing across pension schemes would also be consistent with the recent upswing in calls for partial direction of pension investment into certain areas (further discussed below). Indeed, there is a visible contradiction in an individualised DC system that on the hand forces individuals to face the risks of ensuring retirement income alone, and yet also might force investment in particular asset classes deemed productive or in the public interest. Working for the collective good requires collective pensions.

## **Pension capital and productive investment**

Prevailing UK pension regulation fosters short-termism, as it is excessively focussed on current financial market valuations, in some cases daily. To support a genuinely long-term approach, pension funding rules must be changed. Some of these changes are comparatively modest technical adjustments, and immediately implementable. For instance, rules could promote long-term smoothing of discount rates, and in doing so avoid excessive volatility in liability values, which has been one of the primary drivers of LDI for DB schemes. Stricter rules should be placed on the use of derivatives and leverage, which force short-term liquidity needs onto pension funds. DC schemes should not be subject to daily valuation. All these measures could also decrease the enormous and costly reliance of pension schemes on the asset manager industry, which has thrived in offering new products such as pooled funds and LDI (see Box 3).

With respect to how pension capital is allocated, moving to collectivised pensions as described above would also be beneficial. Risk-sharing directly opens the possibility for the sort of long-term, uncertain, and illiquid investment, such as green infrastructure, that individual DC schemes are much less likely to engage in. Recent calls to achieve this with the current individualised pension system are unlikely to be very successful; however collectively beneficial, the downside risk of investing individual pension savings

in these projects seems disproportionately high compared with the uncertain prospects of very high long-term returns. Moreover, there is evidence that individuals are unlikely to make that choice.<sup>114</sup> Forcing individuals to do so is technically feasible,<sup>115</sup> but is clearly inconsistent with the idea of individual choice inherent to the DC system.

Thanks to risk-sharing, collective schemes would be much better equipped to make these investments, though it would be essential to maintain a stable maturity within the scheme, i.e., the relative proportion of retired versus active members. The closure of many DB schemes to new workers offers a cautionary tale in this respect: the schemes' maturity increased, in doing so limiting their investment horizon, as the funds need to pay out more than they receive and are therefore chiefly the liquidity of their investments. Finally, with respect to the popular trend toward active "stewardship", collectivisation could enhance pension schemes' potential impact. Collectively, UK pension funds would be sufficiently large to exercise their voice as shareholders and bondholders, but their fragmentation and reliance on the asset manager industry severely limits their potential in stewarding firms toward societally beneficial activities and projects. Thus, within the context of the prevailing funded pensions system, large, collective and open schemes are a precondition for long-term financing of socially beneficial projects such as clean energy or transport infrastructure.

All the above said, however, it is vital not to view pensions as a panacea for delivering the capital needed to, for instance, decarbonise key sectors of the UK economy. Indeed, careful consideration is needed of the relationship between private pension provision and the creation of investible assets. The relative inadequacy of public pension provision and expanse of private pension savings has generated an insatiable demand for investible assets.

On the one hand, this demand exerts a troubling structural pressure. For many years privatisation and outsourcing have been used as a means of creating assets with likely dependable returns in which pension funds can invest. The demand for high returns in these areas has frequently stood in direct tension with the purpose of these projects and services, from major pressures on social care firms to the recent crisis at Thames Water, in which Canadian and British pension funds are major shareholders. At the same time, this system provides opportunities for financial intermediaries to profit, as new chains of value extraction (e.g., private equity partners → asset managers → pensions funds) are added to processes of basic service provision or the building of essential infrastructure, generating unnecessary costs which flow toward a concentrated minority.

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114. Ben Franklin and Norma Cohen, "A big bang in pensions", Centre for Progressive Policy, 2022, <https://www.progressive-policy.net/publications/a-big-bang-in-pensions>

115. George Parker and Josephine Cumbo, "Labour willing to force pension plans to invest in £50bn 'growth fund'", *The Financial Times*, 22/05/2023, <https://www.ft.com/content/03593281-2a22-4e9a-919b-cc346384e455>

## A radical reimagining: beyond an unequal, financialised pensions system

Ultimately, the above recommendations all represent moderate, if much needed, adjustments to the prevailing system of pension provision in the UK, which has been shaped by political decisions regarding the correct institutional structures for the UK's "liberal" form of capitalism. Active policy choices have promoted financial capital markets over and above the banking system and encouraged financial "innovation" in terms of new financial institutions and instruments. Again, active policy choices retrenched the offers of the post-war welfare state, visualised the state as a consumer rather than a provider, and as a de-risker rather than an investor. Any serious attempt to create a better system for all requires engaging at this fundamental level. With the powers of hindsight, we must ask: have we created institutions that coherently and fairly organise production and enhance the wellbeing of citizens? Clearly not. Is the pension system based on these structures fit for purpose? Again, certainly not. Deep level reforms will always be accused of "radicalism" (indeed, by tackling problems at their roots, this is precisely their point), but so too was the path to this point, and path dependencies are not reason enough to hold back from considering what could be achieved if we allowed a more fundamental reimagining and transformed the system from its foundations.

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As for pensions themselves, a bolder vision necessarily implies interrogating the benefits of a funded system. Pension provision is inescapably a collective and intergenerational, issue. Accumulating financial assets to nominally back up pension promises cannot evade this problem — it simply moves it from government budgets to financial markets and generates wider societal contradictions. Funded pensions are a basic contradiction for labour, as their success requires value extraction from firms at the expense of wages. They are a contradiction for public citizens as they extract profits from systems of state provision at the expense of the taxpayer. In short: we all need pension funds to do badly and to do well.

Moving beyond a funded pension architecture is necessary if we want to avoid the downsides of an "asset manager society"<sup>116</sup> and open the space for public coordination of investment for the transition to a more democratic and decarbonised economy. The growth of the financial sector in the period of financialisation has not led to increased levels of investment and productivity in UK industry, on which it must ultimately be judged, and therefore efforts to continue to support the sector, be it through preferential tax treatment, state-backed promises of returns, or basic welfare design should desist.

Within the specific policy sphere of pension design, our analysis points to clear transitional steps that should be taken to address some of the more pressing failures

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116. For further elaboration, see Christophers, *Our Lives In Their Portfolios*, Verso, 2023; Mathew Lawrence, "Perspectives: The Asset Manager Society", Common Wealth, 21/04/2023, <https://www.common-wealth.co.uk/perspectives/the-asset-manager-society>

and steep inequalities of the current system and at the very least begin to move toward a system that can provide basic economy security and dignity for all in retirement.

# Appendix: How Different UK Pensions Work

## State Pension

- A worker (and their employers) will make at least ten years of National Insurance (NI) contributions. Alternatively, they'll receive NI credits if unemployed or not in work for caring responsibilities.
- Upon retirement at 66 (the legal minimum age for application to the state pension), people receive a guaranteed payment by the state, up to a maximum of £203.85 a week if they have made thirty-five years of contributions.

**Risk borne by:** The state. The pension is not “funded” by an investment portfolio, working instead as a PAYGO system, financed by NI contributions, and backed by the state.

**Redistributive Impact:** The state pension is the most redistributive pension mechanism, with higher-paid workers supporting pensions of lower paid workers. Regardless of the amount they contribute, citizens who have the same number of years of contribution will receive an equal pension.

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## Occupational Defined Contribution

- A worker and their employer pay money into a pension scheme, arranged either directly by the worker with a pension provider, or typically by the employer in an occupational pension scheme.
- This scheme invests the pool of money into financial markets, either directly or, more often, by contracting this role out to one or more asset managers.
- The investments are meant to generate returns, for example via dividend payments, interest paid on sovereign bonds, or through rising financial asset prices.
- Upon retirement, members should have a fund that they can gradually draw down through old age or use to purchase an annuity from an insurance fund, which provides a guaranteed annual sum throughout retired life. They can also take a lump sum in cash.

**Risk borne by:** Individuals. The employers' contribution is defined, but the pensioners' benefit is uncertain. The level of retirement income depends on the contributions made and the performance of the investment fund. If returns are lower than expected, the individual worker themselves bears the cost and employers are protected.

**Redistributive Impact:** None/ Regressive.

Occupational DC pensions directly reproduce distributions and inequalities of income, with both employee and employer contributions scaled as a percentage of a worker's salary. This gap can be exacerbated if, for instance, under the strain of a cost-of-living crisis, someone on a lower income becomes unable to afford their contributions and either pauses them or lowers their rate, which is then matched by a lower contribution rate or pause on the part of employers. Moreover, contributions are tax-deductible, meaning that higher earners take greater government subsidies than lower earners. Pensions tax relief cost £43 billion in 2020/21.<sup>117</sup>

## Occupational (Funded) Defined Benefit

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- An employer has a workplace pension scheme into which they and individual workers make regular, tax-deductible contributions.
- This scheme invests the pool of money into financial markets, either directly or, more often, by contracting this role out to one or more asset managers.
- The investment fund generates returns, while also receiving new money contributed by current workers and employers.
- Upon retirement, members will have a guaranteed annual sum provided throughout retired life, usually calculated from their average career salary.

**Risk borne by:** Employers. The benefit is defined, but the cost of paying for that promise is uncertain. If returns are lower than expected, the employers make up the shortfall (alongside existing workers). According to the Pensions Protection Fund, in 2020 defined benefit schemes would have needed a combined £668 billion in additional funds before they could all afford to insure all their benefits.

**Redistributive Impact:** Limited.

117. "Tax Relief Statistics (December 2021)", HM Revenue and Customs, 12/01/ 2023, <https://www.gov.uk/government/statistics/minor-tax-expenditures-and-structural-reliefs/estimated-cost-of-tax-reliefs-statistics>

Occupational Defined Benefits schemes reproduce existing labour market inequalities, albeit to a lesser extent than DC schemes. This is because while final pension benefits are based on earnings, these are not linked to contribution rates, which in some cases (e.g., Local Government Pension Schemes<sup>118</sup>) are progressively linked to members' incomes. In this way, those on higher incomes pay proportionately more than those on lower incomes but accrue the same pension entitlements.

## Public Sector (Unfunded) Defined Benefit Pension

- An employer (the NHS, Schools, Civil Service) maintains a workplace pension scheme into which they and employees pay.
- Retired workers are paid a guaranteed annual income based on their career contributions, paid for by the contributions of current workers and employers.

**Risk borne by:** The state. Any shortfall will be covered by the Exchequer, as retirement income is guaranteed. The pension is not “funded” by an investment portfolio, but rather relies on a PAYG system.

**Redistributive Impact:** Limited.

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Like funded Defined Benefits schemes, these funds reproduce existing labour market inequalities, albeit to a lesser extent than DC schemes. Contribution rates in schemes such as Teachers' or NHS pension scheme are linked to members' earnings. In this way, those on higher incomes pay proportionately more than those on lower incomes but accrue the same pension entitlements.

## Personal Pension

- An individual who wants to put money aside for a pension makes contributions into a pension scheme provided by a financial institution. These contributions can also be tax-free, up to a limit.
- The institution will invest on behalf of the individual, either directly or by contracting out to asset manager(s), into a variety of financial assets.
- The investments are intended to generate returns, growing the value of the contributions made by the individual over time.

118. Local Government Pension Scheme, available at <https://www.lgpsmember.org/your-pension/the-essentials/your-contributions>



- Upon retirement, members will have a fund that they can either cash out in one go, draw down from through old age, or use to purchase an annuity from an insurance fund, which provides a guaranteed annual sum throughout retired life.

**Risk borne by:** Individuals. The individual's contributions are defined, but their benefit is uncertain. The level of retirement income depends on the contributions made and the performance of the investment fund. If returns are lower than expected, then the individual themselves bears the cost. This type of pension is effectively a form of tax-incentivised savings account.

**Redistributive Impact:** None/Negative.

Similar to funded Occupational DC schemes, there are no redistributive mechanisms at work here. Personal pensions effectively work as a tax-deductible saving mechanism.



## Undefined Benefit: Fixing the UK Pensions System

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Common Wealth is reimagining ownership for a sustainable and democratic future.

Working at all levels, from community and grassroots groups to national and international policymakers, we combine rigorous analysis and research with bold ideas for an economy that works for everyone.

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