The future of pensions

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Labour have promised a review into our pension system and unlock pension capital for "productive" investment. There is no mystery regarding how to make pensions fairer and more stable; what is needed are resources and political will. As for investment, it is disconcerting to see a Labour official quoted as wanting to get "Blackrock to rebuild Britain". The asset management industry's practices are more often extractive than productive. The new Labour government must confront these issues if it wants to deliver its promise of a more secure future.

Introduction: UK pension fundamentals and securonomics

Pensions have long been a problem in British politics. Far more than just a fiscal outlay, pension policy involves taking a position on the country's broader economic model, as well as a position on gendered norms, family life and the nature of work. The way in which different eras of Labour governments have approached pension policy is a good window into their broader political economic and social agenda.

Clement Attlee's government introduced the UK to a flat state pension in its first term in office, in keeping with William Beveridge's vision for a welfare state linked to a system of national insurance. Harold Wilson attempted a more expanded and redistributive state pension, in keeping with his more interventionist ambition. He also raised the issue of how best to channel occupational pension investments into productive investment. Tony Blair doubled down on the Thatcherite pensions model, focussed on individuals saving into private pension products and trusting financial markets to do the rest. This came hand-in-hand with a more socially liberal view on women and the workplace, whilst skipping over the problem that labour market participation remained (and remains) fundamentally unequal. Where Keir Starmer's government will go is not yet clear.

In a 'Beveridgean' pension system, the state assumes responsibility for insuring against poverty in old age. It does not seek to replace income, as in the 'Bismarckian' system, more commonly found across parts of western and central Europe. Income replacement is left to the 'second pillar': occupational pensions. In truth this dichotomy is more of a spectrum. Many countries now have a two-pillar system. The UK, though, is currently at the extreme end because the state pension is too low to adequately provide security against poverty. This has been the neoliberal twist over the last forty years – collective social insurance minimised and individuals increasingly pushed to use private financial products to manage their own risk of old age poverty.

As it stands, for the vast majority of UK residents – male or female – pensions are a major source of insecurity. Directly, the current pension system reproduces working-life inequalities – including through costly state intervention – and is on course to produce inadequate retirement incomes for most, while exposing individuals to financial market volatility. Indirectly, pension fund investment has often failed to support 'real' investment, and thus growth and productivity, in the UK.

On the face of it, managing these insecurities should fit well into the Labour government's agenda. In her Mais lecture that outlined Labour's 'Secureonomics' approach, chancellor Rachel Reeves, explained how insecurity and instability has reinforced the UK's stagnant and unequal economy. An active state would intervene in partnership with the private sector to develop an environment stable enough to induce productivity-enhancing private investment. Growth, she argued, would follow. To support security for 'working families', Labour would ensure stronger worker rights and recourse to more reliable public services (though actual policy on these two fronts has not followed).

Secureonomics has so far stood clear of including pension security. The last Labour government promised a pensions settlement 'fit for the twenty-first century' but instead reinforced the neoliberal model and left the legacy we have today. Currently, both parties have committed to retaining the triple lock on the state pension, which ensures it does not lose further value. But there is no discussion of the serious problem with the state pension's coverage. There is likewise little discussion on how to improve occupational pensions. For example, defined contribution (DC) schemes currently offer very little security, particularly with low employer contribution rates.

What is being discussed again, as at the time of Wilson, is the more exciting topic of where to invest pension contributions. There is widespread hope that encouraging pension funds to invest into the UK economy will somehow deliver an economic transformation. Unfortunately, unlike Wilson, current discussions are unwilling to cast a discerning eye over real-world financial practices and their destabilising tendencies.

The new Labour government has promised a pensions review, but has not indicated the details it will cover. We outline some of the issues that ought to be included in the next two sections.

Security in retirement: role of the state

There are three policy priorities for the state pension: adequacy, coverage and fairness. The state pension is meagre by international comparison, and insufficient to achieve security in retirement. The Pensions and Lifetime Savings Association[1] publish retirement living standards. Their estimated minimum income 'to cover needs and allow a small amount in reserve' is currently £14,400 for a single person – roughly £277 a week. The lifestyle this affords would entail having £50-a-week for groceries. There is no provision for running a car, and housing costs are assumed to be zero. The full state pension is £221 a week – £50 short of target. There is as-yet, not enough recognition of this shortfall.

The triple lock will gradually improve pensions, but it is a slow fix to an urgent problem. There is, moreover, a more pressing issue than closing this gap: the issue of coverage. Many people fail to qualify for the full pension. Qualifying requires thirty-five years of contributions, which again, by international standards, is a lot. The contribution principle at the heart of our pension design is popular. The state pension is a social insurance system organised through principles of solidarity and responsibility. Not a handout: a right. But the contribution principle begs a question about how confident we are that we capture 'contributions' to the economy, to society, in our current system? This goes back to the question of gendered norms regarding labour market participation: The DWP revealed that in 2022 less than half of the female recipients of the state pension received the full amount.[2]

Our pension accounting system still struggles to cope with people differing from the ideal-type male worker from the 1950s. There is now a credit system for those providing unpaid care: someone registered to receive child benefit for a child under twelve for example receives credits automatically in place of having to make contributions. Equally, those deemed to be actively seeking work can apply to get credits. Given this, how do so many fail to have enough contributions to achieve the full pension?

One key problem is those earning low wages across multiple jobs. If you work three jobs, none of which pay more than £123 a week, you will not get any National Insurance contributions registered. You might be eligible for old-style tax credits and qualify this way, but determining eligibility is not trivial and depends on the worker navigating the benefit system themselves. The irony of our social security system is that the lower a person's income - and the more fragmented their working pattern – the larger are the holes in the safety net.

The most effective response to this problem is to move, at least partially, to a residency-based system. Countries with whom we otherwise share many principles of pension system design (e.g. Canada, Netherlands, New Zealand) adopted aspects of a residency-based state pension some time ago. There is an existing evidence base on the benefits of doing so, in terms of reducing poverty in old age.[3]

Uplifting the full pension and improving coverage are big ticket items in terms of fiscal expenditure. Moving from £221 a week to £277 a week is an increase of 25 per cent. Currently expenditure on state pension is £125 billion; this would need therefore to rise to £160 billion at a minimum.[4] There are however a couple of caveats. First, costs 'saved' through an inadequate state pension tend to pop up elsewhere, like a fiscal game of whack-a-mole. Expenditure on Pension Credit is expected to come in at £5 billion for 23/24, with pensioner Housing Benefit reaching £6bn. Both tend to rise with falling basic pension and vice versa.

And then there is the government expenditure on tax relief paid on pension contributions to occupational pensions. In the 2022/23 tax year, the net cost of this tax relief (relief paid on employee and employer contributions, minus tax received on pension income) was estimated at £48.3 billion.[5] This substantial sum is defended on the grounds that occupational pensions are necessary as an addition to the state pension to ensure pensioners do not fall into poverty. But this system set-up is highly regressive. Higher tax earners receive greater tax relief. Distributionally regressive by default, a 2016 report by the Resolution Foundation calculated that 63 per cent of relief went to the top 15 per cent of earners.[6] On top of this, more and more people are being moved into de-regulated defined contribution schemes that are pensions in name only. Pension 'freedoms' – such as the ability to withdraw a large lump sum at the point of retirement – mean there is no guarantee that the contributions all go towards assuring income until death.

Security in retirement: the second pillar

Coverage is even more of a problem in the second pillar than the first. At the turn of the century only 55 per cent of UK workers were members of an occupational pension scheme. This number then declined further as more defined benefit (DB) occupational schemes closed down to new entrants in the 2000s.[7] In a DB pension scheme the sponsor guarantees a lifetime pension income related to final or career-average pre-retirement income. If it is funded (most private schemes are) this means taking on the risk of financial investments performing less well than predicted. Defined contribution (DC), by contrast, is the 'neoliberal' alternative. Employees have 'individualised' pots. Employers and employees pay into it, and at retirement the sum of those contributions plus/minus financial market returns is used to provide for retirement. The shift from DB to DC is a clear individualisation of risk - the antithesis of the concept of insurance.

One response to encourage greater voluntary engagement with occupational pensions would have been the protection and re-opening of DB schemes. Needless to say, restoration of DB pension was not the path taken. The flagship policy to counter the problem of coverage, developed by the last Labour government, was a system of 'auto-enrolment'. Eventually implemented by the Coalition government in 2012, auto-enrolment requires all UK employers to enrol their employees into a workplace pension scheme and make direct contributions towards it.[8] Nearly all the new autoenrollment schemes are DC schemes.
As Figure 1 shows, since its phased introduction in 2012, auto-enrolment has considerably boosted the coverage of occupational pensions, which now cover about 80 per cent of UK workers.

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Figure 1. Proportion of employees with a workplace pension. Source: Office for National Statistics – Annual Survey of Hours and Earnings (ASHE)

Thanks to this, auto-enrolment has been heralded as a major policy success.[9] Yet, the boost in pension coverage masks significant shortcomings. As for the state pension, coverage gaps remain: there are minimum qualifying earnings on which contributions are paid, reducing the contributions to low-income workers, as well as a minimum age threshold of twenty-two, excluding younger workers. Importantly, auto-enrolment excludes the self-employed and gig-economy workers, which constitute a growing - and often vulnerable - part of the workforce. Being enrolled in a scheme is no guarantee that your retirement income will, when added to your state pension, cross the adequacy line. This is primarily due to very low contribution rates. Auto-enrolment came with minimum contribution rules, set at 5 per cent for employees and 3 per cent for employers. Data from the Annual Survey of Hours and Earnings (ASHE) shows that for 55 per cent of employees' contributions are lower than 4 per cent.

Contributions are significantly higher in more traditional DB schemes: in the Universities Superannuation Scheme, the largest scheme in the UK, contribution rates in 2024 are 6.1 per cent and 14.5 per cent for employees and employer respectively[10]. The Australian superannuation funds, often used as the role model for the UK, currently have a minimum employer contribution rate of 11 per cent. Current contribution rates need urgently to increase significantly if workplace pensions are to provide adequate retirement. In terms of priorities for retirement security in the UK, this is the single most important issue.

Finally, a thornier problem with workplace pensions are the inequalities that are in-built in the system. Currently the holding of occupational pension wealth is wildly unequal – the distribution is even worse than for more general measures of wealth – with the bottom 30 per cent owning zero pension wealth, and the top decile owning over 60 per cent. These outcomes reflect labour market inequalities, with workers with lower income or less secure working conditions more likely to opt out, stick to lower contributions, or to not meet the threshold at all. Labour market inequalities and pay differences together generate a gender pension gap that makes the pay gap blush, with women's pension wealth a third of men's pension wealth at retirement.[11]

The specific design of DC pensions can amplify such inequalities. By tightening the link between individual contributions and benefits, and making the latter contingent on financial market returns, poorer workers are disproportionately negatively affected. Higher earners can benefit from choosing a higher contribution rate in DC schemes, something that DB schemes typically limit. Some DB schemes also have a progressive contribution system, where higher earners pay a higher contribution rate for the same level of accrual. DC pensions are ultimately dependent on the vagaries of markets, so some cohorts can be very negatively affected if they are coming to retirement in periods of financial turbulence.

The bottom line is that workplace pensions need significant changes if they are to provide secure standards of living for British retirees in the future. The current system is overly reliant on DC pension schemes, which are ultimately just an individual saving pot – rather than a pension – based on insufficient contributions, a regressive tax relief system, exposed to financial risks – and they exacerbate existing inequalities. A Labour pensions review should at a minimum consider boosting minimum employer contribution rates and reforming the inequitable tax relief system. A more ambitious progressive policy agenda on workplace pensions should look at re-establishing collective DB schemes, with progressive contribution rules, and a guaranteed pension income at retirements, as the norm rather than a shrinking exception.

Pension investment and economic security

The third and final aspect of the pension system is the investment undertaken by pension funds. As mentioned, this is one area where the policy debate has been more active recently. The Mansion House speech by the then Conservative Chancellor Jeremy Hunt, focussed heavily on the need for pension funds to be more invested in venture capital,[12] and later called for pension funds to disclose their levels of investment in the UK, in an attempt to incentivise more investment into the domestic economy. The Labour party's main policy proposal is to try and use pension funds as a source of 'patient capital' for British business. Rather than anything too proscriptive, they propose establishing a scheme for pension funds, also to invest into British venture capital and small-equity growth companies, with an additional portion intended to support UK infrastructure investment.[13]

The motives behind such calls are the significant divestment of pension funds from UK equity, as well as a long-term issue with access to finance for smaller companies. UK pension fund direct holdings of listed equity are down to only £40bn, out of over £2tn of assets; they own only 6 per cent of the FTSE 100.[14]. This has been put forward as a key cause of the relative decline of the UK stock market,[15] and more substantially British industry. Unlisted equity – investments in start-ups and SMEs – or infrastructure are considered under-represented in pension portfolios, and yet are considered key for economic growth. The preference of UK pension funds for government bonds instead of these assets is seen as a net negative for the British economy.

There are some problems with this approach. The reasons for UK pension funds' divestment from equity are multiple and complex relating to market structures, changes in regulations and accounting standards and heavy sales pressure by the asset management industry. Moreover, there are excessive expectations on what can be achieved by increasing investments in UK equity. Pension funds have never been the primary drivers of productive investment. To put it differently, it would be wrong to primarily attribute the lack of real investment by UK companies to pension funds divestment from the UK stock market. Investment is not determined by the buying and selling of financial assets (a point made by Wilson). Firms invest when they are confident the investment will prove profitable – the key determinants are clarity and ambition in public policy. Underfunding public investment in the UK – despite huge pension funds' demand for government bonds – at the same time as consistent failure to commit to industrial strategy, has choked off economic dynamism.

The often-uncritical support of investments in private equity, and especially in infrastructure, is also problematic. As Brett Christopher shows, 'infrastructure investment' by private funds largely focuses on buying-up existing rather than financing new infrastructure and high returns are achieved through short-term extractive logics[16]. One only needs to look at the experience of Thames Water to show the potential downsides of these strategies. Under the eleven-year ownership of Macquarie, the company increased dividend payouts, and was sold for significant profit, leaving behind fines for untreated sewage and excessive debt which eventually led to a default in March 2024. While not all investments are as catastrophic as Thames Water, pension funds regularly invest in Macquarie's funds as limited partners, whose impacts on the UK real economy are not always clear-cut. Importantly, these investments tend to carry very significant fees. Even in terms of the government's own projections, the net returns (i.e. after fees are deducted) of a 5 per cent increase in allocation to private equity – anything else being constant – actually reduces the pension pot of a £30,000 earner.[17] It is hard to see who, outside the asset management industry, benefits.

Investing in infrastructure – new infrastructure – is perfectly possible for pension funds. It is achieved through holding government bonds. This is how pensions can feed into security. An ambitious and clear government investment strategy to support a just transition is made easier when bond markets are stable, and nothing stabilises a bond market like strong, predictable domestic demand. Pension funds can support the necessary public investment that in turn can provide the stability needed for private investment. This is the pathway to growth. Another consideration could be to allow the National Wealth Fund – core to Labour's 'Clean Energy Superpower' ambitions – to issue fixed liabilities that pensions could hold.

There are other good investments that pension funds can make. For example, GLIL, an independent manager created by the Greater Manchester Pension Fund (GMPF) and the London Pensions Fund Authority (LPFA), has a portfolio almost exclusively made up of UK infrastructure, a proportion of which has gone to fund the development of new assets, such as British-manufactured rolling stock, and does not charge performance fees. What must be acknowledged, however, is that these exceptions to the norm emerge in large, collective DB schemes, with strong governance and, crucially, trade union involvement.

Which brings us to the crunch. The individualisation of pensions – the neoliberal agenda - has rendered the pension system much more risk-averse and passive by depriving the pension system of its collective risk-sharing mechanism. Re-establishing collective pensions – in their governance and design – must be part of the pension agenda if we want pension investments to be part of the solution to our collective problems.

Conclusion: security and pensions

In our view, this experiment, the modern British incarnation of the Beveridge system, has run its course. The second pillar is not fit for the purpose of ensuring poverty avoidance. The majority of the population have wholly inadequate workplace pensions, and the projected retirement incomes are grossly unequal. Workers' contributions towards their workplace pension are turned over to third-party asset managers to invest into extractive mechanisms like private equity funds, feasting on what were once the UK's public assets, and often worsening pay and conditions across the private sector. Things can't go on as they are. This is not to say that there is anything necessarily wrong with a traditional Beveridge design. Such a system can form an adequate pension architecture and given path dependency is likely the most coherent ambition for the UK. But Labour's project cannot forever ignore the inadequacy of a pension system that hardly provides security for most British citizens. The promised pensions review will need tackle this issue.

The objectives of productivity and growth require a re-assessment of pension funds as a source of finance. Too often, pronouncements on pension fund investments are premised on an uncritical understanding of what drives asset allocation decisions, and how exactly financial 'returns' are realised. Pension funds are told to seek the assets with the highest returns, and to turn a blind eye to the processes through which financial actors extract value from critical industry and infrastructure. But high returns are often short-lived returns, with negative knock-on effects elsewhere in the economic system. Delivering 'a decade of national renewal' that Keir Starmer's Labour government promises will necessitate a frankly much more boring approach to re-allocating pension investments.

Short author biogs here

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