Funding the Future

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Most people don’t understand how pensions really work. Not politicians, not City insiders, and probably not you. In this video, I explain why pensions aren’t really about savings at all, but about a fundamental contract between generations, and why private pension systems fail to deliver. And this one is really best watched if you can do that.

https://www.youtube.com/watch?v=DXkznVh3jBA?si=U77SP7jE3hXsnwm_

This is the audio version:

https://www.podbean.com/player-v2/?i=wveqs-18f6556-pb&from=pb6admin&share=1&download=1&rtl=0&fonts=Arial&skin=f6f6f6&font-color=auto&logo_link=episode_page&btn-skin=c73a3a

This is the transcript:

Most people have no understanding of how pensions really work. And when I say most people, I include almost everybody who runs a pension company, almost everybody in the City of London, most politicians and most people who will be watching this video.

And I'm sorry to have to tell you this, but when I say you don't understand pensions I really mean it, because you probably think that a pension arrangement is something that you pay money into one day and sometime deep into the future you will claim it back by way of an income, and in the meantime, that money will be saved either in a bank saving account on your behalf by a pension fund, or in shares, or in property, or whatever. That isn't really how pensions work.

That is the microeconomic description of how we try to provide pensions now, but the truth is, there is what I call a 'fundamental pension contract' between generations, which we have to respect if pensions are going to work, and we don't do that. And that's precisely why we have so many problems with pensions in the UK, and in other countries around the world, but let's concentrate on the UK for now.

Let me explain what this fundamental pension contract is. And this, I stress, is a macroeconomic contract. In other words, it's between whole generations, one with another. It's not between you and a pension company, or you and your children; this is about society.

And the basic fundamental pension contract is this, that a generation who is in work will build assets and infrastructure, so that when they come to their retirement age, those assets and that infrastructure will be available for use by a younger generation, who will use them in the course of their work so that they can generate an income that would be bigger than they could otherwise achieve, and out of that bigger income than they could otherwise achieve they will lay some money aside to support the old in their retirement.

In other words, the older generation has a duty to basically build things for the younger generation to use so the younger generation can, in exchange, keep the elderly when they can no longer work. That is the fundamental pension contract.

Will notice I said nothing about savings mechanisms, stocks and shares, or anything else; I'm talking about real economic activity here. Because let's be clear about it, what the elderly live off is not a pension annuity, nor is it a pension drawdown, nor in some sense is it the money that is actually given to them by the state, paid for through taxation. What they live off is the income generated by those still in work when they no longer are. And this is the point that our pension contracts all fundamentally ignore, and which is why I say that people don't understand pensions. The old are dependent on the young giving up their incomes that they have generated to support the elderly.

If I am retired and not working, but wish to eat, I have to take the food off the table of somebody who has generated that food so that I may eat it. That's what I'm talking about here; a fundamental macroeconomic truth that the elderly want the younger generation to pass over parts of their income to them so that they might survive. And this is not a private arrangement; this is something that has to take place on a macro scale.

And why do I say that people don't understand pensions as a result? That's because almost all the private pension arrangements we have fail to recognise this fundamental social contract.

In particular, since we have basically outsourced all pension provision, bar the state pension, and that's not very big, to the private sector, what the private sector does is save pensioners' money - pension contributors' money - and it doesn't actually fund investment.

So, remember what I said the generation in work has to do. They have to create assets and infrastructure that they can pass on to the next generation, but that is not what private pensions do. What private pensions do is put money into speculative assets. Things like stocks and shares. Things like speculative buildings. And those buildings are bought so they can be sold at a profit, they hope, and the people they hope will buy those buildings at a profit will be the next generation.

But the point is, if that building created no new real value in the economy; it was merely bought and sold for speculative purposes, and exactly the same happened with shares, if buying and selling those shares created no new real value in the economy because buying a share does not result in more funds being made available to a company for investment to take place, or to create any new jobs, but does just provide a return to those who trade in them, who are the people in the City of London, then there is no real gain as a consequence of the pension saving, which is what we now prioritise as the mechanism to deliver our old age pensions.

It's not saving that we need to do as part of our pension arrangements; it's investment that we need to do as part of our pension arrangements, and savings and investment are not the same thing.

Saving is a passive activity of putting money aside. Investment is an active activity because it creates new assets or it creates new skills, or whatever it might be, but it is a positive action to create value, whereas saving is simply withdrawing money from the economy so that one day you might be able to go and pick it up again. And there is, in our current private pension arrangement, no recognition of this fact.

There is, in fact, no recognition of the fact that the working generation has this duty to create assets to pass on to the next generation. Instead, all they have to pass on to the next generation is some overvalued shares or some overvalued properties. There's no value inherent in them, particularly if the next generation decides "Well, I'm sorry, but you didn't leave me assets, and skills, or anything else which are going to boost my income to put aside, to keep you going in your retirement", and this is what really worries me.

Now, pay-as-you-go pensions - and our state pension is a pay-as-you-go pension - do not suffer as much from this malaise as the entire private pension industry does. Basically, at present, the entire private pension industry is completely missing the point. All that speculation that it does, all that investment that supposedly goes on through the City of London, is just saving and very, very, very little at all real value is created as a result.

That's not quite the case with regard to pay-as-you-go pensions like the state pensions.

They actually do recognise that the younger generation is keeping the older generation because the older generation's pay-as-you-go pension is paid by people who are young and in work now, and therefore, that part of the equation - the reality that the old live off the backs of the young - is reflected in the state pension, and to that degree, it's a better scheme than the private pension schemes that we've got because there's a degree of honesty in it, which private pensions completely lack.

But there is still a failure on the part of the government to recognise that pay-as-you-go pensions should also be associated with the government undertaking investment in the economy to create the assets which will allow future payment of that pay-as-you-go cycle. That isn't happening.

We've actually broken the investment cycle that should be underpinning all our pension contributions, and to some extent, I'm going to give Rachel Reeves just a hint of credit here, because she realises that there should be more investment by UK pension funds in the UK. The trouble is, she too is confusing putting money into things like private equity funds with actually creating value, because private equity funds do not create value, they just create speculative gains. So, again, she's got it wrong.

It's actually the case that we've got to stop saving in pension funds and we've literally got to start investing in pension funds. We have to create a new balance, and that's vital.

So, what is it that we should be doing with our pension funds?

We should be creating new, tangible assets. Factories, green power plants, new IT to suit a new generation, new transport systems, insulation, and all those other things that will guarantee that we have a functioning economy in the future.

But intangible things too, like better education, better skills, better healthcare, better research on how we can survive the illnesses that we are going to face as we get older, and investment in long-term productive capacity.

All these things matter because all of them raise incomes and lower costs, and so they expand the base from which pensions can be paid. The intergenerational contract can be respected because there will be the capacity to do it. These things create prosperity. Saving doesn't.

And that's the problem we have. Whilst we continue to focus on saving, we will be pulling money out of the economy, we'll be putting it to unproductive use, we'll be cutting demand, we'll be slowing growth, we'll be risking recession, and ultimately we will shrink the capacity to pay pensioners.

And that's where we are, and that's why I say the vast majority of people don't understand pensions.

So we need to take action to correct this, and thankfully, that's not desperately difficult to do.

One of my suggestions is incredibly straightforward. We should require that 25% of all contributions into UK pension funds should be invested in the creation of productive investments. Only a quarter, let me be clear. I'm letting the City still play with 75% of the money, although heaven knows why. But, in exchange for the tax reliefs that are given on pension contributions, which are incredibly costly to the UK government and amount to more than £70 billion a year, there should be a payback, which is the creation by pension funds of new productive capacity in our economy.

And if the private sector refuses to do that, then the government should do so instead, creating funds for investment inside our own economy, which we could choose between. For example, we could choose an East Anglian fund, a Welsh fund, a Scottish fund, a northeast fund, whatever else it might be. Or perhaps a health fund. But, we should be ensuring that if the private sector will not deliver growth, then the state will, because we have to be able to afford pensions in the future, and if we don't invest, and the UK has an incredibly low investment rate, we won't be able to do that. And the reason why we have such a low investment rate is precisely because we have pensions run by the private sector, and it doesn't understand what it's doing.

The state must take the lead .

We must rethink pensions now to secure long-term well-being. If we don't, we're in the deepest, darkest trouble.

Taking further action

If you want to write a letter to your MP on the issues raised in this blog post, there is a ChatGPT prompt to assist you in doing so, with full instructions, **here**.