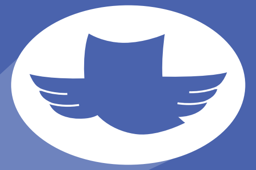
Spotlight on Pensions
PRESENTS
Le Grand View



FEBRUARY 2023

Are pensions hindering economic growth?

There are clear benefits from private pension provision, the most obvious being to provide a fund to replace income when an individual ceases work where one of the causes is related to age.

The state provides a safety net, but realistically in an advanced capitalist economy the level of benefit is always going to be limited, so an individual looking to continue their pre-retirement lifestyle will need to make some contribution to their own financial wellbeing.

The size of the numbers involved in private pension provision are immense. The funds underpinning the sector have a significant impact upon the UK's finances. The total value of assets involved is in the region of £3 trillion and with automatic enrolment, this is continuing to grow. This has to be invested somewhere, and although pension investments are global in nature and scale, a large proportion are invested in assets directly or indirectly in the UK.

Government influence

This amount of money naturally attracts attention, both legitimate and otherwise. Scams are a persistent problem.

Unsurprisingly politicians have also long cast an envious eye over the pensions sector, wishing to exercise influence over how assets are invested. We are beginning to see stronger movement in this direction with the current Government actively promoting policies such as consolidation of small schemes to create larger investment blocks to facilitate investments in smaller newer businesses. This is combined with pressure on trustees and managers of schemes to take more risk in their portfolios by diverting a larger proportion of the assets under their control and influence into small businesses.

Driving growth

Whether or not this will benefit individual scheme members, a key driver of government policy is to address the problem of poor levels of economic growth in the UK. There is a widespread view that small businesses are a vital component of any increase in growth. The problem is a major headache for the future of the nation, and governments are struggling to find a solution to more than a decade of chronic economic underperformance. This was supposedly the driver behind the disastrous mini-Budget of last September, which ironically hit the pensions sector particularly hard, and has left a legacy of reduced consumer spending ability with further negative impacts on growth.

Private pension provision is now exerting a major and direct (but often unrecognised) impact upon the UK's economic growth. A recent House of Lords report has drawn attention to an aspect of this and joins other voices already highlighting related issues. When taken together, they indicate the need for some significant changes to the way in which the system is structured.

The "missing workers" problem

Headlines repeatedly tell of poor national growth rates, low savings rates resulting in small pension pots, and challenges produced by cost-of-living increases across the whole spectrum of goods and services together indicating widespread (and growing) citizen poverty. It may seem strange therefore at the same time to be talking of rates of early retirement being an urgent problem for the nation.

Nevertheless, one of the problems the UK is grappling with is a shortage of workers. It appears that the pandemic has been responsible for driving a reduction in the size of the national workforce, particularly in the 50-64 age group due to sickness and disability arising from Covid infection. In addition, it would appear that a significant number of people have discovered following lockdowns and furloughs that they would prefer to continue working flexibly including from home - despite growing opposition from a number of employers - or not working at all. So far financial issues do not appear to have been a major impediment to this cohort's opting for a more relaxed lifestyle.

This unexpected new cohort of economically inactive citizens is boosting an already anticipated growing number of retirees as the population ages with "baby-boomers" now attaining retirement age.

The impact of the worker shortage problem is further exacerbated by the fact that over the past few decades the economy had become increasingly reliant on imported workers – particularly a low-skilled workforce drawn extensively from eastern Europe. One of the outcomes of Brexit is the loss of most of that workforce, which has not been directly replaced, either from the UK or other countries outside the EU. Although the net number of overseas workers in the UK has remained largely similar to the pre-Brexit position, there has been a change in the makeup of those workers, leaving significant gaps in key areas.

The early retirement issue

The shortage of workers has been the subject of an inquiry by the House of Lords Economic Affairs Committee, which has published a report entitled: Where have all the workers gone? After highlighting the worrying impact of the shrinking workforce on the economy, it analyses where the gaps originate from. Although the picture is complex, a clear driver of the trend of inactivity since 2020 is identified as early retirement, although the Committee felt that the cause of the growth of early retirement is currently unclear.

The Committee's report does not suggest solutions to the problem but highlights the importance of the DWP review of workforce participation announced in the Treasury's autumn statement, which is expected to report later in 2023. It is clear that the contribution played by the private pensions system in allowing or encouraging early retirement should form a part of that review.

How the pensions system exacerbates the problem

High on the list of possible suspects is the ability for members to access their DC pension pots from the age of 55. The average low values of pot sizes masks to some extent the fact that there are many larger ones, enabling their owners the option to give up work from a relatively early age.

Ironically, the Lifetime Allowance (LTA) may be exacerbating this cohort's retirement timing decisions. Although it is intended to limit the costs to the Exchequer of tax relief on pension provision, for a growing number of more wealthy workers it has the unintended effect of demonstrating the futility of further pension savings. Faced with this situation, it is perfectly understandable for individuals to decide that they might as well retire when they hit the LTA and access their pension pots. Also falling into the category of disincentives to continue working is the tapered annual allowance rules. From a better-off worker's perspective, the current system seems designed to encourage early retirement.

If further evidence of the folly of the LTA were needed, arbitrarily restricting the maximum retirement fund that can be accrued before attracting tax also reduces the incentive to increase risk in the portfolio. This is in direct opposition to the policy of encouraging pension funds' investment in a broader range of (often smaller and higher-risk) businesses. Any remaining logic behind the policy is undermined by the amount of the LTA being frozen until at least April 2026.

Flawed decisions?

But, as already noted, most pension pots are not sufficiently large to fund a comfortable retirement – particularly from an early age. So, it is likely that a significant number of those who have decided since 2020 to take early retirement will encounter unplanned financial problems at some future date.

We know that the overall level of financial competence is low, yet the take-up of financial advice – particularly when making crucial decisions around when to retire and how much income to draw from accrued funds – is chronically poor. It is likely therefore that a significant number of the recent cohort of "short-notice" early retirees have not based their decision upon sound long-term financial assumptions. It is also not unreasonable to speculate that in some cases these decisions have been unduly influenced by several decades of historically low inflation and interest rates.

The unique impact of the pandemic will have bolstered confidence in the decision. Many were able to boost their savings largely through reduced expenses from not having to attend a workplace and having fewer opportunities to go out and spend money on non-essential items.

It is likely that some members of this group are already facing the prospect of having to return to being economically active, particularly given the unfolding cost-of-living crisis. But those in this position will then be at the mercy of one further inequitable aspect of the pensions taxation system – the Money Purchase Annual Allowance. When they retired, they will have crystallised their pension pots. If they subsequently need to restart pension

We know that the overall level of financial competence is low, yet the take-up of financial advice – particularly when making crucial decisions around when to retire and how much income to draw from accrued funds – is chronically poor.

contributions to quickly rebuild their retirement funds their scope to do so will be severely impacted by the reduction in the amount of permitted tax-relieved contributions from £40,000 to £4,000 per annum. Whilst most returning workers will not be in the market for contributions at the top end of the allowance, a £4,000 per annum limit will hit many. Knowledge of this may act as a further disincentive to return to paid employment, perpetuating the workforce gaps and increasing the financial hardship awaiting those affected.

Rethink required

Clearly the shrunken workforce is a serious issue. The reasons behind it are complex and still not fully understood. However, there are some contributing issues that can be identified now, and which should be addressed without delay.

Several of those involve the pensions taxation system – the early drawdown facility, the LTA and the MPAA. These issues have been highlighted for many years as problematic, but no action has been taken to date. The House of Lords Committee report adds further reason for action to be taken without further delay.

It will be important for decisions in these areas to be taken in a broad context, to avoid further unintended consequences creating future problems. That should also include a review of whether there are other current pension rules that should be rethought. Any review needs to be undertaken in conjunction with the latest review of the state pension age.

A key aspect underpinning a review will be the low level of financial ability of the population, and the continuing poor levels of take-up of financial advice – which if concerns about the advisability of decisions behind the spike in early retirements prove to be well-founded, will provide a further example of the harm that the current rules can inflict.

We know that the Treasury has been considering fundamental changes to the pensions tax rules for many years, with little progress to date. Perhaps the House of Lords Committee report will be a catalyst for the issue to climb the agenda.

For more information on Spotlight on Pensions contact **Pendragon**

Pendragon
part of Wilmington Intelligence