Mobilising private pension wealth for economic renewal

Why this time will be different

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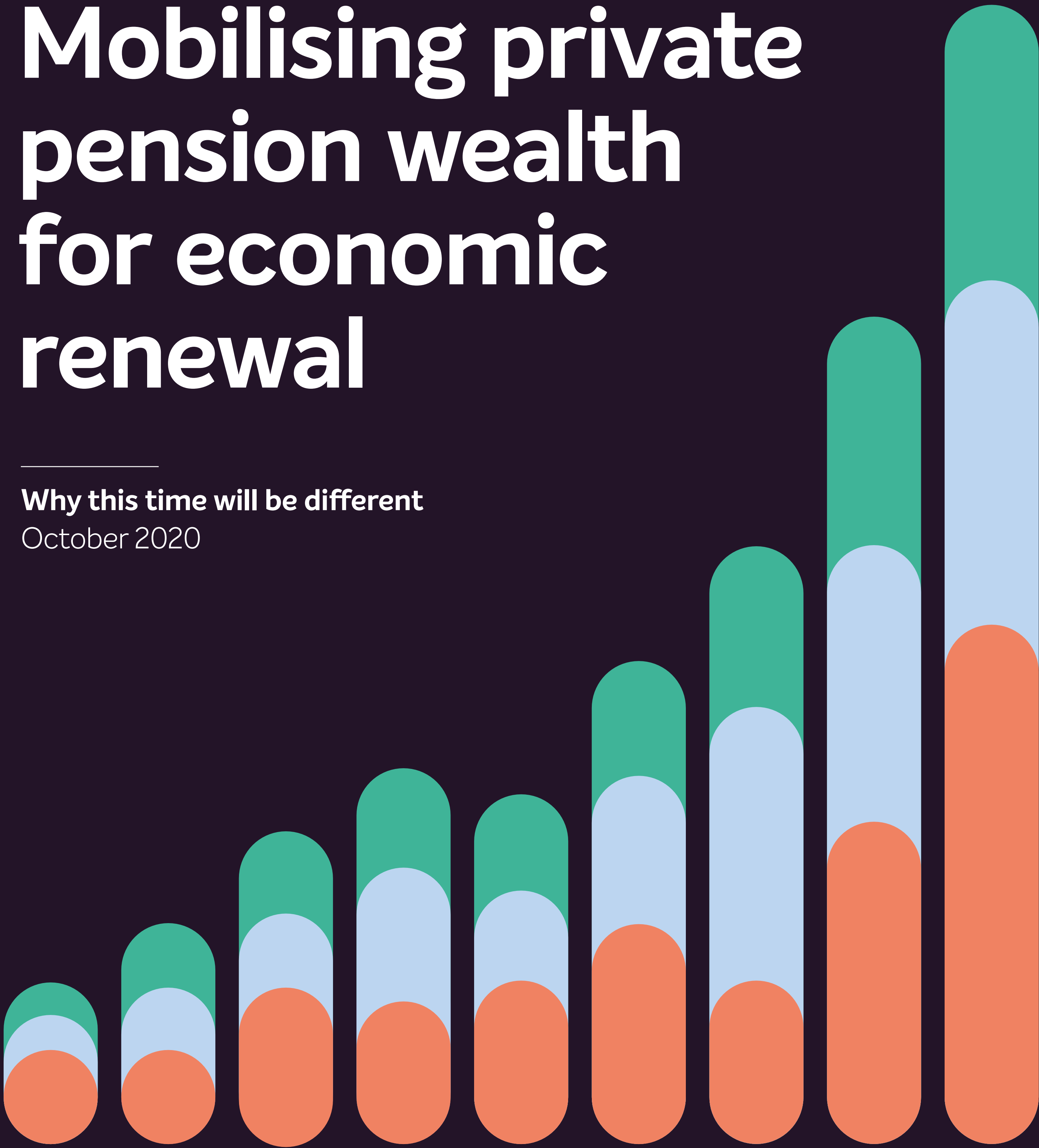

centre for **progressive policy**

About this paper

This paper focuses on the role of private pension capital in supporting economic and social renewal. The underlying thesis is intended as a provocation, containing new ideas about how and why pension capital could unlock productivity gains for developed countries while noting some of the big challenges. The paper is intended as a useful basis for debate rather than claiming to have all the answers.

Summary

The Covid-19 pandemic marks an epochal moment that must not be wasted. Our economic model is up for grabs and global finance must play a critical role in whatever is to come. Failure to invest now in a new economic model will result in more economic and social inequality alongside continued productivity and wage stagnation, all of which will further tear apart the damaged fabric of our societies.

Renewal of our social and economic infrastructure and the creation of a fairer capitalist system must be the headline aims. Renewal can be secured by finding solutions to the long run challenges of climate change, health inequalities, obsolete or low-level skills and poor quality/insufficient housing. Fairness can be delivered by a relentless focus on how companies treat their stakeholders, not just their shareholders – penalising the bad and incentivising the good.

In each of these domains, private capital has a crucial role to play – and this paper focuses on the critical role of private pension wealth. It argues that pension fund members can become the new activist citizen investors – demanding that their investments do social good. This will put institutional investors under increasing pressure to demonstrate responsible investment practices while delivering a financial return. With $32trn in pension assets, funds have the opportunity to be truly transformational – investing in the infrastructure and companies of the future and not the rentier capitalism of the past.

This change is happening, even if at times it feels fragmented and intangible. This paper outlines the potential roles for pension capital within the context of a generational crisis of capitalism exacerbated by a global pandemic.

Amidst the fog of a generational crisis

Even before Covid, capitalism was in crisis. After a generational slowdown in productivity, US economist Robert Gordon rang his own “end of history” death-knell on developed economies, arguing that we have maxed out the key drivers of growth – the working age population, entry of women into the labour force, rising educational attainment and business dynamism.[1] The 2010s became the decade of secular stagnation with growth rates likely to be half what they were during the late 20th century. While Gordon’s gloomy depiction relates to the US, much of it feels true for many developed countries whose growth rates seem permanently lower since the 2008 financial crisis. The current pandemic may be a massive temporary economic shock due to a sudden health emergency, but it comes amidst a deeply entrenched, long-run economic malaise.

In this era of secular stagnation, many companies look to improve their bottom line by a relentless focus on unit cost reduction and rent extraction rather than the creation of new products and services that deliver real value-add. With many governments embracing flexible labour markets and a race to the bottom on corporation taxes, the result has been the squeezing of wages, rising insecure and exploitative working practices and tax avoidance efforts from the world’s richest companies.

The situation is unsustainable. Discontented citizens are increasingly turning to populist leaders and movements, some of which are challenging the fundamental norms and institutions of democracy. This not only threatens our systems of government but also the future of capitalism itself – with the rule of law, good governance and the peaceful transition of power crucial building blocks for functioning market economies.

Infrastructure – social and economic

The continual debasement of our political, economic and social lives does not have to be the story of the 2020s. Parallels with post-World War II reconstruction are useful as it will require a similarly radical response to save and rejuvenate economies in the wake of the worst pandemic for a century.

Social and economic infrastructure were critical components of the post-war recovery with many developed countries seeing the birth of the modern welfare state during this time. This set the foundations for the so- called “golden era of prosperity” as countries

[1] Gordon, Robert J., Secular Stagnation on the Supply Side: U.S. Productivity Growth in the Long Run (November 16, 2015). DIGIWORLD ECONOMIC JOURNAL, no. 100, 4th quarter 2015, p.19, Available at SSRN: https://ssrn.com/abstract=2845327

capitalised on their burgeoning working age populations by educating them better and in greater number than ever before while delivering exponential growth in health and life expectancy through the development and expansion of universal healthcare and public health systems. Whereas politicians and economists rightly vaunt economic infrastructure like trains, roads and telecommunication systems as the critical engines of growth, the role of social infrastructure in driving the unprecedented productivity gains of the latter half of the 20th century cannot be overstated.

In the wake of Covid, we need to rebuild once more and with similar ambition. But aside from the substantial immediate disaster relief to save lives and jobs during the health crisis, most governments are proposing relatively meek long-term infrastructure investments as they look to reset post-Covid.[2] This limited ambition is partly a consequence of the fiscal predicament governments find themselves in – developed countries have long since banked their demographic dividend and now ageing populations present huge risks to government finances. This meant that even before Covid, governments were on an unsustainable path with healthcare and pension costs rising faster than economic growth. Limited ambition also stems from a fatalist belief that the rate of productivity growth is somehow exogenously determined – an unexplained economic residual sometimes called total factor productivity, multifactor productivity or some other overly complex technical term. In this strangled version of the world, we can do little to change the rules of the game.

But nothing is predetermined. There are significant opportunities for productivity growth – many of which relate to closing existing economic inequalities through investment in social and economic infrastructure and by backing companies that support inclusive employment and innovation.

Opportunities for renewal and fairness

- **The economic infrastructure gap:** The demand for economic infrastructure is enormous and growing with OECD estimating global demand of $6.3trn per year, rising to $6.9trn to support a low carbon future.[3]
- **Education gap**: While Robert Gordon is right that education made great strides in the 20th century, adult education can be the game-changer in the 21st. Looking across OECD countries, on average, 1 in 5 adults have below upper secondary levels of education meaning they have only completed basic schooling, while over 3 in 5 have not completed any post-school education.[4]
- **Health gap:** Shrinking working age populations can be stalled or even reversed by preventing ill health and supporting retraining, thereby enabling people to work and remain productive for longer. The critical barrier to this is the health of poorer, less educated groups whose healthy life expectancy is much lower. Recent data for OECD countries shows that people in the lowest education category are twice as likely to view their health as "poor" compared to those with tertiary education (44% vs 23%).[5]
- **Gender gap:** While the employment rate of women has risen in recent decades, the gender gaps in employment and pay remain stark. Closing the pay gap across the OECD could increase total female earnings by US$2 trillion.[6]
- **Innovation gap:** We have not yet reached peak innovation. Never have there been so many well qualified people in the world and this is growing. Looking across OECD and G20 countries, the number of 25-34 year olds with a university degree is forecast to grow from 137 million to 300 million by 2030.[7] This massive growing stock of knowledge will surely drive forward innovation in new and as yet unimagined ways.

Pension scheme members as the catalysts for change

One reason to be optimistic about the 2020s is that it could see the rise of the activist, citizen investor. Longer lives have created an imperative to put more money into pension pots so people are not left destitute in retirement. The stock of global pension savings is already massive with

[2] There are some notable exceptions to this such as France's proposed EUR100bn (4% of GDP) post-Covid stimulus package. https://www.ft.com/content/0921c871-17b5-4e2e-bdea-aab78c2d0090. But even this looks meek in comparison to the New Deal which amounted to an estimated 40% of US output in 1929. For New Deal spend see: https://www.stlouisfed.org/publications/regional-economist/first_quarter_2017/the-recovery-act-of-2009-vs-fdrs-new-deal-which-was-bigger
[3] https://www.oecd.org/env/cc/g20-climate/Technical-note-estimates-of-infrastructure-investment-needs.pdf
[4] CPP analysis of OECD data on adult education level: https://data.oecd.org/eduatt/adult-education-level.htm#indicator-chart
[5] OECD (2019) Health for Everyone?: Social Inequalities in Health and Health Systems, OECD Health Policy Studies, OECD Publishing, Paris, https://doi.org/10.1787/3c8385d0-en.
[6] https://www.pwc.co.uk/economic-services/WIWI/women-in-work-index-2018.pdf
[7] OECD (2019) Benchmarking Higher Education System Performance, Higher Education, OECD Publishing, Paris, https://doi.org/10.1787/be5514d7-en.

pension fund assets reaching $32 trillion in 2019.[8] In the most mature markets such as Canada, the UK, Netherlands and Denmark, pension assets exceed annual economic output. While governments are heavily indebted and reluctant to pursue transformational New Deal style investments, this leaves a gap for pension capital to step in and accelerate growth opportunities.

Across many countries, more and more savers are investing in defined contribution (DC) pension schemes – where an individual's contributions and sometimes their employer's contributions are invested, and the proceeds used to buy a pension. These pension scheme members want a return on their investments, but many are socially conscious too – they would support investment in new infrastructure assets if they can secure a social as well as financial return. Members also care about the practices of the businesses they are invested in. They do not want workers to be exploited, the environment ruined or companies to cheat or break the law to get ahead. And they want to actively promote firms that are ethical and help to solve societal problems rather than contribute to them. In a recent UK survey, nearly half said they would be willing to accept a slightly lower return on their pension investments to invest in companies that care about employee wellbeing (47%) and the environment (46%). 18-24 year olds appear to be the most willing to accept a slightly lower return to invest in companies with strong social and environmental practices.[9] Similarly, academic research in the Netherlands shows that social investors are willing to pay a price to be socially responsible rather than needing a nudge, such as a gift (a book or a voucher). Highly educated individuals have a substantial latent demand that is currently unexploited.[10]

But apathy amongst DC pension scheme members remains a big ongoing challenge. Many members take little or no active decisions in terms of how their investments are allocated, leaving their money in default schemes. People often see the process of pension investment as dull, complex and confusing and so choose to do nothing. Overcoming such apathy is a critical barrier for mobilising capital to do more social good. The Australian Productivity Commission found three key issues underpinned current levels of apathy with the country's superannuation pension savings – products are hard to compare, there are low levels of financial literacy and members do not know where to get help. Their solutions are: simpler information dashboards, better targeted financial literacy programmes and an independent member advocacy body.[11] Other countries are implementing similar measures to support better pension scheme engagement. But there are also moves to ensure pension schemes better account for existing levels of member apathy, by default schemes embedding the principles of responsible investment within them, thereby matching investments to the underlying preferences of scheme members.

In this context, if we can reduce apathy amongst scheme members while offering default schemes that are closer to the preferences of much of the general public, their natural desire for their savings to do social good can drive new investments in real economic and social assets and instil change in the world's biggest companies. They can be the new citizen investors of the 2020s.

Putting the "S" into ESG

To some extent, the institutional investment sector is already leading the charge. The appetite for investment that considers environmental, social and governance (ESG) issues has skyrocketed and today, assets under management of ESG-related funds range between $3 trillion and $31 trillion, depending on the definition.[12] The organisation Principles for Responsible Investment which promotes responsible investment has more than 3,000 signatories which it estimates represent over $100 trillion in assets under management.[13] Responsible investing has been mainstreamed even if it currently means different things to different investors.

However, the massive range in "responsible" assets under management reflects the different ways in which such investment is conducted. This makes it challenging to untangle how much overall progress is being made in terms of the ultimate economic and social impact. For some, a commitment to responsible investing simply involves signing up to a pledge to save face rather than take action, while for others ESG strategies are deployed as a way of sidestepping the most toxic assets and companies. Environmental catastrophes such as the Deep Water Horizon oil spill can cause large losses to firms and insurers not to mention reputational ruin. But for a growing number, ESG strategies are focused on identifying those best in class firms and assets making a positive contribution and investing in them. According to the IMF, this latter group, who adopt positive, best in class screening, make up a smaller but still significant

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8 OECD (2020) Pension Funds in Figures. http://www.oecd.org/daf/fin/private-pensions/Pension-Funds-in-Figures-2020.pdf
9 LCP (2020) https://www.lcp.uk.com/media-centre/2020/02/lcpyougov-employee-wellbeing-tops-list-of-esg-concerns/
10 Rossi, M., Sansone, D., van Soest, A., & Torricelli, C. (2019) Household preferences for socially responsible investments. Journal of Banking & Finance, 105, 107-120. https://doi.org/10.1016/j.jbankfin.2019.05.018
11 Australian Government Productivity Commission (2018) Superannuation: Assessing Efficiency and Competitiveness https://www.pc.gov.au/inquiries/completed/superannuation/assessment/report/superannuation-assessment-overview.pdf
12 IMF (2019) Connecting the Dots Between Sustainable Finance and Financial Stability: https://blogs.imf.org/2019/10/10/connecting-the-dots-between-sustainable-finance-and-financial-stability/
13 https://www.unpri.org/pri

part of the pie worth around $2 trillion.[14] It is this type of investment that needs to be accelerated in order to drive real change in the behaviour of companies and it must be accompanied by a rigorous focus on the social aspect of ESG – which some see as the hardest part of the criteria to pin down and take action on.[15]

Infrastructure investment (physical and social) is an important part of this picture. Such investment can help to deliver better social and environmental outcomes, thereby fulfilling the ESG needs of investors while plugging the infrastructure gaps facing governments and societies. There are also strong financial reasons to invest in social and economic infrastructure. Such investments have long- term, predictable returns (particularly in the case of economic infrastructure), low sensitivity to the business cycle, and helpfully add to the diversity of the portfolio since fluctuations in the value of infrastructure are generally uncorrelated with other assets such as company shares and bonds.[16] With Covid-19 resulting in increased volatility across financial markets and keeping interest rates low for the foreseeable future, pension funds will look towards alternative assets that offer stable long-term returns.

Even before Covid, there was significant demand for infrastructure projects within large institutional investors. In the OECD's latest survey of large pension funds, 44 out of 49 funds were invested in infrastructure assets. Of these, Australian funds reported comparatively high levels - AustralianSuper, CBUS, and Hostplus reported allocations of 9.9%, 8.9% and 10.0%, respectively. As the OECD notes, Australia has well established capital markets for infrastructure finance with defined contribution pension funds active participants. Across many markets demand exceeds supply - of the 20 funds surveyed that have a target for the amount of infrastructure assets they hold, the majority were below intended levels. The most dramatic of these is the Local Authorities Pension Scheme in Canada, which has an infrastructure target of 15% but it could only manage 8.4% (as of 2017).[17]

Yet infrastructure investment is not straightforward. Currently, most of the institutional investment is directed towards projects that are already underway and therefore lower risk rather than money for new projects. New projects pose investor risks around the likelihood of completion and uncertainty about future demand.

Private capital also goes to where the returns are highest, so governments offer sweeteners to encourage investments in one country rather than another. Partly for this reason, private pension capital is often not invested in new domestic projects.[18] Finally, not all infrastructure investments are sustainable – national infrastructure strategies and related projects can fail to live up to the UN Sustainable Development Goals, undermining the efforts of investors to deliver social impact and fulfil their own ESG goals.[19]

Why now for private pension investment in infrastructure?

We have been here before. After the financial crisis of 2008, some governments looked to institutional investors to step in and fund infrastructure projects. At that time, interest rates were low because of general economic conditions and central bank interventions, while government debts had risen following bank bailouts and increased welfare spending. But no big infrastructure push came from pension funds. In the UK, for example, the Pensions Infrastructure Platform was established in 2012, but as of 2020 the fund has a net asset value of just £700m and has fallen way short of the government's initial ambition for it to direct over £20bn into infrastructure investments.[20]

Critical barriers to increased infrastructure investment have been the lack of new projects to invest in and the need for clarity over the likely revenue sources and risks surrounding these investments. Both are solvable by governments working more closely with pension funds and insurers to develop a credible pipeline of investable infrastructure projects. This may include financial commitments from governments to get projects off the ground and a degree of risk sharing and pooling of budgets between governments and private investors. Having new projects that explicitly seek to solve our long- run problems of climate change, poor health, obsolete or low-level skills and education and poor quality/insufficient housing can help reduce perceived risk around likely future demand. National infrastructure strategies must double down on these long-term social and economic challenges and ensure the proposed projects are sustainable for the long-term and fulfil ESG criteria. It also requires a level of political and regulatory stability across countries to support investments in new

[14] IMF (2019) GFSR Chapter 6, Sustainable Finance, (Figure 6.1, panel 2)
[15] A good example of this is Boohoo in the UK which was exploiting its workers. Despite this, many ESG funds unknowingly included it in their investment portfolios. For more see: O'Connor, S. Sustainable funds must work harder to vet their investments: https://www.ft.com/content/48e02694-a54c-4cec-9af6-ada8b4955e20
[16] Inderst, G. (2020) Social Infrastructure Finance and Institutional Investors: A Global Perspective. https://realassets.ipe.com/download?ac=97221
[17] OECD (2019) Annual Survey of Large Pension Funds and Public Pension Reserve Funds http://www.oecd.org/daf/fin/private-pensions/Survey-of-Large-Pension-Funds-2019.pdf
[18] Inderst, Georg, Pension Fund Investment in Infrastructure: Lessons from Australia and Canada (May 23, 2014). Rotman International Journal of Pension Management, Vol. 7, No. 1, 2014, Available at SSRN: https://ssrn.com/abstract=2449777
[19] UNPRI (2020) Are national infrastructure plans SDG-aligned, and how can investors play their part? https://www.unpri.org/sustainable-development-goals/are-national-infrastructure-plans-sdg-aligned-and-how-can-investors-play-their-part/5636.article
[20] PiP has a portfolio of 17 assets covering the Energy from Waste, Renewables, Social and Transport sectors, with a Net Asset Value in excess of £700 million. https://www.pipfunds.co.uk/foresight-broadens-its-infrastructure-platform-with-the-acquisition-of-pip/

domestic infrastructure assets, rather than countries offering short- term "sweeteners" to attract private capital towards infrastructure assets that are already in existence. In this sense, international institutions and cross-government collaboration will be vital in reducing the potential for arbitrage.

Conclusion

This time will be different. On the political side, government fatalism will give way to action – it is only by delivering the necessary economic and social infrastructure that governments can live up to the challenges of the 2020s to drive renewal and consign secular stagnation to the pre-pandemic era. Governments will develop ambitious national strategies for transformative and investible infrastructure. We will overcome apathy amongst pension scheme members who will want to drive economic and social improvements as a new generation of citizen investors who care deeply about moral as well as financial returns on investment. And institutional investors will lead the charge with more funds basing their investment decisions on best in class ESG screening, while ramping up infrastructure allocations for critical new economic and social projects. This is the way forward – harnessing private capital to set a new productive path for developed economies in the decades to come. It is the building blocks for a fairer capitalism which puts the interests of stakeholders and wider society at its heart.

About the Centre for Progressive Policy

The Centre for Progressive Policy is a think tank committed to making inclusive economic growth a reality. By working with national, local and international partners, our aim is to devise effective, pragmatic policy solutions to drive productivity and shared prosperity in the UK.

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