Beyond Tax Relief - a new savings incentive framework

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Currently the UK has relatively high per capita retirement savings - higher than most of Europe. The development of a *strong pension savings culture is related to the low and falling level of the UK state pension. Indeed if this continues then we will need an even higher level of private savings for retirement. Yet, a number of factors would suggest that this good savings culture may be at risk. There is the much publicised shift from Defined Benefit (DB) to Defined Contribution (DC) pensions *(which is usually accompanied by much lower employer contributions), the failure of UK pensions laws to protect pension rights of non-retired members of final salary schemes, the incentive problems created by complex state provision (IPPR, 2002); a series of mis-selling scandals and corporate failures in the financial services industry and the weakness of consumers of long-term saving products, due to lack of access to clear information and advice (Sandler, 2002).

At the same time as this trend towards increasing *need* for individual provision, it is becoming harder for this to actually happen. There are many people who do not save much, if at all. If savings levels fall further, this will mean much higher costs of state support and the risk of more pensioner poverty in the UK.

Many people, especially the less affluent, currently seem to feel that the risks or difficulties of saving are greater than the risks or difficulties of not saving. This is partly symptomatic of the disincentives that exist in the current system. However, something which has received relatively little attention is the UK's structure of incentives to save, and particularly the use of the tax system as the main means of incentivising saving. This lack of attention is surprising because the present system is highly regressive. Those who tend to be saving are in higher income groups and, as tax relief is given at the highest marginal tax rate, they receive a significantly higher incentive to save. If it is important to encourage all members of society, not just the better off, to develop the savings habit then this situation needs to be challenged.

The recent Sandler report recognised the limitations of tax relief and suggested that, while it might affect where people saved, it may not increase overall levels of saving. Although the academic literature is unclear on this question, if it is accepted one thing that is clear is that Sandler's analysis stopped short of thinking in detail about any solution to this problem. The one thing that Sandler did suggest is that a system of matching grants could be more effective than the current system. This is exactly what this paper examines. What might an alternative and more progressive incentive structure look like?

What are the aims of Government Savings Policy?

Government wants to spread the benefits of savings and asset ownership to all members of society. 'Financial assets should be the preserve of the many, not the few' (HMT, 2001a). The Treasury also argues it is important that individuals are encouraged to develop a regular saving habit and to recognise the benefits of saving.

As far as retirement support is concerned, the government has declared that it aims to shift the balance between state and private pension provision. Currently, State pensions account for 60 percent of retirement income, with private provision accounting for 40 percent, but the aim is to move to a position where this balance is reversed, with 60 percent of retirement income from private means. This would entail a significant increase in private pension provision. Measures have been taken to try and encourage *this trend. The most significant has been the implementation of Stakeholder pensions, which were designed to be attractive to middle and lower income earners. However, sales levels have been relatively low and it is unclear whether Stakeholders have created any new savers in their moderate-income target group (ABI, 2001). If Government is to meet its stated aim, further measures will undoubtedly be required.

Why does Government want to encourage saving?

There are many benefits of saving, both from the individual saver's point of view, and from the point of view of society as a whole. Some of these benefits are practical and some behavioural. The latter are only likely to come from the actual act of saving. Just receiving cash benefits will not have the same effect:

Table 1: Benefits of Saving for Individuals and Society

	Behavioural benefits	Practical benefits
Benefits to the individual	• Increased self-reliance and feeling of independence. • Improved attitude to personal development. • Increased ability to forward plan. • Affordability of luxuries.	• Precautionary savings to provide cover in times of adversity such as emergencies, unemployment or retirement. • Increased comfort in old age. • Improved lifetime chances such as higher earnings or *less unemployment. • Ability to pass on bequests.
Benefits to Society	• Higher stock of national assets. • The population being more focussed on the future should increase economic efficiency. • Having a stake in *the country's economic performance could make people more motivated.	• Reduced cost of welfare support. • Improved capital stock of the economy. • Improved long-run economic growth. • Ensure sufficient domestic support for capital markets.

How does Government currently encourage savings?

Since 1997 a number of policy measures have been introduced to increase saving. These include:

- Raising capital limits for pensions.
- Introduction of CAT standards.
- Steps to fight financial exclusion, for example by making basic bank accounts available to all.
- Creating the Financial Services Authority as the single financial regulator.
- Making financial education part of the national curriculum.
- Launching Stakeholder pensions.
- The announcement of the Pension Credit.

There are also two other proposed measures that have not yet been implemented, namely the Child Trust Fund and Saving Gateway (HMT, 2001a HMT, 2001b). These new measures could be particularly helpful to achieve two important aims. Firstly the Child Trust Fund could help establish a lifetime savings culture, something we return to below. It would be socially equitable, giving the same amounts to all, regardless of income. The Savings Gateway (designed to match at a rate of 1:1 any savings made by the lowest income groups) could be particularly useful in allowing the poorest sections of society to experience the benefits of saving.

Tax relief

The major financial incentive, currently provided by the government to encourage people to save is tax relief. There are generous tax breaks on many forms of savings and most people could, if they realised, do all their savings tax-free. This represents a huge cost to the Exchequer. As will be demonstrated below, this benefits the higher income groups most and is of *<u>little or</u> no benefit to non-taxpayers.

Tax relief is used for pensions as well as shorter-term savings products such as ISAs, which have been designed to appeal particularly to young people and those on low incomes. Although there are these other tax-free or tax favoured products, the most generous treatment is of pension saving. In order to encourage people to lock their money away until retirement and to try to ensure that the state will not support them, the rules for pensions have been made more generous. For example, they provide a tax-free lump sum and the contribution limits are far higher than for ISA's.

The inequity of tax relief

Tax relief might work for *<u>higher earners (the top 10% of taxpayers who earn over about £34,500)</u> but it is not so much of an incentive, if any, for lower income groups. It is regressive and lacks transparency. Most people (and especially the 90% of taxpayers on basic rate tax) do not understand tax relief and do not know exactly how much money Government is putting into their pension fund from it. Surveys have found that some people believe that receiving tax relief is something 'negative' rather than 'positive' (Sandler, 2002).Tax relief is also inflexible, since the amount of incentive Government is able to give is determined by what tax rates happen to be, rather than by how much incentive is actually required to encourage people to save. It is certainly true that tax relief is much more beneficial to higher income groups and it could well result in increased inequality of income among the retired.

This can be illustrated with some examples. Tax relief on pension contributions means that higher income groups receive much more money from Government than basic rate taxpayers, even when they put the same net amount into their pension fund. Table 2 shows that higher rate tax relief, versus standard rate tax relief can exacerbate wealth inequalities. The effect of compounding over time on the extra amounts put into the pension from government tax relief means that for the *same* effective cost to the individual, (of £12 per month for 30 years in the case below), the higher rate taxpayers will end up with much higher pension pots than those on lower rate. They will have accumulated over £16,000, compared with just over £12,000 for basic rate taxpayers.

Table 2. The current system of tax relief exacerbates wealth inequality

	22 percent tax payer (assuming 20 percent for simplicity)	*40 percent tax payer*
Gross or pre-tax contribution by individual.	£15	£20
Net or post tax contribution from individual.	£12 net per month for 30 years.	£12 net per month for 30 years.
State funded tax relief paid in per month.	Government puts in £3 per month on top.	Government effectively puts in £8 per month on top (£4 into the pension and £4 off the tax bill)
Total state contribution over 30 years	£1,080	*£2,880*
Pension pot after 30 years	*£12,280*	*£16,373*

Note for Table 2: These figures assume 5 percent real investment growth in all cases. The higher rate taxpayer receives the basic rate tax relief straight into the pension as with those paying in at the basic rate, but can then claim more money back at the end of the financial year, which it is assumed they simply put straight into their pension.

The current system has other inequitable effects. The ability to take 25 percent of a pension pot tax-free is costly for the state and benefits the lower income groups far less than others. For someone paying 40 percent tax both when contributing to a pension and in retirement, the value of the effective subsidy provided by the tax free lump sum is twice as large as the subsidy for someone paying lower rate tax when contributing and in retirement. As shown in Table 3, with a £10,000 pension pot, the effective subsidy for a lower rate taxpayer is only £500, compared with £1,000 for the higher ratepayer. However, the biggest benefits go to people who paid higher rate tax when contributing and lower rate tax in retirement. They receive five times the amount that the lower income group gets. This is arbitrarily inequitable from a social perspective. I would certainly not argue for removing the tax free lump sum, but I believe the effects of it should not be skewed in favour of a particular group.

Table 3. Inequitable effects of tax relief: the tax-free lump sum.

Marginal tax rate (assume basic rate 20% rather than 22%)	Value of tax saved by having tax free lump sum of 25 percent
20 per cent while working and 20 per cent in retirement	£500
40 per cent while working and 40 per cent in retirement	£1,000
40 per cent while working and 20 per cent in retirement	£2,500

It seems clear that tax relief benefits higher earners most and those who stay in regular employment throughout their lives. As well as being regressive it is also extremely expensive. The cost to the Exchequer has fluctuated around 1.5 per cent of GDP since the mid-1980s and in 1999/2000 it cost around £12billion (Sinfield, 2000) and current estimates are around £14billion. This is the net cost, after deducting the tax received from pensions in payment. The amount is so high partly because many high earners put large amounts into their pension fund, in order to get the benefit of 40% 'grossing up' from Government. Effectively this means that, for every £60 a higher rate taxpayer puts into his/her pension, Government will add an extra £40 on top (that is an extra two thirds!). Therefore, even if the value of the investments in the pension fund halves, the higher rate taxpayer will not be worse off. In theory, the tax should then be recouped from pensions when they are finally paid in retirement. However, there are many reasons why the full amount of tax relief is not paid back. Firstly, up to 25 percent of the pension fund accumulated can be paid out as a tax-free lump sum, so this escapes tax altogether. Secondly, many people who are in the 40 percent tax band when at work are not in this band when retired. They will, therefore, not pay back the full tax relief on their pension. Thirdly, tax relief is given at the highest marginal rate on the full amount of all contributions made, whereas the tax on a pension in payment will only attract 40 percent tax on the top slice and the basic rate band is used up first.

In 1999/2000, Government was spending £2.5billion more on tax relief for pensions than on means tested benefits for the elderly and the sum spent on tax relief was about one third of the total spent on National Insurance pensions in payment. Yet estimates suggest that over half the money spent on tax relief for private pensions in the UK goes to the top income decile of tax payers and a quarter of it to the top 2.5 percent of taxpayers (Legrand and Agulnik, 1999). This implies that looking across the population as a whole, including non-taxpayers, the regressivity is even worse.

Moving beyond tax-relief

Government needs to consider moving away from the whole concept of tax relief as the main means of financially incentivising saving. It is regressive, socially unjust and is not encouraging the majority of the population to save. Tax relief also lacks transparency in two ways. Firstly, from the individuals' perspective because people do not usually see the actual amount of money that Government is putting into the pension and do not understand how it works. Secondly, for policy makers and people wanting to scrutinise government expenditure, transparency is reduced because it is not part of the annual public expenditure round in the way that direct expenditure is.

Tax relief is also inflexible because the amount of incentive that can be given is determined by what tax rates happen to be at the time, rather than by what particular level of incentive may be required to encourage people to actually save. The lower tax rates go, the less incentive can be given. This may not be optimal from the point of view of savings policy. It is costing the Exchequer huge amounts of money, which should be redistributed to provide better incentives to those who need them most, those on middle and low incomes. It would be much more equitable and efficient to give everyone the same amount of incentive to save – in the form of higher incentives for basic rate taxpayers, not just removing higher rate tax relief. If Government did not want to commit extra resources to this, then at the very least, they should redistribute the public money currently spent on pensions tax relief.

The precedent for moving away from tax relief in this way has already been set by stakeholder pensions, which gross up contributions by 22 percent even for non-taxpayers. We have also recently seen proposals from the Conservative Party, which will lead to moving beyond tax relief. The proposed introduction of a Lifetime Savings Account, into which savings will be matched by Government, is significant. At the time of writing the details remain unclear but the principles are important. Although the match given to people will not be as significant as the figures suggested in this chapter, it does suggest that this is a serious policy proposal (Conservative Party: 2002).

The key principle for a reformed system of saving is that everyone, regardless of their income should receive the same matching or saving incentive for the same level of saving. The rates for this new system need to be determined independently of the tax system. To achieve these two aims the contribution limits should be set in monetary amounts. Overall, higher income groups will still receive more payments into their pensions from the state, because they are likely to be able to afford to save more than lower income groups. However, real incentives will be available for all people. If, for example someone on low income receives an inheritance, they will be much more likely to consider putting some or all of it into a pension because they know that they will receive substantial extra payment from Government to do so. In the current system their incentives would merely be at their marginal tax rate, which might not be enough.

The aim of pensions savings incentives should be that as many people as possible are encouraged to provide themselves with sufficient financial means to support themselves for the rest of their lives. This could perhaps be thought of as a 'minimum lifetime annuity', with policy using limits on the amount of pension savings which is incentivised, designed to achieve this 'minimum' level of income that would ensure people will not need to draw means tested benefits later in life. These amounts could be actuarially calculated, using investment and interest rate assumptions projected forward over a number of years. £14

In order to control the costs of the new scheme, Government would need to set some limits on the amount of savings which will receive matching payment incentives from the Exchequer. The level at which these limits are set will be important. Depending on whether Government was willing to commit extra resources to incentivising savings, the limits could be higher or lower. My main argument is that this should result in a 'levelling up' of incentives to save, not an overall reduction. I believe people who can currently only receive 22% grossing up need a higher incentive to save. If Government were not willing to commit any extra resources to incentivise higher savings, then the limits would need to be set to redistribute the current amount of about £14billion that is spent on pensions tax relief at the moment.. The precise limits would be calculated to try to ensure that this £1414 billion (or hopefully an even higher amount), is used instead for a new system of standard matched payments added by Government to all pension contributions.

One possible structure for new matching incentives is outlined in Table 4. For every pound that a person contributes to their pension, Government could put in a certain amount extra, as an inducement to get people to deposit money in the first place. For the first part of the pension contribution (say £240240 per year or £20 per month) the matching could be pound for pound, acting as a powerful initial incentive. The matching rate would probably need to be reduced for higher amounts of contributions, in order to contain the costs and to ensure progressivity. It is suggested in this chapter that Government could put in £1 for every £2 the person contributes for the next £10,000 per year, then £1 for every £3 of the next £10,000 (with limits carried forward to allow backdating of contributions). Table 4 shows a suggested representation of what these 'Government savings incentives' or matching payments could look like for pensions.

Table 4. Reformed government incentives for pensions saving

Level of contribution *per annum*	Matching rate
First £240240	£1 for £1 matching
Next £10,000	£1 from Government for every £2 contributed
Next £10,000	£1 from Government for every £3 contributed
Above £22,240	No Government incentive

Encouraging savings throughout the lifecycle

The second key change that the government needs to make to current saving incentives is to think more coherently about saving across the life cycle. There are two main reasons for this. Firstly, it can help in simplifying the savings environment and secondly, it will help to ensure that people develop a savings habit early in their lives. Starting to save early will allow people to build up a stock of assets to use for emergencies, for funding unexpected needs such as mid-career retraining, as well as for retirement.

The current savings and pension regime has become extremely complex. People generally do not understand it; they do not receive adequate information, education or advice to be able to make the best decisions for their future. They often do not really understand how to plan their finances for the future, what options they have and what the benefits of saving and investing really are. Financial education is not well provided in this country, either in schools or in the workplace. If Government really wants to encourage people to start saving, it needs to find ways of raising the level of understanding and education in financial matters. If children were to learn the benefits of saving, even as early as primary school, they would be more likely to develop the ‘savings habit’ and understand how important savings can be in influencing their future lifetime opportunities.

Policy should also encourage people to start saving from a much earlier age. The earlier people start to put money aside, the longer the period over which the funds can grow and the larger the amount of capital they should ultimately end up with. However, at the moment, pension policy discriminates against the young because of age related limits on contributions. This is despite the fact that those in their twenties, who perhaps are not yet supporting partners or families, would benefit from being able to put as much into their pension as those who are older. Savings could be encouraged in a variety of forms over the life cycle, with some being put into pensions, some into medium term savings and some into shorter-term vehicles.

The Child Trust Fund; kick starting a savings habit

In order to get more people saving, for more years, we need to change social attitudes and establish a lifetime savings culture. To facilitate this, it would be helpful to provide a more coherent structure of financial products and products which could be used to keep saving from childhood, right through to retirement.

Because the younger you start saving the better, the Child Trust Fund could be a powerful policy. It will be paid to every baby in the country and could therefore be used to start the savings habit for *everyone*. It is currently proposed that at 18, the child will be free to withdraw all the funds and close the account. This would be a dreadful waste. It is vital that people are incentivised to keep their savings account open. This will make it much easier for people to decide to save, as they start working. Even if people have money to save, they often cannot be bothered to go and open an account, so they just spend it. Inertia is a powerful factor in financial services. However, if every young adult already has an account they are familiar with, which they have followed for many years, they will know what to do. For example, part of their first pay cheques could be paid into the savings account already in existence. If the account is closed at 18, then the potential for the Child Trust Fund to kick start a lifetime savings habits could be lost.

A new fixed term ISA - encouraging medium term savings

There is one new product which needs to be introduced into the Government-incentivised savings arena; a fixed term ISA that could hold equities and bonds. The funds in ISAs are currently totally accessible. A new ISA type product which limits access to the funds would aim to encourage people to keep their money invested for a longer time and help them become accustomed to managing longer term savings. Hopefully they can watch the investment grow over time. Many people will realise that they can manage without this money, and therefore will be encouraged to continue saving. They could either retain some precautionary medium-term saving or potentially start to accumulate retirement savings.

A fixed term ISA could have a standard 25 percent financial incentive (£1 added for every £4 invested), which would be the same for everyone, regardless of their income and tax rate. The amount that could be put into this each year would be limited by Government, as with the current £7000 ISA limit. It would also be helpful to offer extra government incentives every time the funds are left untouched for a given length of time, say 5 years, to encourage maintaining an investment.

Retirement savings – highest financial incentive
Policy should aim to encourage people to move from the medium term ISA product into pension products. These should remain locked until later life, but should continue to benefit from highest levels of government financial incentive. In the previous section a revised incentive structure for pensions has been outlined in some detail. If all these products and changes were introduced then a more coherent savings environment that encourages asset-accumulation over the lifecycle, would be created. The diagram below shows what this would look like.

Summary of savings vehicles and government incentives

Child Trust Fund
Incentive provided at the age of eighteen to keep the account open.

Cash – short term investment
Fully withdrawable ISA

Monetary Limit: Up to £2000 per annum

Tax free on accumulation and withdrawal
(No financial payment added to contributions from Government)

Retirement - All stakeholder and DC pensions

First £240 per annum: Pound for pound matching from Government
Next £10,000 per annum: £1 for every £2
Next £10,000: £1 for every £3
Above £22,240 per annum: no financial incentive added by Government
All growth tax free, but taxed on withdrawal (at a special ‘pensions’ rate to be set by Revenue).

All growth tax free, but taxed on withdrawal

The effect of new incentives

What impact will there be on individual savers from different income groups? These proposals will impact to some degree on saving of the highest income groups. It may be that, shorn of their previous incentives they will save in a different form, and not put so much of their money into pensions. There is a risk they will save less, though extent of the effect is impossible to predict accurately. however, for the main target group of people on middle and moderate incomes, this new system is highly likely to encourage more savings than before. Again the exact nature of the effect would be difficult to predict and further work would be required.

We must also consider the impact on government expenditure. If the amount spent on matching contributions just redistributes the current expenditure on tax relief, there need be no additional cost to the Exchequer. However, it will be difficult to ensure what the exact expenditure will be, because the actual cost will depend on what happens to contributions. The impact on savings by different income groups is impossible to accurately predict, since this system of incentives has never been in place before. The system would be flexible enough to be changed quickly though. If for example, people started to put too much money into pensions and the cost rises higher than desired, the limits on contributions can be changed.

Conclusion

Government wants and needs to encourage more people, especially in middle and lower income groups to save. However, the current policy structure has a number of drawbacks, which make this difficult. There are serious disincentives for people on moderate and low incomes to save. At the same time the incentives that do exist are poorly focussed and insufficient for the very people who most need to save more.

The Exchequer spends enormous amounts on trying to encourage saving. For pensions alone, the cost of tax relief is over one per cent of GDP, around £14 billion each year, even after the tax paid on pensions in retirement is accounted for. This sum is around one third of the cost of state pensions. It is also highly regressive expenditure with approximately half of this money going to the top 10 percent of taxpayers. In no other area would we accept such a degree of inequity.

Using the tax system as the means of encouraging saving is regressive, inefficient, inflexible and illogical. It benefits those on highest incomes the most, even though these people probably need incentivising the least. The level of incentive is set by what tax rates happen to be, rather than with regard to how much incentive is actually needed to encourage people to save. It also lacks transparency, both to those contributing to pensions and to those trying to evaluate or change the effects of government expenditure.

Government also needs to think more coherently about incentivising saving across the lifecycle. Currently, people often do not start thinking about providing for their pension until they are in their 40s or 50s. This gives much less time for the benefits of saving to accrue. Ideally, saving should be encouraged from much younger ages, to fund emergencies, lifetime opportunities and retirement support. The earlier the 'savings habit' is encouraged, the greater the likely stock of assets that will be built up.

To help achieve these aims this chapter recommends:

- To make incentives to save more coherent and progressive we need to move away from using the tax system.

- Everyone should receive the same financial incentive for the same amount saved. Government is not currently offering enough incentive to people on basic rate tax, to encourage this target group to put more money into pensions. They clearly need higher savings incentives, but, using tax relief as the incentive mechanism has meant that, as tax rates have fallen, the incentive which can be given has also declined.

- If Government insists on improving incentives for 'middle Britain' in a revenue neutral manner, rather than devoting extra resources to this, then it could redistribute the £14 billion currently spent on tax relief for pensions to finance a more equitable system of financial incentives, related to the amount of money saved, rather than the income level of the saver.

- This could be achieved by the government matching pension saving. Initial savings could be matched pound-for pound, though as people save more the incentive would be reduced, first to £1 for every £2, then £1 for every £3.

- To help encourage more saving across the lifecycle, savings products should be better joined up. To facilitate this, a new medium term savings vehicle – a fixed term ISA should be introduced.

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