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Incentives to save in a world of individual – and fiscal – responsibility

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A follow-up to HMT's consultation: "Strengthening the incentive to save: a consultation on pensions tax relief". Taking in Michael Johnson's arguments for "An ISA-Centric Savings World" and the government's postponement of plans for "pot follows member".

Incentives for long-term saving
Individual wealth/savings warehouse
Fiscal responsibility

Incentives for long-term saving

1. Saving for later life needs much more encouragement than short-term saving. Instant access saving, for example in an ISA, is popular. But saving for a rainy day, or for a relatively short-term goal such as a holiday or a deposit for a house, is different from long-term saving – or investment. Returns to cash ISAs are poor: the best rates for easy access in October 2015 were 1.5-1.6%. So the tax benefit for a standard rate taxpayer is a paltry 0.3% - £3 on £1,000 of savings.

2. Long-term saving involves deferred consumption, locking money away and an uncertain outcome. It does, however, provide access to significant investment gains through the compounding effect. The lock-in also facilitates riskier investment, such as a bias towards equities rather than government bonds or cash, because it precludes panic withdrawals triggered by volatile price movements.

3. Because both compounding and lock-ins are a hard sell to most savers, other incentives are needed. Pension saving regimes have, therefore, tended to include contributions from both employers and the government – the latter

as a tax rebate. Auto-enrolment, on which the government wishes to build, follows this pattern.

4. The government should maintain the "simple principle at the heart of the current system", as set out by the Treasury in *Strengthening the incentive to save: a consultation on pensions tax relief.* This is that "the contributions you make to a pension during your working life are tax free, and you pay tax on them when you come to take your pension". The "you" applies to individuals. So the first question is: how much will the government add to every £1 you put in? Since people think in terms of post-tax income (take-home pay), that is what the £1 should refer to.

5. Whether it's "you put in £2 and the government puts in £1" or "For every £1 you put in, the government puts in 40p", the slogan is an encouragement to save. While a flat rate can be seen as severing the direct link with income tax, it should be underpinned by reference to the standard rate. So the minimum government "top-up" should be 25%.

6. The employer generally makes a larger contribution than the government's top-up. Under the present AE regime, the target is £3 for every £4 the employee puts in, with £1 from the government. A simpler and more generous message would be: "For every £1 you put in, the employer puts in £1."

7. Increasing both the employer's contribution and the government top-up for most people (on standard-rate tax) could quickly get to a formula of 5+5+2 = 12% (with a near 30% flat rate or 12.5% with a 33% flat rate of "tax relief"). This is in line with the Pensions Policy Institute models, which show 11-13% as necessary for low-mid earners to have a good chance of achieving two thirds of late-career salary, including the state pension (*What level of pension contribution is needed to obtain an adequate retirement income? October 2013)*.

8. Individual savers do not need to worry about how the employer is taxed, or not, on these contributions. Like other staff costs, they reduce taxable profits for corporation tax purposes and they are effectively tax-exempt remuneration for the individual. At this stage, some employers are facing rising pension contributions as AE is phased in, and others face a higher National Insurance bill as contracting out ends for defined benefit schemes. While the government needs to be careful about forcing further increases in staff costs, there is a case for removing the NI exemption on all pension contributions, which costs about £14bn in lost tax revenue. This could be presented as helping to fund the more generous basic state pension.

Individual wealth/savings warehouse

1. Michael Johnson has promoted two ideas that would help with individual responsibility for providing for old age: aggregation of long-term savings *Aggregation is the Key* (September 2013) and what he calls an "ISA Warehouse" (*An ISA-Centric Savings World, Centre for Policy Studies, October 2015).* Remove the focus on ISAs and the warehouse idea can be applied more generally to individual savings. In my view, long-term saving is intrinsically different from ISAs and so those accounts should have another name, such as a pensions or retirement account – I'll refer to this as an IRA.

2. While the individual approach to ISAs, and other instant access savings accounts, is well established, the switch to "defined contribution" pension schemes based on the workplace has tended to keep some old DB habits. These are that the employer chooses the provider and that changes of employment have resulted in a trail of pots being left behind. Both need to be tackled. In *The Death of Retirement (CSFI, July 2015),* I suggest that the employer's role should simply be as a collector of employees' contributions and as a contributor. In an ideal world, individuals would choose the savings vehicle for themselves, from a list of approved providers. They might go for a trusted brand such as an insurer or a retailer with a financial services arm; or they might choose a multi-employer/industry-wide scheme; or a specialist savings provider, including new internet-based wealth managers; or they might set up a SIPP. In the absence of any of these, they could be defaulted into NEST.

Once an IRA provider is chosen, individuals should be able to stick with it no matter how often they change jobs, or switch to self-employment. They could have more than one IRA, but differential charges for small pots and transfer or set-up fees would be likely to encourage consolidation.

3. Which ever pension savings vehicle they choose, they should have the option to transfer in savings from a) other pension funds; and b) other savings funds such as ISAs. Because the latter have not yet benefited from a government top-up, they would gain this on transfer to an IRA. Arguably a significant proportion of the roughly £240bn in cash ISAs, currently making a poor return, should be invested for the long-term. There should be no ineligible pots. It is welcome that the government is rethinking the "pot follows member" plan, which lacked ambition.

4. To help with this process, the Pension Tracing Service should be more active in finding dormant pots, informing people about their existence and encouraging aggregation.

5. Individuals should be able to see all their savings pots on what some call a dashboard. By extending Michael Johnson's idea of a warehouse, this on-line aggregator of information could also be manipulated by the individual to include the estimated value of his/her house and other assets. It could be called the "wealth warehouse", or "asset store", or "my investments". It should also be set up to include debt.

Increasingly, when people seek to make an investment, they are asked for information about their assets and liabilities as well as their income. In New Zealand, the Commission for Financial Literacy and Retirement runs a website called Sorted, which allows the saver to plug in savings and debt, and encourages repayment of high-interest debt.

Fiscal responsibility

My response to HM Treasury on *Strengthening the incentive to save* made the following suggestions:

1. A further cut in the total annual allowance to £30,000 and a lifetime cap on tax-exempt (or government incentivised) contributions. Caps up to a neutral level compared with today's rules should be modelled. This would replace the lifetime cap on fund size.

2. The employers' exemption from NICs on pension contributions to should be phased out, saving about £14bn a year.

3. Income tax relief, or the government top-up, for individuals should be at a flat rate. At about 30% of gross pay, according to the PPI, this might save £1bn. If restricted to the standard rate of 20%, it could save £13bn, or more on some estimates.

4. The tax-free lump sum on reaching 55 should be phased out or capped, saving at least £2bn of the £4bn cost.

5. Savings can also be made on pensioner-specific benefits. The winter fuel allowance, free bus passes and TV licences (now a burden on the BBC) could be phased out, saving £3bn. And the pension/guarantee credits that are now available should wither away, saving £6.5bn.

6. In addition to the £6bn that is already set to be cut by reducing allowances, this would save a minimum of £32.5bn.

7. It should also be borne in mind that £13.1bn was raised by tax on pension payments in 2013-14. With about 1m people over 65 still in work and that number set to rise, the broader outlook for taxation income from that age group is positive.