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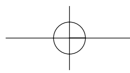

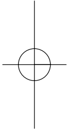

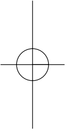

Charles Jackson

Saving Savings:

How to Promote Personal Investment

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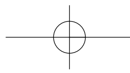

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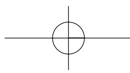

Saving Savings:

How to Promote Personal Investment

Charles Jackson

POLITEIA

2004

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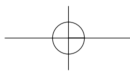

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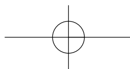
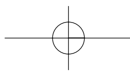
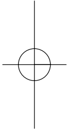
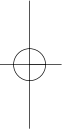
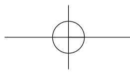




The Author

Charles Jackson consults and writes on savings and investment issues. He has twenty-five years experience in the financial services industry, most recently as a Managing Director of Merrill Lynch Investment Management. Prior to that, he was thirteen years at Mercury Asset Management where he was a Vice Chairman of the Main Board. His publications include *Active Investment Management: Finding and Harnessing Investment Skill*, 2003.

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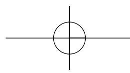

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Preface

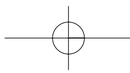
Hardly a week in politics passes without an attempt to encourage more people to save: save for the rainy day, save for the future, save for retirement. The proposals – already in place, or piloted, or promised – are legion. But will they tackle the fundamental obstacles to saving and the fact that the UK saves too little? Or are more radical measures needed?

The savings system, explains Charles Jackson, is riddled with obstacles from taxes to problems of inflexibility, affordability and complexity. Taxes, or other charges, are imposed on investment income, capital gains, turnover of housing (stamp duty), and the transfer of inheritance. Inflexibility poses a disincentive too as potential savers find their savings locked away from use when they need them. And even where the government introduces a subsidy to save, further problems arise: affordability to the public purse or restrictions and conditions, introduced to curb use (and costs). Added to these are the problems of complexity, administrative costs and means testing, all prevalent in the system, which also act as serious disincentives to save.

The author explains that people in Britain today tend to save in two main ways, each of which has its problems. First, they save through their houses (the most important), though many people on low pay cannot afford a house. Housing, however, is not an economically productive investment. Second, they save through their pensions, though many people cannot afford to tie up large proportions of their savings for the long term in this way. Both of these are free of income and capital gains tax, though each have a number of disincentives, from savers being too reliant on a single house to the inflexibility and uncertainty attached to pension schemes.

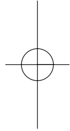
What is to be done? Although the main political parties propose a series of schemes to promote savings, Charles Jackson warns that these may also suffer from a number of obstacles, particularly the difficulties created by subsidy or means testing.

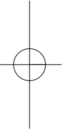
The author recommends a system which minimises the obstacles to savings with just two clear schemes: a *Before Tax Scheme* and an *After Tax Scheme*. The Before Tax Scheme would allow savers to save income free of income tax (as they can now in pension schemes) and pay income tax when they withdraw money. The After Tax Scheme would allow savers to save out of tax-paid income and withdraw without further tax liability (as with an ISA now). The beauty of the plan is that savers can pay into either scheme (or both) subject to an annual limitation on the After Tax Scheme, withdraw their savings when they wish and invest them in what they wish. Investments in the schemes would be free from income and capital gains tax. Savers could save and withdraw their savings at any time and would be free to use them as they judge best – without suffering tax penalties if they do so.

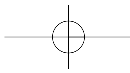


Such a system would have enormous advantages and its effect would most likely be to encourage far more widespread savings. Saved assets would be free of income and capital gains tax. They could be invested as savers pleased. Costs would be low and affordability high. Charles Jackson's proposals should be welcomed by all responsible politicians in this country anxious to solve the UK's serious savings problem.

Sheila Lawlor
Director, Politeia







I

The Problem with Savings

In Britain today people are saving too little. The habit, once so well established – indeed ingrained – of setting money aside for life's uncertainties, and above all for old age, has been in sharp decline over recent years. This is a major issue which needs to engage the urgent attention of politicians and decision makers.

Savings are important both because they supply the capital that is needed for economic productivity and because they allow people to continue to finance their consumption during periods of economic inactivity, such as retirement or ill-health. To do this effectively, savings have both to be sufficient and to be invested in a way that helps economic productivity. The problem with savings in Britain is that there appears to be a shortage, which is being invested less productively. The pattern of savings has tended to change from stocks and bonds or other savings into housing, while the foreign savings, which until now have provided capital, may be less forthcoming in the future.

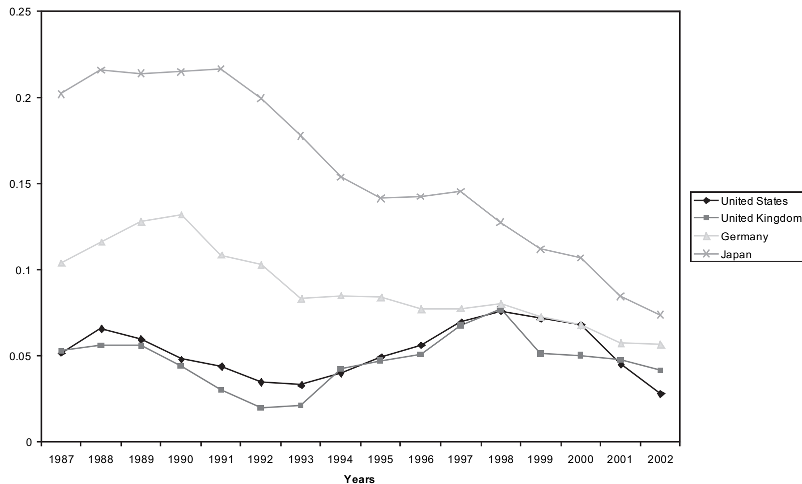


Figure 1 Saving as Proportion of Disposable Income

Evidence for a shortage of savings comes from the fact that the United Kingdom has been a consistent importer of capital over the last twenty years.[1] This has not hitherto been a problem because other countries have been happy to make up the deficiency on easy terms. But they may be less willing to do so in the future. In order to avoid

[1] According to the Office of National Statistics (ONS) Statistical Database, the British current account has had an annual deficit since 1983.

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a deteriorating external position, Britain would then have to satisfy more of its needs for productive capital from domestic saving. Figure 1 shows saving in relation to disposable income over the last fifteen years for the four largest industrialised economies.[2] While the ratios of Britain and the United States have been consistently low, those of Japan and Germany have shrunk so that these countries now have less capital available for export.

Table 1

Asset Type	1957	1973	2003
Houses Less Mortgages	19.1%	39.8%	46.9%
Retirement Savings	20.6%	23.4%	27.1%
Stocks & Bonds	45.4%	25.9%	15.6%
Cash & Miscellaneous	14.9%	10.9%	10.4%
Total Wealth Per Head	100%	100%	100%
Total Per Head, 2003 Prices	**£13,731**	**£26,556**	**£80,672**

Evidence of a diminution in the productivity of savings is set out in Table 1, which shows personal wealth holdings in the United Kingdom in terms of percentage breakdown by both asset type and value in 2003 prices for the years 1957, 1973 and 2003.[3] Although houses are necessary and desirable, they have a limited effect on the economic productivity of the people who live in them. The growth in housing investment from less than a fifth to nearly half of all personal wealth holdings in fewer than fifty years therefore suggests that savings are tending to be invested less productively. An equally worrying trend is the decline, over the same period, of the proportion of British savings invested in the stocks and bonds that generally finance productive investment.

The problem of how to encourage people to save more and to invest their savings more productively has been recognised since the nineteenth century. The solution that has emerged is to offer them privileged savings vehicles that incorporate incentives to save and to invest in ways that are considered particularly beneficial. Because of the way that they have been constructed, these privileged vehicles all incorporate some or all of a number of discouragements, or obstacles, to savers. These obstacles are present in the two most popular ways in which Britons save – housing investment and pension schemes – and have created a number of problems

[2] The figures underlying the graph are taken from the OECD Statistical Database on National Accounts. The ratio plotted is net saving divided by net national disposable income.

[3] Retirement saving excludes retirement assets that are unfunded claims on future tax resources. Cash and miscellaneous assets are net of non-mortgage debt. Figures for 2003 are adapted from the table on p.173 of Pensions Commission, 2004, with stocks and bonds including unquoted equity and insurance company policies that do not relate to pensions. Figures for 1957 and 1973 are taken from the table on p.65 of Kay & King, 1978, with retirement savings including pension funds and life insurance. The Kay & King amounts per head in 1973 prices are adjusted by the change in RPI from 1973 to 2003 as reported by the ONS.

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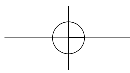
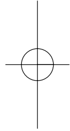
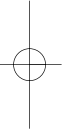
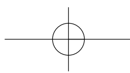


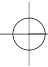
for them. They are also present in the three new offerings proposed by the Government and the Opposition, and will lead to problems for these.

An alternative approach is to construct a savings platform specifically designed to minimise the obstacles that would discourage savers from using it for saving. Such a platform would not only encourage people to save more and to invest their savings more productively, but would also go some way towards tackling the problems of housing investment and retirement saving.









II

The Background

Central to the historical debate on savings policy is the issue of whether savings should be taxed and, if so, how. There are essentially two positions. The first is the simple one that, as those with savings are wealthier than those without, it is fair to tax savings as part of the general redistributive process required for social justice. The second comes from the nineteenth century English philosopher and economist John Stuart Mill, who maintained that 'no income tax is really just, from which savings are not exempted'.[4] The gist of the argument for exempting savings from tax is that tax has already been paid on the income saved and that to tax again would lead to double taxation. This tax in turn creates inefficiency because it biases people against saving and in favour of consumption.

Mill failed to convince British policy-makers. Over the next century, new taxes on savings were introduced in the form of inheritance tax (1894) and capital gains tax (1965). In addition, investment income was subject to a surcharge, which raised its highest marginal rate of taxation to 98 per cent in 1978. But the poor performance of the British economy in the 1960s and 1970s prompted debate about the effectiveness of existing economic policies. The 1978 report of the Meade Committee on the Structure and Reform of Direct Taxation suggested that it would be more efficient to shift the basis of taxation from income to expenditure and thus away from savings. The trend illustrated in Table 1 had also raised concerns that too much saving was going into housing investment and too little into business investment. As part of a wider package of economic measures enacted from 1979 onwards, the then Conservative Government reduced income tax rates, removed the investment income surcharge, converged capital gains and income tax rates and reduced the value of mortgage interest tax relief. After 1997, political priorities changed again. In addition to completing the abolition of mortgage interest relief, the present Labour Government has raised taxes on property values and dividend income.

Such policy swings over the taxation of savings and investments are not unique to the United Kingdom. The Republican Administration in the United States, where the problem (Figure 1) with low savings is similar to that of the United Kingdom, has taken steps since 2001 to reduce taxes on savings. The 2001 tax reform phased out estate tax. The 2003 tax reform sharply reduced taxes on dividends and capital gains, setting their maximum rates at 15 per cent. Also in that year, the administration proposed introducing a Lifetime Savings Account, which would allow savers to save up to $5,000 per year, free of taxes on investment income and capital gains. Although it is still on the official agenda for the Bush second term, this proposal has made limited progress.[5] The Democrat Opposition has undertaken to reverse such of these changes that it considers are favouring wealthier savers.[6]

[4] Mill, 1865, p. 404.
[5] According to press comment, this is: 'largely because of the opposition of the American Council of Life Insurers, which fears the idea could cost it billions of dollars of business' *The Boston Globe*, 20 Jan 05.
[6] Democratic National Convention, *Democratic National Platform for America*, 2004, p. 25.

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The experience of the United Kingdom and the United States suggests that the broad policy framework will include some taxation of saving but the extent at any moment depends on the political consensus that then obtains. There are good arguments for avoiding the extremes. The Soviet Union, which treated savings as just another source of state revenue, was a baleful example of what happens when savings are effectively confiscated.[7] But proponents of taxing savings and investments point out that complete abolition would, by sheltering those who live off the returns from their capital, immediately put the entire burden of paying for government on to people with jobs. The greater the share of economic activity that is taken by government expenditure, the greater the burden and the more painful and disruptive to social cohesion such a shift becomes.

In order to encourage new savings, while still retaining existing taxation of savings, the British Government has concentrated since the 1980s on legislating into existence a stream of savings vehicles. The result has been a confusing alphabet soup of initiatives: BES, VCT, PEP, TESSA, EIS, ISA, AVC, FSAVC, SIPP, SPS & etc.[8] Savings held in each of these enjoys exemption from income and capital gains taxes. Some of them have other privileges. In order to encourage investments that the government favours, a number of vehicles are only allowed to invest in them. Despite their privileges, some vehicles have failed to have any impact. It is estimated that 82 per cent of the 350,000 employer-sponsored stakeholder pension schemes remain 'empty boxes' with no pensions yet active.[9] Some have had an impact, but at the expense of existing forms of saving. Net inflow into the British unit trust industry rapidly shifted from direct purchases to PEP acquisition when the PEP was introduced.

The effect of these initiatives on the size and structure of savings flows has been modest. Table 1 shows that net housing investment as a percentage of total savings has increased over the past thirty years. It also shows that the share represented by investment in stocks and bonds, including investment through the initiatives listed above, has fallen. The best that can therefore be said for them is that they may have slowed the shift from securities to houses. As discussed in more detail later, the response of the Government and the Opposition to the disappointing impact of past initiatives has been to introduce or to propose new initiatives, which offer state subsidy for saving. But these initiatives have problems of their own, which make it likely that they will also have a disappointing impact on saving in Britain. The next section looks at the factors that cause problems for these and other savings vehicles.

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[7] Macdonald, 2003, pp. 447–450.
[8] BES= Business Expansion Scheme, VCT= Venture Capital Trust, PEP= Personal Equity Plan, TESSA= Tax Exempt Special Savings Plan, EIS= Enterprise Investment Scheme, ISA= Individual Savings Account, AVC= Additional Voluntary Contributions, FSAVC= Free Standing Additional Voluntary Contributions, SIPP= Self Invested Pension Plan, SPS= Stakeholder Pension Scheme.
[9] News Release from Association of British Insurers dated 24 Aug 03.

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III

Obstacles to Saving

A number of obstacles discourage people from saving and though governments have often tried to counter such obstacles by introducing special savings schemes, the solution has had its own disincentives. Obstacles include taxation, subsidy, affordability, inflexibility and – now the focus of more popular concern – complexity, administrative costs and the impact of means testing.

Taxation
The most common privilege provided to savings vehicles is exemption from taxes on investment income and capital gains. The vast bulk of the net worth of the household sector in the United Kingdom is deployed in ways that are free of these taxes. Two alone, housing investment and retirement saving, accounted for 74 per cent of wealth in 2003 (Table 1). However, there are other taxes on investment income and the capital value of investments. These reduce investment returns and thereby act as disincentives. They include turnover charges on investments, such as stamp duty, taxes on capital transfers, such as inheritance tax, and taxes on profits when income tax is also charged on dividends paid out of profits. All privileged savings vehicles suffer from one or more of these forms of taxation.

Subsidy
Financial inducements provided by government to savers are incentives whether they are direct cash payments or in the form of a concession that allows the saver to avoid income tax. But they also cause disincentives by making other obstacles to saving worse. Thus subsidy of some savings vehicles is financed by taxing the income and capital gains of other savings vehicles. This in turn distorts savers' asset allocations. When subsidy is given to a saver who is also a taxpayer, its effect is to reduce his flexibility at the expense of the administrative costs of collecting the tax and distributing the subsidy. A perverse aspect of subsidy is that, when it is attached to the amount saved, it favours wealthier savers over those who are less well off.

Affordability
The cost to government of privileged savings vehicles, either through lost taxes or through the cost of subsidising them, leads to disincentives for savers. The more widely available a subsidised vehicle is, the more it will cost, and the less affordable it will be. Government compensates for this by introducing some or all the problems of complexity, inflexibility and means testing into subsidised vehicles. Affordability thus provides an explanation of the paradox that schemes designed to increase saving through use of subsidy are hedged around with restrictions that compromise their effectiveness in carrying out their stated mission.

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Inflexibility

Restrictions on savings vehicles lead to costs by introducing the potential problem for savers that their savings will be either not available or costly to withdraw when needed. This can result in severe financial hardship. To illustrate this, consider a saver with all his savings in his pension fund, who cannot keep his outgoings below his income net of tax and pension contributions. If he is unable to borrow against his pension fund and has no other source of credit, he will be forced to resort to borrowing at a penal rate on his credit card. This will change his net worth at a rate equal to the debt outstanding multiplied by the difference between the return on his pension fund and the credit card rate. If the debt is large and the return on the fund is negative, his net worth will implode. Inflexibility explains why rational savers fail to take up advantageous saving opportunities in whole or in part. Lack of flexibility causes complexity, particularly when a saver ends up holding a large variety of different schemes and products. His consolidated portfolio of savings will then be hard to monitor and expensive to change. This in turn leads to inappropriate investment polices and ineffective active investment management.[10]

Complexity

Savers incur costs by investing the time and effort necessary to understand the structure and implications of complex products. If they do not, they run the risk of finding, too late, that these products do not meet their needs. Some schemes, such as defined benefit pension schemes, are inherently complex. But complexity can also be the result of government policy. Government-imposed constrictions and restraints have already been mentioned. In addition, government tends to complicate matters still further by introducing new savings vehicles without giving savers reasonable opportunities to transfer the assets of existing legacy vehicles into these. For example, savers were expected to continue with their existing PEP and TESSA holdings even after these products were terminated in favour of the ISA for new investment.

Administration

The cost to an account provider of administering a saver's account depends on its complexity and, unless there is cross-subsidy between different groups of savers, it is passed on to the saver. The cost to government depends on the degree of government involvement resulting from factors such as subsidy and means testing for eligibility. Both types of cost have a high fixed element, as a large component of cost depends on the cost of setting up and maintaining schemes and individual accounts, irrespective of the assets contained within them.

Means Testing

Targeting welfare benefits creates disincentives for savers when savings, including those held in privileged vehicles, are taken into account in means tests for welfare benefits. Through benefit withdrawal, it also creates costs for savers with savings

[10] See Jackson, 2003, chapters 8-11.

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who lose out in this way. Not surprisingly, most low-income people have no or negligible savings. Those who do save feel cheated relative to those with similar lifetime earnings, who capture greater benefits by not saving. By limiting eligibility, means testing improves the affordability of subsidised savings vehicles at the cost of increasing their restrictions and complexity.

As the discussion above demonstrates, a striking feature of these obstacles is that they are all interrelated, so that, by the same token that making one worse will make the others worse, reducing the impact of one will reduce the impact of the others. Another feature, whose implications are explored in the next section, is that they are present in both the vehicles that dominate contemporary British saving.

IV

How People Save Now

Housing Investment
As demonstrated in Table 1, in the first section of this pamphlet, the most important way in which British people now save is through their houses. The attraction of owning a house is straightforward. People need somewhere to live and, generally speaking, the more valuable the house, the more pleasant it is to live in. In addition, housing investment provides an unlimited opportunity to shelter assets from taxes on income and capital gains tax. However, the great success of housing as an investment medium has led to a number of problems. One is that, because the value of housing investment has gone from less than half GDP in 1957 to more than double GDP in 2003, the risk from a given percentage fall in house prices to savers' wealth and consequently broad economic stability is now much increased. Another is that housing investment is no longer accessible to many less well-off people. Housing investment also crowds out more economically productive investment. Many of the causes of these problems can be traced back to the obstacles to saving within housing investment.

Housing investment is free from income and capital gains tax. However, recent measures that increase taxation of housing capital values include increases that are a multiple of inflation in stamp duty, where the top rate has quadrupled as a percentage of house purchase price, and council tax, where the basis of assessment is rapidly shifting from services provided to housing values. By discouraging demand, these measures have made the market more vulnerable to a downturn.

Housing investment does not attract government subsidy so there is no affordability issue. However, until recently, the government allowed mortgage interest on debt up to a certain level as a charge against taxable income. The subsidy implicit in this process was enhanced by inflation, as interest rates then included an element of principal repayment.[11] This was particularly valuable during periods of high inflation, such as the 1970s. As, up to a limit, the subsidy was proportional to the size of mortgage taken out, it tended to go to better-off home owners. Housing subsidy has thus contributed to the build-up of capital in the housing market and the crowding out of other forms of investment. By raising historical demand and therefore current prices, housing subsidy has also contributed to both the problem of access and the market's vulnerability to a downturn.

Unlike all other forms of saving that are free of income and capital gains tax, housing investment is unlimited. Favouring housing in this way has contributed to the

[11] Suppose a home-owner buys a house with a mortgage and then sells it for a tax-free profit of £*P*. Suppose also that he pays mortgage interest of £*P* over his holding period so that his profit, after taking financing costs into account, is zero. If the interest can be charged against income tax and his tax rate is *t*, he will be £*Pt* better off. As the before tax return is zero, £*Pt* is a subsidy from the taxman, which can be removed by putting the financing cost on the same tax basis as the asset return.

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crowding out problem. But housing does suffer from one major restriction. This is that tax advantaged investment is confined to one house, which the saver is expected to live in. As housing forms a large part of savers' wealth (Table 1), this results in the average saver holding an unbalanced and undiversified wealth portfolio. Savers' lack of concern about the investment risks they are running can only be attributed to a perception that housing investment is much less risky than financial assets. Changes in the economic environment could quickly alter this perception.

The process whereby a saver changes his physical housing investment is complicated and cumbersome. Exchanging houses involves a highly disruptive physical move, transaction costs are high and there are long time lags for buying and selling. But mortgage lenders now give borrowers flexibility to increase or to reduce their housing debt. This has greatly simplified the process whereby savers increase or reduce the capital they commit to housing investment by allowing them to do this without the trouble and expense of moving house. However, a less welcome effect of the debt is that it increases risk by leveraging the effect of house price movements.

As is clear from the relationship between the value of the housing market and GDP, house prices have outstripped pay over the last fifty years. As mortgage lenders restrict their loans to a multiple of pay, this has made it increasingly difficult for people with low pay and few savings to afford even the cheapest dwellings. Eligibility for the housing market is thus subject to a *de facto* means test, which discriminates against the less affluent.

The government views the current housing market arrangements as unsustainable and is in the process of implementing the changes recommended in a recently published report.[12] The supply side changes include expanded provision of publicly funded housing and changes to the planning regime that, by increasing supply, are designed to improve housing affordability and house price stability.[13] Demand side policy changes focus on the reform of property taxation and recommend that 'in any reform of council tax, consideration should be given to having an element of this tax which is more closely related to property prices.'[14] Both the demand and the supply side policy recommendations increase the likelihood of a market downturn. This is because the supply side changes increase the risk of oversupply while the demand side changes increase the double taxation of housing investment.

Pension Schemes

As demonstrated in Table 1, retirement saving is now the second most important way in which people save. Most of this is through pension schemes, which were introduced in the early twentieth century and became widespread by the end. In a pension scheme, the saver gives up income[15] before paying tax on it,

[12] Barker, *Executive Summary*, 2004.
[13] Ibid, pp. 4,5,6.
[14] Ibid, p. 6.
[15] Sometimes an employer makes all or part of the contribution on the employee's behalf. In practice, both employer and employee view this contribution as part of the employee's pay and benefit package.

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invests[16] it free of income and capital gains tax and draws it down as taxable benefits. Pension schemes are popular both because they provide an income in retirement and because, as favoured savings vehicles, they enjoy a number of tax privileges. Despite their popularity, pension schemes have two problems. The first is that scheme sponsors are not contributing enough to them. Many schemes are now facing large deficits, or shortfalls between the value of their financial assets and the value of the pensions they have promised.[17] The second is that many members of the working population are not contributing enough to pension schemes to provide themselves with an adequate income in their retirement.[18] Many of the causes of these problems can be traced back to the obstacles to saving that are built into pension schemes.

Two key tax changes have contributed to the growth in scheme deficits. Before 1987, if a company paid too much into its pension scheme so that there was an excessive surplus, it could withdraw the excess without suffering adverse tax consequences. Penalties introduced on surplus withdrawal in that year acted to discourage sponsors from building these up, and encouraged the subsequent culture of contribution holidays. Before 1997, it was considered unfair in Britain to charge income tax on dividends paid out of profits that had already been subject to a company's normal corporation tax. Dividends consequently came with the right to offset corporation tax against income tax, or to recover it for exempt funds. But the government then took a policy decision to abolish this right. The cost of this decision for pension funds is widely estimated to be 5 billion pounds a year.

Pension schemes attract substantial subsidies. The main one is that savers are allowed to withdraw up to 25 per cent of the value of their pension funds as a tax-free lump sum immediately preceding retirement, thereby avoiding income tax on this amount.[19] An additional subsidy is that, subject to certain restrictions, savers can avoid British income tax on their retirement income by emigrating to another tax jurisdiction. As the higher the tax rate, the more valuable the right to avoid it, the subsidy goes disproportionately to the better off, who pay higher tax rates and are allowed to save more in their pension schemes.

The subsidies for pension schemes make their affordability an issue for government. Adding the value of unfunded public sector pension rights to the value of the assets supporting pension funds and policies gives a total of £1775 billion. If we assume that half of this is attributable to savers able to take lump sums in the future and that these savers have an average marginal tax rate of 33⅓ per cent, the present value of the latent government subsidy is £74 billion. Problems with affordability may explain the

[16] United Kingdom Government contributions to the pensions of its employees usually come in the form of promises on the taxpayers' behalf rather than cash. The Pensions Commission, p.173, estimates the value of these promises to be £475 billion, although consulting actuaries Watson Wyatt calculate it to be £580 billion, *The Times*, 11 Aug 04.

[17] The personal sector claim against pension funds is £1370 billion while the total assets of pension funds are £1300 billion, leaving a total deficit of £70 billion Pensions Commission, 2004, p. 173.

[18] *Pensions Commission*, 2004, pp. xi–xiii.

[19] Certain retirement saving schemes such as AVCs and FSAVCs do not currently attract this subsidy but are planned to do so when the current pension legislation changes.

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paradox that, despite rhetoric that is consistently in favour of retirement saving, the thrust of policy is towards taxing it more. In addition to the 1997 tax on equity dividends, the 2004 budget imposed penal taxes on savers' pension portfolios above a certain maximum size. These developments will tend to discourage retirement saving.

Pension schemes are highly restricted. Savers can only access their savings on retirement. They cannot use the savings either to finance housing and education or to support themselves during rainy days such as periods of unemployment and/or sickness. The amounts that savers can contribute without paying income tax are limited according to a varying formula set by government. In addition, savers are required on retirement to invest their pension funds in annuities at rates which are now very low when compared to those available in the past. All these restrictions discourage retirement saving.

Pension schemes are highly complex. This is particularly the case for defined benefit pension schemes, where the link between contributions and benefits is weakened by uncertainty over life expectancy and market returns. Although deficits are underwritten by the sponsoring organisation, members are at risk if the scheme is wound up, particularly when this is because the sponsor has encountered financial difficulties.[20] The regulations governing pay-outs in such circumstances create extra risks. As these give priority to retired members, they can give rise to sudden and unexpected shifts of resources from active and deferred members to retired members.[21] Other problem areas include with-profits endowment policies, where policy values have suffered sudden and unexpected falls.[22] This complexity generates uncertainty that also acts to discourage retirement saving.

Because of their complexity, pension schemes involve a high level of costly administration. The cost is multiplied for the large number of savers owning more than one retirement product. This acts to discourage retirement saving because the cost is charged against savers' and sponsors' contributions, which reduces the eventual realised return on investment. For example, it is common for the first year's premium of a with-profits policy to be absorbed by sales and administration costs.

Although eligibility for pension schemes is not generally means tested, a saver who has retirement savings or pension rights may find that this affects his eligibility for state funded retirement benefits. For example, the possession of even a small occupational pension reduces eligibility for the means tested pension credit. As it is estimated that 52 per cent of adults aged over 65 are currently eligible to receive the pension credit and that this will rise to 82 per cent by 2050, this is obviously an

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[20] Who are increasingly unwilling to do so. The percentage of employers with defined benefit schemes still open to new members has fallen from 60 per cent in 2002 to 40 per cent in 2004 *The Pensions Predicament Means Testing, the Savings Trap and the Labour Market*, Thornton, 2005, p. 13.

[21] The DWP estimates that 65,000 people have lost 20 per cent or more of the income they were expecting in retirement from under-funded schemes wound up by insolvent employers Press Release, 30 June 2004.

[22] Despite rising stock markets, the maturity values of these policies fell between February 2003 and February 2004 by between 1.8 per cent and 25 per cent, depending on the term and life office involved. *Money Management Survey*, April 2004.

impediment that discourages an increasing proportion of savers from saving for retirement.[23]

The current policy response to the problems of scheme deficits and inadequate saving through pension schemes is likely to lead to further problems. As part of the Pensions Act 2004, the Government has set up the Pension Protection Fund, which compels defined benefit schemes to contribute to a mutual reserve fund designed to underwrite schemes against the risk of employer insolvency. The basis of contribution is controversial. If the levy is based on assets, well funded schemes will subsidise poorly funded schemes and prudent funding measures will be discouraged. If the levy is based on risk of failure, the cost for poorly funded schemes will itself drive them towards failure. The quantum of the levy itself is controversial and the risk of getting it wrong is high.[24] The Government has also set up the Pensions Commission, the aim of which is to recommend solutions to the pensions problem. The solutions it is currently considering include higher tax-payer funded retirement benefits and compulsory retirement saving.[25] The former will put further pressure on government finances and the latter is likely to be viewed as a closet tax increase.

The problems associated with existing privileged forms of saving have led to calls for new privileged savings vehicles that both increase the flow of savings and change non-savers into savers by helping them to amass sufficient savings to make a material difference to their behaviour. As a result, the main political parties have been prompted to introduce or to propose new savings initiatives. The next section analyses the likely success of these new offerings in terms of increasing savings, providing value for taxpayer money and making a meaningful difference to a worthwhile number of individuals.

[23] Thornton, 2005, p. 11.
[24] The financial position of the US equivalent, the Pension Benefit Guarantee Corporation, has gone from a $10 billion surplus to a $24 billion deficit in three years.
[25] Pensions Commission, 2004, Executive Summary, xiii.

V

What's on Offer

The Labour Government has introduced the Saving Gateway Account and the Child Trust Fund. The Conservative Opposition has proposed a Lifetime Savings Account. Government subsidy is central to all three.

The Saving Gateway Account

This initiative has been in existence in pilot form for several years and is now being rolled out across the United Kingdom**.** It is a scheme open to those in receipt of the Working Tax Credit. This is currently available to those with incomes of £11,000 a year or less (or £15,000 a year or less for those with children or a disability allowance).[26] It has a limited life of eighteen months. The saver can save a maximum of £25 a month or £375 over the life of the account. On maturity, the state provides a subsidy by matching any funds remaining in the account in full. No investment return is paid. The obstacles to saving are the subsidy and its affordability, the restrictions on eligibility, amount saved and scheme life, the complexity of these, the cost of administration and the means testing.

To see what problems these obstacles lead to, it is useful to turn to the Treasury sponsored study of the pilot for the scheme, which set out to assess its impact/success against a number of criteria.[27] This states that 'if the scheme were rolled out nationally, we estimate that around 25 per cent of households could, potentially, qualify to open an account'. It estimates that participants in the pilot schemes were 'saving around 63 per cent of the maximum each month'. It indicates that only 51 per cent of these participants were actually cutting back expenditure to fund their accounts, with the rest using current accounts, savings accounts and borrowings. It also indicates that many of the participants were, not surprisingly, planning to spend some or all of the savings plus subsidy after their accounts matured. Also unsurprisingly, in view of the maximum possible size of account plus subsidy of £750, the impact on participants seemed modest. A typical participant view quoted in the study was: 'it's not life-changing'.

The findings in the study allow estimates of the effect of the scheme on savings and government expenditure. If eligible savers save 63 per cent of the maximum, the average maturity value of accounts will be £236, giving an average subsidy value of £236 as well. As there is a budget deficit, the £236 will have to be funded by increased government borrowing so the subsidy will have a zero net effect on the sum of public and private sector saving.[28] As 49 per cent of the accounts are funded by cannibalising existing assets,

[26] Kempson et al, 2003, p. 3.
[27] Kempson et al, 2003, pp. vi, vii, 41, 46.
[28] This is also the case, even with a budget surplus, if the money spent on the subsidy would otherwise have been spent on buying back government debt.

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the true incremental saving will be £120 per account. But the accounts will be expensive for the account provider and government to promote and to administer. Costs of over £120 will be sufficient to make net saving negative. Even if the cost is below £120, the increment to saving will inevitably become negative as the account holder draws down his savings and subsidy at the conclusion of the eighteen-month period. Thus the Saving Gateway Account will reduce saving in the United Kingdom by a modest margin and increase government expenditure by a larger margin.

The Child Trust Fund
This initiative provides £250 for every child born after September 1st, 2002 irrespective of income, with twice that amount for children whose parents have an income below the Child Tax Credit threshold, which is currently £13,230. The same subsidy is paid when children with accounts reach their seventh birthdays. Nothing can be withdrawn until the child's 18th birthday. Investments in the accounts are free of income and capital gains tax. A Child Trust Fund can also accept gifts of up to £1,200 a year. The obstacles to saving are the subsidy and its affordability, the restrictions on the amount saved and the withdrawal of funds, the complexity caused by the restrictions, the administrative cost and the means testing.

The subsidies on birth or reaching the age of seven are £250 or £500 but, as we have already seen, these have no net effect on saving when they are paid**.** Net new saving comes from gifts not funded by donor borrowing or cannibalisation of existing savings, less the cost of administration to savers and government. Until there is some experience of the practical workings of the scheme, it is hard to estimate this figure, but it is likely to be low. Net saving will in any case turn negative once young adults start drawing down their accounts after 2020.

There are a number of reasons why the Child Trust Fund is unlikely to have much success in converting children from non-savers into savers. First, many will withdraw the money and spend it as soon as they can after they turn 18. Second, for those children who save their balances, the amounts in their accounts will be relatively small without gifts. If we assume that accounts achieve a real return of two per cent per annum and that the values of the subsidies and the limit on gifts are adjusted each year for inflation, the amount in the account on the child's 18th birthday without gifts will be £668 in today's money, or £1,336 including the means tested increment. We have already seen similar amounts dismissed as 'not life-changing' by Saving Gateway Account participants from the lowest economic quartile. Third, although a child receiving gifts at the maximum rate will have, based on these assumptions, an account balance of £26,363 in today's money at the age of 18, this does not represent the marginal impact of the scheme for such children. This is because children receiving gifts from relations and family friends at the maximum rate are likely to come from affluent backgrounds and to have benefited from the generosity of these donors in any case.

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The Lifetime Savings Account

The Conservative Opposition has criticised the Saving Gateway Account as being means tested and short term. It has also criticised the Child Trust Fund as 'doing nothing to encourage a savings habit.'[29] It proposes to introduce an alternative scheme, the Lifetime Savings Account, which is different from the American proposal of the same name both because it has a much lower annual limit and because the saver gets a matching subsidy.[30] This will be available to all adults aged between 18 and 65. Savings of up to £20 a month will be fully or partially matched by government deposits into a separate parallel account, which the saver eventually is able to withdraw either after ten years or on reaching the age of 65. Return on investment will be free of income and capital gains tax. Unlike the government initiatives, withdrawals are allowed, but result in withdrawals from the parallel account unless they conform to certain restrictions.

The obstacles to saving are the subsidy and its affordability to government, the restrictions on amounts saved and withdrawals, the complexity caused by the restrictions, the administrative cost and the inclusion of account assets in means tests for welfare benefits. It can confidently be predicted that the longer the scheme is in operation, the worse these obstacles are likely to get. This is because individuals, who want the subsidy but do not want to make the associated savings, will game the scheme's rules to minimise the savings they have to make in order to collect the maximum subsidy. Efforts to prevent this behaviour will result in further restrictions, which in turn will lead to increased complexity, cost and inflexibility.

Like the subsidies of the Government initiatives, the matching deposits will have a zero effect on savings when they are paid. Net saving will come from deposits by savers into the Lifetime Savings Accounts not funded by borrowing or the cannibalisation of existing savings, less the cost of administration to savers and government. Until there is some experience available, it is hard to estimate this figure, but it is likely to be low. This is because the subsidy provides a strong incentive to cannibalise existing savings and the limits are low so that the administration costs will be high in relation to them. Net saving is in any case set to turn negative over time as more and more participating savers become able to withdraw and spend their matching account balances.

In contrast to the Government initiatives, the subsidy and the universal eligibility to participate mean that the scheme has a good chance of making a major impact on a large number of people. If a saver opens a Lifetime Savings Account on his 25th birthday, saves £20 a month adjusted for inflation, has this matched pound for pound and gets a real return on investment of two per cent per annum, he will receive £28,993 in today's money on reaching 65. Even if he funded his account

[29] *Towards a Lifetime of Savings*, 2004, pp. 30, 31.
[30] The proposal is described in detail in *Towards a Lifetime of Savings*, 2004. Modifications to the original proposal are described in Annex 1 of *Tax on Savings A New Direction*, 2005.

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entirely by cannibalising other forms of saving or borrowing, he still ends up with extra wealth in the form of a parallel account balance of £14,496.

In less favourable contrast to the Government initiatives, the subsidy is likely to be much larger, making the affordability of the initiative much worse. As it is a finite scheme and there are 25.3 million households in the United Kingdom, the maximum total subsidy that can be paid out on the Saving Gateway Account can be estimated as the cost of providing one quarter of these with £236 each, or £1.5 billion. The birth-rate in the United Kingdom is currently running at 695,500. If this remains constant and babies in the bottom economic quartile get the higher payments, the annual subsidy of the Child Trust Fund can be estimated at £0.4 billion once the first cohort reaches seven. As there are 36.7 million people in the United Kingdom aged between 18 and 65, the maximum annual deposits into matching accounts can be estimated as this multiplied by £240, or £8.8 billion.[31] Thus, depending on the actual take-up rate, monthly limit and matching rate, the annual cost of the Lifetime Savings Account subsidy will be comparable with the revenues from either Capital Gains Tax (£1.6 billion) or Inheritance Tax (£2.4 billion) or Stamp Duty (£7.5 billion).[32]

The subsidies make the Lifetime Savings Account attractive to savers. In addition, there is much to be said for encouraging savings without means testing. However, it is highly questionable whether these benefits can justify the cost of putting the scheme into operation. The Government initiatives have much lower costs, but much reduced benefits. All three initiatives have very unfavourable ratios of benefits achieved to public expenditure incurred. The next section investigates whether a better approach is available.

[31] This figure together with number of births and number of households are the most recent figures available from the ONS.
[32] Figures for amounts collected in the 2002/3 tax year, *The Economist*, 26 Aug 04.

VI

A Proposal for the Future

Looking at the effect of the obstacles to saving built into both existing schemes and new initiatives provides two key insights. The first is that, as subsidy is part of the problem rather than the solution, the approach used by the new initiatives, of attempting to solve the problem by using subsidies, is bound to create new problems. The second insight is that the obstacles are interrelated. This leads directly to the notion that the most robust and effective arrangements for saving are the ones that minimise the obstacles that distort or discourage saving. In effect, rather than attempting to solve the problem by inducing people to save more by subsidising them with their own or other people's money, we should solve the problem by minimising the obstacles to saving and relying on savers' enlightened self-interest to do the rest. This can be done by creating, as far as is practically possible, an environment where savers can save or withdraw, from income before or after tax, what they want, when they want to, and where saved assets are free of taxes and can be invested as savers please.

Privileged Savings Vehicles

Because the option of abolishing all taxes on savings and investments has not proved a practical policy in the United Kingdom, tax privileged savings vehicles are necessary. These come in two basic forms. The first accepts income before tax, but requires the saver to add withdrawals to his taxable income. Pension schemes are examples of before tax vehicles. The second accepts after tax income, and so exempts the saver from paying income tax on withdrawals. Housing investment and all three new offerings are examples of after tax vehicles. Savings held within these vehicles are invariably exempt from income and capital gains tax. Provided borrowings secured on after tax schemes are serviced from after tax income and savings, while borrowings secured on before tax schemes are serviced from before tax income and savings, both types of scheme will deliver the same result for the individual saver.[33]

Comparative assessment of after tax and before tax savings schemes shows no clear advantage for either. From the perspective of the saver, an after tax savings scheme has two advantages over a before tax savings scheme. First, the future value to the saver of savings made now only depends on the investment return of his portfolio and is independent of future income tax rates. Second, his income tax computation is decoupled from his after tax savings decisions. There is also one disadvantage. He cannot offset investment losses against income before tax. From the perspective of government, an after tax savings scheme has the timing advantage that the saver

[33] Suppose that the before tax return on investment converts *£1* into *£R* over the period it is saved and that the tax rate at the beginning and end of the period is *t*. With a before tax vehicle, a saver puts aside one pound, which grows to *£R*. But as he pays tax on the increased amount, he is left with *£R(1-t)* to spend at the end of the period. With an after tax vehicle, he is only able to put aside what he has left after tax on a pound of income, or *£1-t*. This then grows to *£R(1-t)* by the end of the period. As no further tax is payable, this is also what he has available to spend.

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pays his tax before he spends the money. But there is also the disadvantage of cannibalisation, where the accounts are funded by drawing down existing savings that are subject to income and capital gains taxes. With the exception of housing investment, this has led to limits on the amount of money that can be invested each year in after tax schemes.

A platform for savings

The proposed savings platform described in the remainder of this section incorporates one of each type of account. The structure's versions are called, for convenience, the After Tax Account, which is funded out of taxed income but where withdrawals are exempt and the Before Tax Account, which is funded out of exempt income but where withdrawals are subject to income tax. Investments held in both types of account are free of income and capital gains tax. Each saver will be perfectly free to open either, or both, or neither. However, he will not be able to have more than one of each type of account at any time. Savers will be free to transfer their accounts from one provider to another, subject to a period of notice that is set in advance by the provider and is likely to vary according to the liquidity of the assets held in the account.

Financial institutions acting as account providers will also be perfectly free to offer either, or both, or neither. Their incentive to offer these accounts will be the pivotal place they will assume in the wealth management arrangements of individual savers. Account providers can offer the same investments in both accounts. These investments will need to meet existing regulatory standards and can be existing products, provided that they can be freed from taxes on income and capital gains. Subject to proper disclosure on services and pricing, any product provider can offer any asset or combination of assets. Although the assets can be foreign, each account provider will need to be based in a jurisdiction with which the British tax and regulatory authorities are comfortable.

Account providers will be free to configure the accounts they offer in such a way that the incremental administrative costs of delivering the capability they choose to provide will be minimised. It is likely that they will, at least initially, offer the accounts as wraps around the products used by their existing customer bases. Thus banks and building societies may choose to offer accounts that solely invest in deposits with them. Similarly, investment firms specialising in pooled equity products may choose to offer accounts that solely invest in these. Other providers may offer wider services. Thus, full service brokers may choose to offer segregated portfolios, asset allocation advice and product open architecture while high net worth specialists may also offer private equity and other alternative investment opportunities. The combination of disclosure, competition and account transferability will ensure that savers will be able to access the services they want at competitive prices.

Savers will be free to save as much as they want, when they want to, subject to any limit on annual investment. They will also be able to withdraw as much as they

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want, when they want to, subject to their having sufficient funds to cover the withdrawals. To give them further flexibility, the accounts will also be eligible for use as collateral for loans. Loans to After Tax Accounts will be serviced out of after tax income or account balances. Loans to Before Tax Accounts will be serviced out before tax income or account balances.

The After Tax Account

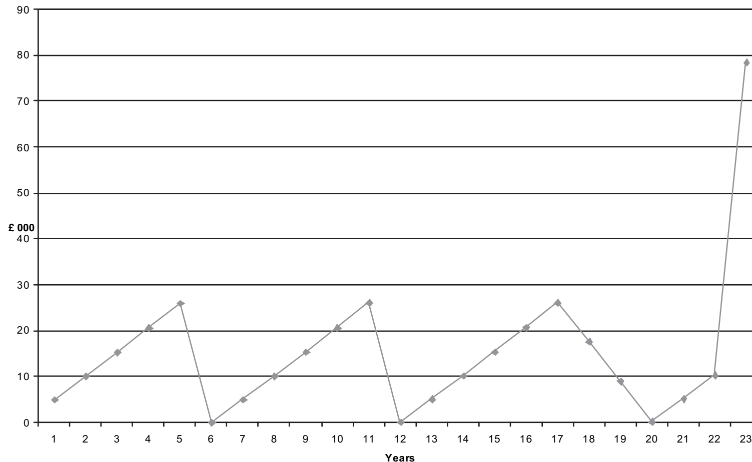
Savers can only put after tax income into their After Tax Accounts but their withdrawals are exempt. It is thus a more flexible substitute for the existing ISA vehicle and should replace it. In order to maintain affordability, the amount that can be invested in an After Tax Account during each tax year will need to be constrained because at least some of the money will come from cannibalising existing taxable savings.[34] The initial limit should be similar to, but probably less than, the maximum ISA investment. The account provider will need to ensure that net investment never exceeds the limit at any stage during the year by maintaining a running total of inflow and outflow per account. This is in order to prevent savers from investing over the limit at the beginning of the tax year, enjoying tax-free returns over the course of the year and withdrawing the excess over the limit just before the end of the tax year.

In order to allow savers the flexibility to withdraw funds from their After Tax Accounts and replace the withdrawals in subsequent years, the annual limit against which the running total is checked should be adjusted for cumulative shortfall against limit in prior years. In order that account providers do not become accountable for the administration of their competitors, such shortfalls will need to be eliminated, either by investment or by cancellation, when accounts are transferred.[35] In order to allow savers to simplify their portfolios, they should be allowed to transfer the assets of existing holdings of privileged after tax products such as PEP, TESSA and ISA, into their accounts without affecting their limits.

[34] *Tax on Savings A New Direction*, 2005, p.8, finds the annual cost to government of increasing the ISA limit from £7,000 to £9,000 is £100 million. On the same page it finds the annual cost of introducing a more flexible system for additions and withdrawals, of the kind described here, for cash ISA, to be £75 million.

[35] Suppose a saver transfers his account from provider A to provider B with a cumulative deficit of D. This introduces administrative complexity for B, particularly if he is required to verify D. In addition, if A has made an error, which subsequently comes to light, B has further administration and liability.

Adam and Barbara's After Tax Account Balance



Adam and Barbara

Have twins but Barbara keeps her part-time job. Adam's job pays well, but his income fluctuates, so that they often have periods of negative cash flow. After tax and normal outgoings, they are able to put aside £5,000 a year. Six years after the twins are born, they put down a £31,500 deposit on a house. After a further six years, they add an extension, which also costs £31,500. When the twins reach eighteen, they go to university for three years, which costs £7,000 a year for each child. They then move away. Three years later, Adam and Barbara move to a smaller house and are able to withdraw equity of £63,000 (all amounts in real £).

What Happens Now

Because of their volatile cash position, the ISA is too inflexible for them to use. They consequently keep their money in the bank, where it produces a negative real return after tax. They therefore do not have enough money to cover the major outgoings and end up borrowing on their credit cards. Because of the poor investment return and penal credit card rates, the shortfall widens each time so that most, if not all, of what they save over the two years after the twins leave university goes to paying off debt. They then find that, because of the ISA limits (assumed constant in real £), they will have to buy nine separate ISAs over five years to invest the £63,000.

How the After Tax Account Helps Them

They can use it for their savings because of its flexibility over inflows and outflows. Even at a modest real return of 2%, there is enough built up in the account to pay the major outgoings when they occur. The entire £63,000 can be put in the account immediately as, with a £5,000 annual limit, they have a cumulative shortfall against limit of the £105,000 (£31,500 + £31,500 + 3 X £14,000) they have withdrawn.

The Before Tax Account

The Before Tax Account is an account into which a saver will be able to put income before tax and out of which he will be able to realise taxable income, at his discretion. Income so deferred will be deducted from his taxable income in the year of deferral. Withdrawals from the account will be added to his taxable income in the year of withdrawal. The account will provide an opportunity to put investment in human capital on a fiscal par with other investments.[36] No one will be able to make net withdrawals from a Before Tax Account without paying tax. Affordability is now only affected by one residual factor, the variability of marginal income tax rates, and there is therefore no need to limit annual investment.

If he leaves the United Kingdom, a saver will only be able to transfer the value in his account to his new tax jurisdiction by taking it as income and paying the tax. If he dies, the proceeds of the assets remaining in his account are added to his last year's taxable income. One possible exception to the 'no withdrawal without paying tax' rule would be to allow transfers from a saver's account to the Before Tax Accounts of selected beneficiaries, such as a deceased saver's spouse. This would be relatively painless for the government as the tax is then deferred rather than avoided. In order to give savers the ability to simplify their portfolios, they should be allowed to transfer the assets of existing holdings of privileged before tax products into their Before Tax Accounts.[37]

Financial institutions providing Before Tax Accounts will have to do what is necessary to incorporate them into the existing tax mechanism. This is complicated by the variability of marginal income tax rates. It would be particularly undesirable to require a recalculation of the saver's marginal tax rate for each inflow or outflow as this would impose a substantial and costly administrative burden. Restricting annual inflows and outflows to a single amount declared in advance would minimise the administrative burden, but at the expense of imposing severe restrictions on savers. There is a simple way to deal with frequent inflows and outflows in a regime of variable marginal income tax rates. This is for the account provider to act on the tax authorities' behalf, when flows occur, by debiting or crediting the account with a standard tax charge or refund. This standard rate should reflect, as closely as possible, the average marginal tax rate of all Before Tax Account holders and would have to apply to all accounts throughout the tax year. Thus, if the rate was 33⅓ per cent, a withdrawal of a pound would lead to the account provider debiting an interim tax charge of 50 pence, while an addition of a pound would lead to the account provider crediting an interim tax refund of 50 pence. The process for adjusting these interim debits and credits to reflect the true figure at the end of each tax year is set out in Appendix A.

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[36] To illustrate how this would work, consider a saver who pays fees of F to gain a qualification Q that leads to a cumulative increase in income of E over and above what he would have earned without Q. Suppose that he decides to hold Q in his Before Tax Account. He can borrow F through his account, with the loan secured either by guarantee or by using other assets in the account as collateral. He finances the loan by paying, out of E, amounts equal to its principal and interest into his account. As his payments are before tax, this has the effect of making only that part of E that is net of the full cost of F subject to income tax, which is equivalent to taxing only the profit from his investment in Q.

[37] Utilisation of this privilege will be inversely related to the degree to which existing retirement savings products continue to be subsidised.

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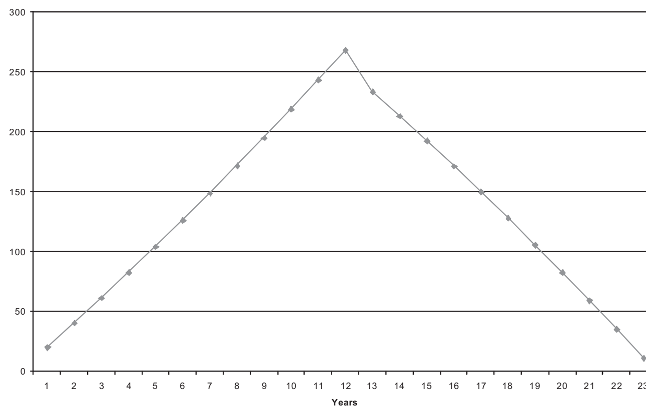
Finally, providers of both types of account will need to ensure that prices paid and received for assets are reasonably accurate. If they are not, there are opportunities for tax avoidance or evasion. For example, if a saver sells an asset from his Before Tax Account to an associate for a fraudulently understated price and recovers the shortfall, he evades tax equal to the product of his tax rate and the shortfall. The next section reviews what is likely to happen if the proposed structure is introduced.

Christine's Before Tax Account Balance



Christine

Has a good job, which pays her £60,000 a year. She has a flat, a mortgage and a pension contract, which will give her a comfortable retirement in 23 years time, provided she keeps up her contributions. She wants to take a year off at some stage so that she can travel around the world. She also wants to spend at least ten years of her remaining career working for a charity that she is passionate about. But she knows that she would only earn £15,000 a year doing this and she needs a minimum salary of £40,000 a year both to meet her pension & mortgage commitments and to maintain a standard of living with which she is comfortable (all amounts in real £).

What Happens Now

She eventually realizes that, for two reasons, she will never be able to save enough to achieve her ambitions without suffering a painful fall in living standards. First, the money she saves is after paying her highest rate of tax. Second, because of the ISA limit, the investment return is reduced by tax as she can only invest some of her savings in a way that is free of taxes on investment income and capital gains. She also realizes that, if she gives up on working for the charity, she no longer needs to save more than is needed for the year of travel and might as well spend it instead.

How the Before Tax Account Helps Her

Each year, Christine pays the £20,000 she can spare into her Before Tax Account. After twelve years, even at a modest real return of 2%, she has enough in the account both to pay herself £40,000 during her year off and to top her income up by £25,000 a year for the next ten years, at the end of which she still has £11,000 left.

VII

The Advantages of the Scheme

The proposed savings platform will achieve benefits in at least three areas. First, it will encourage people to save more and to invest their savings more productively. Second, it will tackle the problems with housing investment in a way that avoids the problems associated with the existing policy approach of 'predict and provide' combined with increased subsidised provision. Third, it will tackle the problems with retirement saving in a way that avoids the problems associated with the existing, increasingly prescriptive, policy approach.

How it will encourage savings

The proposition for savers is very attractive. They can save or withdraw, from income before or after tax, what they want, when they want to, subject only to the limitation[38] on inflow into their After Tax Accounts.[39] Their saved assets are free of income and capital gains taxes and can be invested as they please, subject only to the limitations they agree with their account providers. They also have the opportunity to rationalise their savings portfolios by transferring the assets of some or all of their holdings of legacy privileged vehicles into the new structure.

The additional savings flow the proposed savings platform generates will be good value for public money. Costs are low and affordability is high because subsidies and the costs of administering them are eliminated. There will be some administrative costs arising from the need to maintain mechanical links between the appropriate government agencies and the account providers. The remaining costs will come from revenue lost through cannibalisation and adverse movements in marginal tax rates. Both can be managed. The marginal cost of cannibalisation comes from the income and capital gains tax lost when After Tax Accounts are funded by cannibalisation of taxable savings over and above the tax currently lost when ISAs are funded from the same source. This cost can be managed by adjusting the annual limit.

If a saver puts money into his Before Tax Account when his marginal tax rate is high and withdraws it when his marginal tax rate is low, there is a cost to government. The cost turns into a gain if the inflows are at a lower marginal rate than the outflows. This cost can be managed through managing the volatility of the marginal

[38] Allowing unlimited inflow into After Tax Accounts would rapidly translate into a *de facto* abolition of income and capital gains tax on savings.

[39] After Tax Accounts have a number of similarities with the proposed American Lifetime Savings Accounts. Both have freedom from income and capital gains tax, freedom on investment policy and total flexibility on withdrawals. Both also have limits on annual investment. The main difference is that, with the American account, once money is taken out, it cannot be replaced.

tax rate. This is because, when the marginal rate is constant, there is tax neutrality and no net cost.[40]

Government can neutralise the timing effect by borrowing or paying down debt as appropriate. Administrative costs charged to savers will be kept low by competition and could become negative at the margin for savers who fold existing holdings of privileged accounts into the new structure.

Because it is open to all, the proposed platform has the potential to generate substantial balances for many individual savers. Amounts saved through the Before Tax Account are unlimited and the limit on the After Tax Account is high enough to accommodate the build-up of large balances over time. For example, if the limit is held at a real £5,000, a saver investing the maximum and receiving a real return of two per cent each year will have a real £121,487 at the end of twenty years. The success of the accounts in attracting both large absolute sums and large shares of savers' total savings makes it almost inevitable that they will be included in means tests for welfare benefits. However, the structure can be flexed[41] to mitigate the extent to which means testing will obstruct saving in the accounts by less well off savers.

How it tackles the problems of saving through houses

The proposed savings platform will address the problems of market risk, crowding out and access that are built into housing investment. The increased volume of saving will reduce the share of housing investment in overall savings, also reducing its potential to cause broad economic instability. Balances in the accounts will be available for productive investment, thus mitigating the crowding out problem. The flexibility of the accounts will allow savers to withdraw the balances in them without penalty in order to fund their initial deposits. This will give more access to the housing market to less well off savers, without having to resort to government subsidy. By reducing the need for policy changes designed to increase supply and reduce demand, the proposed framework will also reduce the risk these cause of a housing market downturn.

The performance of the proposed savings platform in addressing housing investment's problems would be improved if savers were allowed to use their Before Tax Accounts to invest in their houses as an alternative to investing directly.[42] Access

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[40] If a saver's marginal rate is a constant t, government loses £tI of tax when he elects to put £I into his account rather than taking it as taxable income. If the return while this inflow is held in his account is R, then government receives £tRI of tax when he eventually draws the inflow down as £RI of taxable income. Thus government can correct for the timing effect by borrowing £tI and paying a return of R. In practice, government can sterilise the effects of aggregated flows into and out of Before Tax Accounts if it stabilises the average marginal rate at a constant t', for then it can borrow £$t'D$ in years when flows total a positive £D and repay £$t'W$ of debt in years when flows total a negative £W.

[41] As no saver can hold more than one of each type of account, the distribution of account size is also the distribution of savers' holdings in the account type. If policy is to protect the fourth quartile of savers from means testing, all accounts below the three/four quartile boundary can be exempted.

[42] Government would need to satisfy itself that the prices at which Before Tax Accounts bought and sold houses were sufficiently accurate to eliminate opportunities to avoid or to evade income tax.

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would be improved as housing would become more affordable because both the initial deposit and the cost of servicing the mortgage would come out of before tax savings. The impact of house price volatility would be reduced by the extra diversification savers would achieve.[43] Crowding out would be reduced by the availability of the diversifying assets for business investment. Housing investment through a Before Tax Account would have to be on the same basis[44] as other investments so that housing equity withdrawal not reinvested in the account would be subject to income tax.

How it tackles the problems of retirement saving

The proposed savings platform will reduce the need for compulsory retirement savings or new taxes to fund additional state retirement benefits. It will do so by providing a supplement to existing forms of retirement saving for savers who retain assets in the accounts beyond retirement age. If a future government decides to phase out the tax free lump sum, the Before Tax Account would become an attractive, because more flexible, alternative to pension schemes as a place to hold savings that savers have specifically earmarked for retirement. Without subsidy, the main reason for savers to continue to use pension schemes would be if they felt that saving for retirement needed to be separated from saving for other purposes and held until retirement, whatever the saver's changing circumstances. But the main argument used for segregating and ring-fencing retirement saving is that its long term nature makes it more suitable for investments, which carry higher risks and therefore higher returns. Though superficially plausible, this proposition is dubious.[45]

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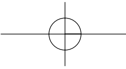
[43] Consider a saver with a tax rate of t, who invests *£C(1-t)* in his house. He can do this out of after tax income by paying tax on cumulative income of *£C*. Alternatively, he can defer £C of his income into his Before Tax Account and invest *£C(1-t)* in his house and *£Ct* in diversifying assets.

[44] In principle, the saver would have to pay rent to his Before Tax Account out of after tax income while the account would have to maintain the property. This complication would be simplified if the rent were deemed equal to the maintenance cost. For then, the two would net so that no cash transfer to cover rent would be required from a saver who maintained his house out of after tax income.

[45] Appendix B discusses the weakness in this argument, which might ultimately lead to its rejection. But the main argument used for segregating and ring-fencing retirement saving is that its long term nature makes it more suitable for investments, which carry higher risks and therefore higher returns. Though superficially plausible, this proposition is dubious.



VIII

Conclusion

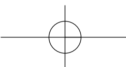
The proposals set out in this pamphlet would transform saving in this country – inculcating the saving habit widely once more and reversing the trend, so worrying for the future, towards wholly inadequate saving, particularly for retirement, which has become so marked in the last few years.

For that to happen, three central conditions have to be met:

1. People need to be able to invest their savings simply, flexibly and productively. They have to be able to get access to their savings easily to deal with circumstances that arise in their lives.
2. Housing must cease to absorb such a disproportionate share of investment in Britain – setting the housing market free from the state-run plans under which the government decides how many new houses should be built and where they should be put.
3. People need freedom to arrange savings for their old age and other contingencies in ways that suit them rather than having to fit in with the tightly drawn set of rules which tie down retirement savings in Britain now.

The scheme, offering two simple alternatives for saving, set out in detail in this pamphlet meets these conditions:

1. Investors can put money into their savings accounts and invest it tax free. They can also take it out when they want and put it back when they can – all without penalty.
2. Housing would lose its overwhelming attractions as a repository for saving as investments build up in the new accounts – and the British economy will as a result become more stable.
3. A wholly new approach to saving for retirement and other contingencies would be created - reducing if not eliminating, the spectre of compulsory investment for old age or much higher taxes. This would give people control over their savings rather than having to make the most of their current array of complicated schemes.



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Appendix A

Incorporating Before Tax Accounts into the existing tax computation requires adding two simple and easy to mechanise (because the only additional information required that is specific to the individual saver is D, as defined below) steps to the normal tax computation that already occurs.

P = A + T (Existing computation)

A – D = P′ – T′ (Computation incorporating Before Tax Account net flow)

R = T – T′ – DF (End-year tax adjustment to Before Tax Account)

Where:

P is income after all allowances, as calculated either by the tax authorities or by individuals choosing self-assessment.

A is income after deducting allowances and income tax as currently calculated.

T is income tax computed from P using the rates and bands obtaining for that year as currently calculated.

D is net flow into the Before Tax Account during that fiscal year as calculated by the account provider from inflows and outflows during the year.

P′ is income after deducting allowances and pre-tax equivalent of D. It is a unique function of A-D.

T′ is tax after adjusting for the effect of D. It is also a unique function of A-D.

F is the proportion of contributions or withdrawals treated as tax refunds or payments when the flows occur. It is fixed for the fiscal year.

R is the adjustment made to the Before Tax Account by the account provider, on behalf of the tax authorities, to equalise DF to the true refund or deduction.

Appendix B

It is argued that an investment portfolio with a long time horizon is more suitable for investing in risky assets than an investment portfolio with a short time horizon, because it has more time to recover from periods of poor performance by these assets.

To illustrate the weakness of this argument, let us consider whether two savers, one with a short and one with a long time horizon, can afford to behave differently when they experience bad equity performance. Let us suppose that saver A and saver B both have an initial portfolio of £1 but A has a liability of £2 after one period while B has a liability of £4 after two periods. Both expect that equities will double every period so both expect to meet their liabilities by investing their money in equities. Suppose now that performance in the first period is poor so that equities, rather than doubling, have a zero return. Both portfolios remain valued at £1 at the end of the period. A clearly has a shortfall of £1. If B still expects that equities will double over the next period, he has to inject £1 into his portfolio in order to meet his liability at the end of the second period. B therefore has to recognise a shortfall of £1 as well.

B can only justify behaving differently from A, by not recognising the full amount of the shortfall, if he expects that the market will more than double in the second period. But, if such expectations were consistently realised, it would also be easy to make money by buying equities after periods of bad performance and selling them after periods of good performance. The evidence suggests that consistently making money through active investment management is a good deal harder than this.[46]

[46] See Jackson, 2003, chapter 6.

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In the UK today people are not saving enough for the future. The consequences – for individuals and the country – could be dire. In *Saving Savings: How to Promote Personal Investment*, Charles Jackson explains that the obstacles to saving are many and the penalties great. The system is over-complex and rigid. There is a confusing array of schemes and regulation adds to the burdens. Too often savings are locked away from the savers when most needed. Above all costs are high: the tax regime is unfair, with savings often double taxed, while means testing penalises those who save or build up assets.

What needs to be done so that people, once again, can save with confidence? The author explains that the schemes now on offer suffer from many of the existing defects and might only add to the problems. Instead he proposes a radical solution which sweeps away the existing array of complex models. Two simple schemes should take their place. The Before Tax Scheme would allow savers to save income free of income tax and pay it when they withdraw money. The After Tax Scheme would allow savers to save out of tax-paid income and withdraw without further tax liability. Savings would gain, as savers would save what and when they wish, without the costs, complexity and penalties they how face.

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