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Briefing Note

AN ISA-CENTRIC FRAMEWORK BECKONS

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INTRODUCTION

The recent publication of the Savings (Government Contributions) Bill confirmed that the Government intends to press ahead with the Lifetime ISA, to be launched in April 2017. This is welcomed.[1] Questions of detail remain, but there is a growing sense of inevitability about the UK gravitating towards a purely ISA-centric framework. This is reinforced by the following observations.

- The introduction of "freedom and choice" (April 2015), ending the annuitisation requirement, is fundamentally incompatible with tax relief on pensions contributions. It

[1] The bones of the Lifetime ISA were originally proposed in 2014, in *Introducing the Lifetime ISA*; Michael Johnson, CPS.

exposes the Treasury to an expensive arbitrage, in that within a few days either side of the age of 55 one can claim tax relief and then the 25% tax-free lump sum.

It also contradicts some fundamental tenets of the pensions framework, captured in the final report of Lord Turner's Pensions Commission: *Since the whole objective of either compelling or encouraging people to save, and of providing tax relief as an incentive, is to ensure people make adequate provision, it is reasonable to require that pensions savings is turned into regular pension income at some time.*

The Treasury's 2006 review of the annuities market is equally clear: *the fundamental reason for giving tax relief is to provide a pension income. Therefore when an individual comes to take their pension benefits they can take up to 25 per cent of the pension fund as a tax-free lump sum; the remainder must be converted into a pension – or in other words annuitised.*

With the advent of "freedom and choice", this no longer applies.

- The Savings Bill's impact assessment estimates the cost of the Lifetime ISA's bonus at £830 million in 2020-21. Since Budget 2016, when the Lifetime ISA was first announced, there have no reductions in pensions tax relief, so the total cost of incentivising saving has actually increased. Given the uncertainty over economic growth and tax revenues following the BREXIT vote, tax relief is unlikely to remain intact for long.
- Society has long accepted that Income Tax should be progressive. Tax relief, being regressive, acts to unwind such societal "buy-in".
- As a developed economy with an ageing population, we need to catalyse a broad based savings culture (i.e. more low- to middle-income workers saving more). Yet, in 2015, our Net Household Savings ratio, at -0.2%, was one of the lowest in the OECD.[2] As an expensive up-front incentive (last year, over £40 billion in cash and taxes foregone), Income Tax relief is patently failing to change behaviour: it is an ineffective use of scarce Treasury funds. In addition, this cost is set to rocket because employees' minimum contributions under auto-enrolment are scheduled to quintuple between now and April 2019 (and triple for employers).
- The word "pension" does not resonate with Generation Y, in particular. Consequently, it is missing out on tax relief, at a time of looming intergenerational inequality.
- The rapidly rising Personal Allowance means that today more than half the pensioner population pays no Income Tax. Consequently, pensions' EET tax framework is increasingly looking like EEE which, from a Treasury perspective, is a raw deal.

[2] OECD definition of Net Household Saving ratio = {Household disposable income + the change in net equity of households' pension funds – household consumption expenditure} / household disposable income.

- NICs relief on employers' contributions (£14 billion last year) benefits their shareholders directly. Employees are oblivious of it, so it does nothing to encourage their engagement with saving. Better to redeploy it within individuals' savings pots, as Lifetime ISA and Workplace ISA bonuses. Ending NICs relief would also put an end to salary sacrifice schemes which are iniquitous given that they are unavailable to those without a scheme sponsor (notably the self-employed). This would save, roughly, an additional £2 billion per year.

- An ISA-centric TEE framework would make for a more robust tax regime because it would put an end to the huge cost of "band shifting", whereby workers drop down one (or more) tax bands once they retire (many higher earners receive relief at 40%, but retire paying only 20% Income Tax). This would be consistent with HMRC's hardening attitudes towards tax avoidance.

- Public opinion is getting behind the Lifetime ISA. A post-Budget survey of 1000 adults aged between 18 and 35 found that 57% positively welcomed it, and were significantly more interested in saving this way than into a pension.[3] A different survey reported that 64% of employers found that some or most of their employees would prefer a Lifetime ISA over a pension scheme.[4]

1. NEXT STEPS FOR THE LIFETIME ISA

- Consideration should now be given to including some additions[5] to the Lifetime ISA, such as:

  (i) a bridge linking the Lifetime ISA to the Cash ISA. Transfers of cash across the bridge would immediately attract the Lifetime ISA's bonus. The underlying objective would be to encourage a culture of *investing* in asset classes other than cash;

  (ii) assimilating today's two Junior ISAs, the two "New" ISAs and legacy Child Trust Funds into the Lifetime ISA, thereby considerably simplifying the ISA landscape; and

  (iii) putting the Lifetime ISA's Inheritance Tax rules onto the same footing as that of pension assets'; and

  (iv) features that rely on passive acceptance, starting with an early shove (rather than a nudge). At the time of registering a child's name, a Lifetime ISA should be automatically established by a parent-nominated provider, perhaps with a £500 starter bonus (accessible from 18). Other default features could include a passively managed (non-cash) default fund (already very popular amongst NEST's members, with a take-up rate of over 99%), perhaps with a cost cap, and automatic reinvestment of all income. In addition, taking stock dividends could be made the default for holdings of shares,

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3 Gorkana: Budget 2016 Reaction; 16 March 2016.

4 *2016 UK Budget Survey* (of 131 businesses); Willis Towers Watson.

5 See *The Lifetime ISA: potential next steps*; Michael Johnson, CPS, 2016.

thereby harnessing the positive power of compounding. Today, incredibly, ISAs can only accommodate cash dividends.

2. ISAs AND AUTO-ENROLMENT

- A Workplace ISA should be introduced to accommodate employer contributions made within the automatic enrolment framework.[6] These should be taxed at the employee's marginal rate but eligible for the same bonus as the Lifetime ISA.

- Withdrawals from the Workplace ISA should not be permitted until the age of 60. Thereafter, they would be tax-free.

- Auto-enrolled employee contributions, made with post-tax income, should be payable directly into the employee's Lifetime ISA. They should also be eligible for the Treasury's bonus, and subject to the same tax, withdrawal and penalty rules as other Lifetime ISA savings.

- Employee and employer contributions to Lifetime and Workplace ISAs should share an annual contributions cap of some £8,000 to £10,000 (subject to Treasury modelling confirmation). Combined with the Treasury bonus, this would provide a more than adequate savings capacity for almost all of the population. Individuals with sporadic savings capacity (for example, those investing in their own businesses) should be allowed to roll-up unused annual allowances, perhaps over five to ten years. They would therefore not miss out on past bonuses.

3. A 50% BONUS

- In time, the ISAs' bonus rate could be doubled to a highly redistributive 50%, funded by scrapping all Income Tax and employer NICs reliefs on pensions contributions. A 50% bonus, paid irrespective of tax-paying status, would double the rate of incentive for basic rate taxpayers, 84% of the workforce.[7] It would be a politically attractive policy to adopt.

4. CONCLUSION

- Over the next few years the Treasury has an opportunity to reshape the (retirement) savings landscape in a manner that could increase the savings of millions of people *and* reduce Treasury expenditure.

- An integrated Lifetime ISA and Workplace ISA would leave the individual with a single retirement savings vehicle, able to hold cash and investments, to serve from cradle to grave. This would signal the emergence of a true lifetime savings agenda (as opposed to "pensions") in a manner consistent with the "freedom and choice" agenda launched in 2014's liberalising Budget.

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6 See *The Workplace ISA* (2016), and *What of DB in a TEE world* (2016); Michael Johnson, CPS.

7 Today, basic rate taxpayers receive tax relief of 25p per post-tax £1 saved (which is £1.25 pre-tax, less 25p, being 20% Income Tax).

- Replacing tax relief with a bonus framework would nail the conundrum that because Income Tax is progressive, tax relief is inevitably regressive. It would also put an end to the widely misunderstood concept (and language) of tax relief, and make for a far more effective use of Treasury funds: tax relief primarily benefits the wealthy, who save anyway.

- The simplicity of an incentivised, ISA-centric framework would help catalyse the broad-based savings culture that the UK so desperately needs. It would also help address looming intergenerational inequality. Many people of modest means could then achieve one simple goal at the point of retirement: to be a debt-free home owner (including no consumer debt). Thereafter, they could perhaps downsize to top-up their retirement income, and perhaps finance long-term care.

The referenced papers are all available at www.cps.org.uk.

THE AUTHOR

Michael Johnson is a Research Fellow of the Centre for Policy Studies and a highly regarded pensions analyst. He originally trained with JP Morgan in New York and, after 21 years in investment banking, joined Towers Watson, the actuarial consultants. More recently he was Secretary to the Conservative Party's Economic Competitiveness Policy Group.

He is the author of more than 30 influential pensions-related papers for the Centre for Policy Studies (all of which can be freely downloaded from www.cps.org.uk). He is occasionally consulted on pension reform by serving Ministers and shadow Ministers, the DWP Select Committee and the House of Lords Select Committee on Public Service and Demographic Change.

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