14

Reforming the Taxation of Savings

The current system of savings taxation in the UK is beset by complexity and unequal treatment. Saving in many forms is discouraged. Simple interest-bearing accounts are treated particularly harshly. Other forms of savings receive rather generous tax treatment. This complexity and unequal treatment have spawned a thriving industry advising people on how to allocate their savings, not on the basis of the best underlying investments but on the basis of tax treatment.

In setting out some practical directions for reform, we start by providing a brief overview of savings taxation in the UK, with a particular focus on explaining how the different tax treatments of different assets lead to different effective tax rates. The difficulty of taxing capital gains within the current system, and the problems this creates, are substantial. There are also complexities created by the progressive structure of the income tax and, in particular, by the effects of means-tested benefits and tax credits.

We go on to look at directions for reform. One obvious step is to move to an earnings tax treatment (TEE) of interest-bearing accounts. In addition, we propose that the rate-of-return allowance (RRA, which we denoted TtE) described in the last chapter should be made available to those with substantial holdings of risky assets such as shares. We make some arguments in favour of an RRA treatment over an EET expenditure tax treatment for these assets, but the main thrust of our reform package could be achieved with an EET or RRA form of tax-neutral treatment of these assets.

We also look in some detail at the taxation of pensions, which is currently close to a consumption tax (EET) regime, and make some suggestions regarding how the current tax treatment could be modified. Importantly, in the case of both pensions and the RRA, we need to consider not just income tax but also National Insurance contributions (NICs). For supernormal returns to be taxed at the same rate as earnings, that rate should be the rate inclusive of NICs. Equally, we cannot neglect the effect of NICs in the taxation of pensions, where the current system provides a large subsidy to employer contributions to pensions.

We end by looking at the issue of the extent to which we can or should seek to maximize opportunities for 'tax-smoothing' by allowing free access to different forms of tax treatment of savings (and borrowing).

In this chapter, we try to keep things simple at least to the extent of focusing on just three classes of assets—simple risk-free assets such as interest-bearing accounts, riskier assets such as equities, bonds, and unit trusts, and pensions. Other assets such as life assurance could be brought within our framework fairly straightforwardly. The taxation of financial savings is, of course, intimately bound up with the taxation of housing, small businesses, and inheritance, all issues we look at in detail in other chapters.

14.1. OVERVIEW OF THE CURRENT SITUATION IN THE UK

A description of how different forms of savings are taxed requires us to take account of not only income tax but also NICs and capital gains tax (CGT). Table 14.1 summarizes the treatment of a limited range of assets for each of these taxes. For ease of exposition, we avoid discussion of more esoteric assets and of a range of specific assets and schemes which have, over the years, attracted a complex and changing array of tax advantages.

For owner-occupied housing and for cash and shares held in ISAs, saving is out of taxed income and there is no tax on returns and no tax on withdrawals (the proceeds of sale in the case of housing): a TEE treatment. This treatment is very limited in the case of Individual Savings Accounts (ISAs), into which just over £10,000 can be placed each year. Of this, a maximum of half can be in a cash ISA, though one can choose to place the whole amount in an equity ISA. Rather oddly, then, TEE treatment is more widely available for equity investments than for cash savings.

Tax exemption is provided in a different way for pensions: saving is out of untaxed income, fund income is untaxed, but withdrawals are taxed: EET. This regime for pensions would produce the same effective tax rate of zero

Table 14.1. Tax treatment of different assets (in 2010–11)

Asset	Income tax and NICs on contributions	Returns		Income tax and NICs on withdrawals
		Income tax on interest/dividends	Capital gains tax[a]	
Pension—employee contribution	Exempt from income tax, not exempt from employer and employee NICs	Exempt	Exempt	Taxed except for a 25% lump sum, no NICs
Pension—employer contribution	Exempt from income tax and employer and employee NICs	Exempt	Exempt	Taxed except for a 25% lump sum, no NICs
ISA	Taxed	Exempt	Exempt	Exempt
Interest-bearing account	Taxed	Taxed at 10%, 20%, 40%, or 50%	n/a	Exempt
Direct equity holdings	Taxed	Taxed at 10%, 32.5%, or 42.5%, but offsetting dividend tax credit means effective rates are 0%, 25%, and 36%	Taxed	Exempt
Housing—main or only house	Taxed	Exempt[b]	Exempt	Exempt
Housing—second or subsequent house	Taxed	Rental income taxed	Taxed	Exempt

[a] CGT was charged at 18% for basic-rate taxpayers and 28% for higher-rate taxpayers on gains above an allowance of £10,100. Note that a flat rate of 18% was in place before 23 June 2010 (http://www.hmrc.gov.uk/cgt/intro/basics.htm#6).

[b] Dividends are effectively the imputed value of income from owner-occupation—this was taxed on the basis of the notional rental value of the property until 1963. Note that income tax is payable on income received from letting out part of a main residence while the owner resides there, although the first £4,250 per year is tax free.

on the normal return to savings;[1] but the 25% lump sum that can be withdrawn from pension funds tax free means that pension saving is in effect subsidized. In addition, employers' pension contributions are particularly tax favoured since they are not subject to employer or employee NICs either at the point of contribution or at the point of withdrawal.

National Insurance contributions are not charged on the returns to any form of savings; nor is relief from NICs available for contributions to any form of savings other than employer contributions to pensions. This means that the NICs treatment of all other savings is effectively TEE. Savings are made from income on which NICs have already been charged, but returns are not subject to NICs.

Perhaps unsurprisingly, most of the wealth held by the UK population is in pensions, housing, and ISAs. Saving in other forms is discouraged by the tax system. Cash in ordinary interest-bearing accounts is saved out of taxed income, and income tax is then applied to the full nominal return: TTE. The same is true of equities held outside ISAs, with CGT also applicable to capital gains.

Given this set of tax treatments, under certain assumptions, we can calculate the effective tax rate (ETR) on savings in each of the different asset types: the percentage reduction in the annual real rate of return caused by tax.[2] Table 14.2 illustrates ETRs for basic- and higher-rate taxpayers if all assets earn a 3% real rate of return before tax and inflation is 2%. The ISA regime (TEE in our earlier notation) can be taken as the base case with an effective tax rate of zero because there is no tax on the real return.

Note that the ETR on an interest-bearing account is 33% for a basic-rate taxpayer, not the statutory income tax rate of 20%. This is because tax is charged on the nominal return, not the real return. With a 3% real return and 2% inflation, £100 of savings yields nominal interest of about £5; 20% tax on this, £1, represents 33% of the £3 increase in the real purchasing power of the deposit. Inflation does not, however, affect ETRs on pensions, ISAs, and owner-occupied housing, where the return is tax exempt.

[1] Assuming that the individual faces the same marginal tax rate in retirement as when making the contribution—the implications of relaxing this assumption are discussed below.

[2] The calculation of ETRs here broadly follows that of IFS Capital Taxes Group (1989). For more detail of methodology and results, see Wakefield (2009).

Table 14.2. Effective tax rates on savings in different assets

Asset		Effective tax rate (%) for: Basic-rate taxpayer	Higher-rate taxpayer
ISA		0	0
Interest-bearing account		33	67
Pension—employee contribution	– invested 10 years	–21	–53
	– invested 25 years	–8	–21
Pension—employer contribution	– invested 10 years	–115	–102
	– invested 25 years	–45	–40
Housing—main or only house		0	0
Rental housing	– invested 10 years	30	50
	– invested 25 years	28	48
Direct equity holdings	– invested 10 years	10	35
	– invested 25 years	7	33

Notes: Assumes 3% annual real rate of return and 2% inflation. Calculations for rental housing and direct equity holdings assume that real returns accrue as rental income or interest or dividends while capital gains match price inflation and are realized at the end of the period in question. Rental housing is assumed to be owned outright, with no outstanding mortgage. Calculations for employer pension contribution assume that the employee is contracted into the state second pension. Saver is assumed to be a basic- or higher-rate taxpayer throughout the period in question, to have exhausted the CGT exempt amount where appropriate, and to have no entitlement to means-tested benefits or tax credits.

Source: Wakefield, 2009.

Pension savings are treated more favourably than by a pure cash-flow expenditure tax and are therefore shown as having a negative ETR. This arises because of the tax-free lump sum and from the fact that employer contributions are exempt from NICs whilst no NICs are charged on withdrawal. The measured ETR depends on the period for which the pension is held because the ETR is a measure of the tax as a percentage of the real return. Over longer periods, the real return is greater, so the value of a tax subsidy to the contribution (the NICs treatment) or the final withdrawal (the lump sum) is lower as a proportion of the total return.

The ETRs on direct equity holdings and on rental housing represent a combination of income tax and capital gains tax.[3] The ETRs are lower for longer holding periods because CGT is levied when an asset is sold rather than when the rise in value occurs. This interest-free deferral of the tax liability is worth more the longer the asset is held, reducing the ETR over time and creating an incentive (the 'lock-in effect' introduced in the last chapter) for people to hold on to assets for longer than they would in the absence of the tax.

Table 14.3. Contribution to a range of assets required to match TEE return

Asset		Required contribution for: Basic-rate taxpayer	Higher-rate taxpayer
ISA		100	100
Interest-bearing account	– invested 1 year	101	102
	– invested 10 years	110	121
	– invested 25 years	127	163
Pension—employee contribution		94	86
Pension—employer contribution		72	75
Owner-occupied housing		100	100
Rental housing[a]	– invested 10 years	109	116
	– invested 25 years	122	142
Stocks and shares[b]	– invested 10 years	103	111
	– invested 25 years	105	127

[a] We have assumed capital gains that match price inflation, and real returns that accrue as rent. We assume rental housing is owned outright, with no outstanding mortgage. We assume that a CGT liability is incurred. If no CGT were incurred, then the figures for the basic-rate (higher-rate) taxpayer would be 106 and 116 (112 and 134) for the respective horizons. With a CGT liability, if we were to incorporate mortgage interest that could be offset against half the rental income, then the figures for a basic-rate (higher-rate) taxpayer would be 106 and 113 (109 and 122), instead of 109 and 122 (116 and 142).

[b] We have assumed capital gains that match price inflation, and real returns that accrue as interest or dividends. We assume that a CGT liability is incurred. If no CGT were incurred, then the figures for the basic-rate (higher-rate) taxpayer would be 100 and 100 (108 and 120) for the respective horizons.

Source: Wakefield, 2009.

[3] For simplicity, we assume that asset price inflation matches general inflation and that real returns are received as interest or dividends or rental income.

The ETRs in Table 14.2 illustrate the effect of tax on annual rates of return. Perhaps a more intuitive way of thinking about this is to ask the question 'What contribution would be required to match the net return to an ISA?'. In other words, what amount of money do I need to put in an ordinary interest-bearing account, or into a pension, so that I would end up with the same net value of asset as I would have done had I contributed £100 to an ISA, assuming some underlying pre-tax return? Answers are provided in Table 14.3 for basic- and higher-rate taxpayers. In this case, the answer depends on the holding period for interest-bearing accounts. Taxes on the return to savings compound over time. So the longer an interest-bearing account is held, the more has to be invested to match the return to an ISA. Taxes on initial contributions or final withdrawals do not have this property, so the net tax subsidies for pensions are invariant to the length of holding.

Despite these differences between the treatments of different assets, there has in fact been a narrowing in the dispersion of effective tax rates over the past three decades, as illustrated in Figure 14.1. This partly results from lower and less dispersed income tax rates and lower levels of inflation. But there has also been a series of more specific reforms. Importantly, the introduction of personal pensions and ISAs (previously PEPs and TESSAs) has extended the range of tax-free savings vehicles available. But as we saw in

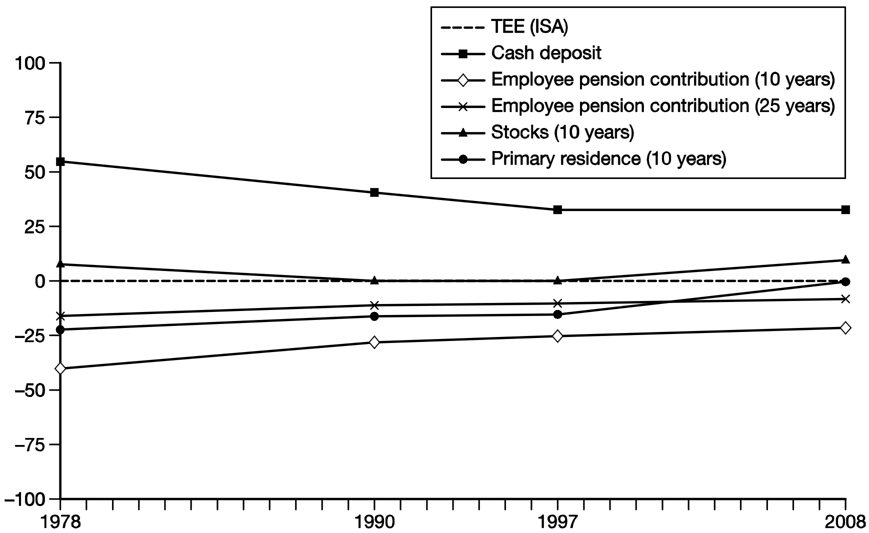

Figure 14.1. Effective tax rates for a range of assets in selected years

the last chapter, whilst most savings are indeed held in these tax-free forms, a significant minority are still held in tax-disadvantaged forms, and this is particularly true for lower-wealth households.

It is worth briefly mentioning the taxation of capital gains. As we saw in the last chapter, the standard approach to taxing capital gains at realization within an income tax system creates a lock-in effect favouring holding assets for longer than in a world without tax. This arises because tax is levied only on the realization of the gain and there is no adjustment of tax liability to make it equivalent to an accrual-based tax system. In practice, there are other problems created by the way in which we tax capital gains. As with the rest of the savings tax system, there is no allowance for inflation, so nominal gains are taxed.

In the UK in 2010–11, CGT was charged at 28% for higher-rate taxpayers and 18% for basic-rate taxpayers,[4] on realized capital gains in the year of more than £10,100. The effective value of these rates varies between assets since there is no allowance made for corporation tax paid as there is when income tax is due on dividends.

The high additional tax-free allowance for CGT unambiguously makes taking returns as capital gains relatively attractive. The allowance means that for many people with significant asset holdings, who can divest themselves of their holdings over a period of time, there is effectively no tax at all on capital gains. Whilst capital gains realized in any year remain below £10,100, no tax is payable.

Particularly attractive are gains in the value of personal business assets, the first £5 million of which, through 'entrepreneur's relief', are entirely exempt from CGT. The existence of this relief is, of course, in complete contravention of the principles for an effective tax system which we discussed in the last chapter. It ensures that, for a small group, a significant part of the return to effort is not captured in the tax system and a very big incentive is created to take returns in the form of capital gains. These issues are compounded by the fact that there is a complete exemption from CGT at death.

The result has been a great deal of tax planning focused around capital gains. The ability of some of the very wealthy, including many private equity

[4] See note a to Table 14.1.

fund managers, to take returns in the form of capital gains has generated controversy and concern around the equity of the whole tax system.[5] All of this makes CGT a highly unsatisfactory tax. Possibly more than any other tax, it has been subject to frequent, dramatic, and often controversial changes, despite accounting for less than 1% of all revenues.[6] Within the current tax system, this reflects the fundamental tension between the desire for a tax regime that does not penalize saving and one that treats similar levels of income similarly. It is this tension that we argue can be overcome in an expenditure tax or rate-of-return allowance regime.

14.1.1. Progressive Taxes and Means Tests

There is one other complication which makes the potential differences in effective tax rates much greater than those illustrated. Thus far, we have assumed that the income tax rate faced at the point of saving is the same as that faced at the point of withdrawal. As we saw in the last chapter, the fact that we have a progressive income tax schedule means that, in practice, this is often not the case.

Consider saving in a pension. Putting earnings into a pension fund in effect defers the tax on those earnings until they are withdrawn from the fund. If the tax rate at withdrawal is different from the rate when the income was earned, the deferral of tax can make a dramatic difference to the amount of tax actually paid. Many of those facing a 40% marginal rate while in work will face the basic rate of 20% in retirement. Their incentives to save in a pension are substantial. Indeed, there are substantial incentives to adjust the timing of pension saving to take advantage of differential tax incentives—much better to save when you are facing the higher tax rate than when you are a basic-rate taxpayer.

In Table 14.2 above, we showed the effective tax rates on employee pension contributions into a pension fund held for 25 years. The tax rates were –8% and –21% for basic- and higher-rate taxpayers respectively, on the assumption that they paid the same rate of tax in work as in retirement. If instead they make contributions when paying 40% tax and withdraw when

[5] See House of Commons Treasury Committee (2007).

[6] Source: HM Treasury, 2010b, table C11.

facing a 20% tax rate, the effective tax rate on their pension savings is –48%. The lower tax rate in retirement is a reflection of the fact that lifetime income is not so high as to justify taxation at the higher rate in all periods. To that extent, we may not worry too much about the apparent generosity of this incentive for higher-rate taxpayers to save in a pension. As we saw in the last chapter, in principle, with a standard progressive tax system, a free choice between EET and TEE savings vehicles could allow full consumption-smoothing for any individual, irrespective of their pattern of income receipt.

This picture, though, is much complicated by the existence of means-tested benefits and tax credits. To the extent that accumulated savings reduce entitlement to benefits, the incentive to save is reduced. On the other hand, if contributions to savings products are deducted from income in assessing entitlement to benefits, then incentives to save are enhanced. The way in which the benefit system in the UK takes account of savings is complex and inconsistent. The most important points to note are that entitlements to means-tested benefits are reduced at quite high marginal rates in the face of income from private pensions. Entitlement to Pension Credit, for example, is reduced by 40p for every pound of pension income and Housing Benefit entitlement is reduced by 65p in every pound. This matters since just under half of pensioners are entitled to some form of means-tested benefit.[7] In addition, having stocks of savings above quite low limits results in reductions in means-tested benefit entitlement. On the other hand, owner-occupied housing is ignored in all means tests.

For pension savings, it also matters how contributions are treated for calculating benefit or tax credit entitlement. Pension contributions are in fact not counted as part of the income on which tax credit entitlement is calculated, just as they are excluded from income when calculating tax due. This potentially provides a significant saving incentive for tax credit recipients since it effectively costs a tax credit recipient only 39p in lost income to save £1 in a pension.[8]

More details are provided in Box 14.1.

The potential impact of tax credits and Pension Credit, along with different income tax rates, on the incentive to save in a pension is illustrated in Table 14.4. The table shows how much you would need to contribute to a

[7] Department for Work and Pensions, 2006, ch. 3.
[8] This and other statistics here refer to the 2010–11 tax and benefit system.

pension to match the return to saving £1 under a TEE regime. The differences are dramatic. There is clearly a very strong incentive for anyone on the tax credit taper to contribute to a pension. Equally, there is a strong disincentive to pension saving for basic-rate taxpayers expecting to end up on the Pension Credit taper. In terms of scale, however, note that the

Box 14.1. Means-tested benefits and tax credits

Different financial assets are treated differently by different parts of the means-tested benefit and tax credit system. Tax credits are assessed on the same measure of income as is income tax, so most forms of savings income are counted for the means test but any savings held in an ISA, for example, do not affect entitlement. For other means-tested benefits—principally, Housing Benefit, Income Support, Pension Credit, and Council Tax Benefit—any actual income generated by financial assets is ignored in calculating entitlement. But an income is *deemed* on any asset-holding above £6,000, with every £250 in assets above this level (£500 for those aged over 60) assumed to provide an income of £1 a week for the purposes of the means test. Those with assets of more than £16,000 are not eligible for means-tested benefits at all. These rules, combined with the high withdrawal rates of means-tested benefits, create a very strong disincentive for those who are on means-tested benefits, or consider themselves likely to be eligible for them in the future, to build up financial assets worth more than £6,000.

In terms of contributions, the treatment of different benefits is also inconsistent. Whilst all pension contributions are excluded from income when calculating tax credit entitlement, only half of employee contributions are deducted when calculating entitlement to means-tested benefits.

One way of summarizing these different treatments is to use our standard notation and apply it to means-tested benefits. In broad terms, we can say the following:

- housing is subject to a TEE regime for all means-tested benefits and tax credits;
- pensions are subject to an EET regime for tax credits and a ½TET regime for means-tested benefits;
- other savings (including ISAs) are subject to a TEE regime for means-tested benefits but with an assets test on top that rapidly reduces entitlement once savings exceed £6,000;
- ISAs are subject to a TEE regime for tax credits;
- other savings are subject to a TTE regime for tax credits.

Table 14.4. Employee contribution to pension (ten-year investment) required to match £1 contribution to TEE vehicle for different combinations of working-life and retirement tax rates

Tax rate in work	Tax rate in retirement	Required contribution (p)
Basic rate (20%)	Basic rate (20%)	94
Higher rate (40%)	Higher rate (40%)	86
Higher rate (40%)	Basic rate (20%)	71
Basic rate (20%)	Pension Credit taper (40%)	114
Tax credit taper (59%)	Basic rate (20%)	48
Tax credit taper (59%)	Pension Credit taper (40%)	59

Note: Assumes 3% annual real rate of return and 2% inflation.

Source: Wakefield, 2009.

disincentive for pension saving in the face of the Pension Credit taper is not much greater than the disincentive that basic-rate taxpayers face from saving in an ordinary interest-bearing account for ten years. (Compare the required contribution of 114p in Table 14.4 to the 110p in Table 14.3.)

As illustrated in Box 14.1, the current regime treats different assets in different ways, and it gives rise to some peculiar saving incentives. That said, no easy reform presents itself. It would be nice if we could adopt one or more of the approaches we have discussed for income taxation (TEE, TtE, or EET). But this turns out to be much more problematic for means-testing than for taxation. There are two reasons for that. First, there is little correlation between being in receipt of any particular benefit when saving and when withdrawing the savings. Second, unlike a standard progressive tax schedule, means-testing implies levying higher effective tax rates on those with lower incomes.

A TEE-type regime makes little sense in the context of means-testing. If Pension Credit, for example, were not reduced in the face of higher private pension income, it would no longer be a means-tested benefit. One could conceive of a system in which a saver sacrifices Pension Credit now in order to enjoy the benefits of that saving, and of Pension Credit, in the future. But that is not consistent with the usual pattern of behaviour: almost nobody saves in a pension while in receipt of Pension Credit.

An EET regime suffers from the mirror-image problem. Many of those on means-tested tapers when they withdraw the savings (receive a pension) will have been facing just the basic tax rate when saving (in work). They will face the 'T' without ever having benefited from the 'E'. And because means-testing involves higher effective tax rates when incomes are lower, saving to smooth consumption will result in an overall higher level of tax paid than would have occurred in the absence of saving. This is the opposite effect of an EET regime in the face of a tax system with rising marginal rates. In this case, as we have already seen, saving when income (and the tax rate) is higher and consuming when income is lower allows the overall tax paid to be smoothed, at least to some extent, to reflect income over a longer period.

There is no easy way around the issue of means-testing and savings. Obviously, less reliance on means-testing would help. But that can only be achieved either by reducing the generosity of benefits or by increasing universal benefits. The first makes poor people worse off; the second requires increases in taxes to pay for the benefits. Another path is to make some level of saving compulsory. If this leads to very small increases in eventual incomes because of the action of means-testing, then it has much the same effect as an increase in direct taxes on those affected.

14.2. REFORMS

There is a strong case for substantial reforms to the taxation of savings. In keeping with our goal of promoting neutrality toward savings for the majority of taxpayers, we favour an approach that exempts the normal return to savings from taxation. As we have seen, for many assets, this can be achieved in two ways. We could implement a consumption tax (EET) in which contributions to savings are made gross of tax and tax is paid on withdrawal. Or we could implement a rate-of-return allowance (TtE) in which savings are made net of tax, but with tax then charged only on any returns above the normal rate. For assets such as interest-bearing accounts, where no supernormal returns can be earned, an earnings tax (TEE) is also equivalent.

In the next subsections, we outline some of the issues in applying these regimes to different assets, arguing that the TEE regime is the only one appropriate to ordinary interest-bearing accounts, and looking at the RRA particularly in the context of shareholdings and the consumption tax in the context of pensions.

14.2.1. TEE and Cash Savings

Ordinary interest-bearing accounts are currently subject to a standard income tax treatment, with no allowance for the effect of inflation on nominal interest rates. Savings are made out of taxed income and tax is levied on any returns. This violates the neutrality principle discussed in Chapter 13. Such a system is particularly punitive at times of high inflation, since a large part of the tax burden then falls on the component of the return that is simply compensating holders for inflation.

Cash ISAs already allow returns to be accumulated free of tax (TEE) on contributions up to an annual limit of £5,100 (in 2010–11). The argument for moving towards a more general TEE treatment of cash accounts is persuasive. They will not achieve 'supernormal' returns and there is little scope to disguise labour income as bank interest, so TEE treatment is entirely appropriate. This form of savings also tends to be the focus of less well-off and perhaps less sophisticated savers, though of course in absolute terms the biggest winners would be those who currently have substantial savings—simple interest-bearing accounts may form a higher *share* of total financial assets for those with lower levels of income and wealth, but wealthier individuals tend to have more in absolute terms.

It might appear that an alternative would be to allow consumption tax (EET) or RRA (TtE) treatment of such accounts. Given that we are going to go on to suggest such treatment for other assets, it is reasonable to ask why we would want an earnings tax treatment of savings accounts. There is, in fact, one rather important reason for this, related to our discussion of the taxation of financial services in Chapter 8. Suppose we were to offer RRA treatment on bank accounts. It would then be straightforward for such accounts to offer a range of services in exchange for a low or zero return. Under an RRA, this 'loss' could be offset against gains elsewhere. Equally, under EET, no tax would be paid on the implicit value of the financial services received. To avoid these distortions and the associated opportunities for tax avoidance, we therefore support the use of a TEE regime for these savings.[9]

14.2.2. The RRA and the Treatment of Risky Assets

Broader application of the TEE regime would fail to tax supernormal returns, and it would result in very different marginal tax rates being applied to labour income and capital income. TEE treatment of business income would be especially problematic. Exempting trading profits or dividends from taxation while seeking to tax self-declared labour income creates a range of obvious avoidance opportunities.[10] In order to avoid creating such tax avoidance opportunities, we focus on alternatives to general TEE treatment.

Introducing either an expenditure tax (EET) or a rate-of-return allowance (TtE) ensures that whilst the normal return remains untaxed, any excess returns are taxed. As we saw in the last chapter, these tax treatments can also ensure neutral treatment between income and capital gains. From our point of view, a crucial part of their attraction is that they can achieve neutrality while setting the tax rates on income, and capital gains, from investments equal to the tax rates on labour income. So there is no incentive to take income in one form rather than another. This is an important neutrality property and central to our proposals on small business taxation (Chapter 19).

This neutrality is only achieved if the rates of tax applied to above-normal returns are set not at current income tax rates but at rates equal to the income tax plus full (employee and employer) National Insurance contribution rates. Otherwise, a substantial incentive remains to transform earned income into capital income. Of course, for the RRA, this rate

[9] For all the same reasons, TEE is also suitable for cash borrowing such as bank loans—simply ignoring them for tax purposes, neither taxing the principal borrowed nor deducting repayments of interest or principal—as is already standard practice. Box 16.1 discusses the tax treatment of mortgages specifically.

[10] These issues are discussed further in Chapter 19.

schedule would apply only to returns above the normal return. So whilst the proposal might seem to involve a punitive increase in rates relative to the current system, the reality is that the RRA allows these rates to be aligned whilst ending the taxation of the normal return. By complete contrast to the current situation, both an expenditure tax and an RRA would allow capital gains to be treated wholly consistently with income.

In principle, a rate-of-return allowance (TtE) and an expenditure tax (EET) confer similar advantages. We have shown how they are economically equivalent. As we explain in the next subsection, there remains a strong case for keeping (and improving) the current EET treatment of pension savings. But it may make sense to offer the rate-of-return allowance for savings in other risky assets. In part, the transition to, and implementation of, such a regime are likely to be easier than the transition to EET for all. In part, as we discuss in Section 14.3, there may be benefits in having both regimes in existence for different assets and allowing people some degree of choice.

That said, there are several potential implementation complications to deal with under an RRA regime. These include the record-keeping requirements, the relative complexity or unfamiliarity of the calculations required, and the treatment of 'losses'—or, more properly, returns below the normal rate. On the other hand, one of the attractions of the RRA is that the transition to it is likely to be easier, both technically and politically, than the transition that would be required to move us to a cash-flow consumption tax.

One particular practical issue worth mentioning briefly is that if we plan to tax people making high (above-normal) returns on their assets, we should equally provide relief to those making 'losses' (below-normal returns). If we fail to do this, then we introduce a different distortion because the expected tax on returns to risky assets would be positive, undermining neutrality both over the timing of consumption and between more and less risky assets. More generally, the effect of this approach to taxing the returns to risky investments on the incentives to invest in risky assets is likely to depend on the structure of capital market opportunities available to investors as well as on the tax rules applying to loss offsets, for example. This is a topic of ongoing study.

To achieve neutrality on the timing and risky-versus-riskless asset dimensions would require that losses (i.e. net returns below the RRA allowance) be offset in some way. In principle, this could take the form of outright tax refunds, setting losses on one asset against gains on another (or perhaps against labour earnings), or carrying losses forward or back to set against taxable income or gains in other years. We do not discuss further the detailed economic and practical considerations surrounding these different ways in which loss offsets could be implemented.[11] But it is worth emphasizing that, unlike current practice, losses offset in other periods should be carried forward or back with interest, thereby maintaining the value of tax relief.

An RRA regime could simplify the capital tax system as a whole by reducing opportunities for avoidance, and hence reducing the plethora of concomitant laws and regulations designed to minimize avoidance. But, not just because of the issue of losses, it would be more complex for some people than the current regime. It would require more record-keeping for some—though no more than is needed for CGT to operate—and the calculations involved would be unfamiliar. We make two proposals to ensure that this does not become a barrier to implementation.

First, we would propose maintaining a limited TEE vehicle, such as an equity ISA, with limits like those currently in place or somewhat reduced. That would avoid unlimited availability of tax-free returns for those skilful or lucky enough to do well by investing in risky assets. And, like ISAs at present, the TEE vehicle would only be available for arm's-length assets: it would not be possible for people to put shares in their owner-managed business into a tax-free wrapper as a way to convert their labour income into untaxed capital income. But it would ensure that a simple vehicle remains for the vast majority of people wanting to invest in equities. This is in keeping with our goal of savings neutrality for most taxpayers.

And second, for holdings above the limit on the TEE vehicle, investors could opt to use a rate-of-return allowance. But if they do not take that option, their investments would, by default, be taxed under a comprehensive income tax regime similar to the one currently in place. There would clearly be an incentive to use the RRA regime, but no obligation for those with relatively small holdings or a strong aversion to extra record-keeping and calculations.

[11] For such discussion, see Devereux (1989) or Altshuler and Auerbach (1990).

14.2.3. Pensions and the Consumption Tax

The UK currently has something close to an EET taxation treatment of pensions. We see no reason to move away from that system, which delivers savings-neutral tax treatment for those who save through pensions. Indeed, there are many practical reasons for believing this is much the best way of approaching the tax treatment of pensions. Both because pensions account for by far the majority of non-housing wealth and because they play a central role in government policy aimed at ensuring adequate incomes in retirement, getting their tax treatment right is extremely important.

It is worth starting with some context. Unlike all the other assets we consider in this book—equities, housing, interest-bearing accounts, and so on—a pension is not defined by the underlying assets in which money is invested. In fact, money saved in a 'pension' can be invested in virtually any underlying asset. The main defining characteristic of a pension is that access to the savings contained therein is allowed only from a certain age (55 in the UK from 2010). Additional rules regarding requirements to purchase annuities also often exist—though in some countries (Australia, for example), there are no such constraints. If people are to save voluntarily in a form subject to these limitations, they will need to be encouraged to do so, either with more generous tax treatment than is available for alternatives or through some other incentive.

Public policy towards pension saving spans many issues beyond tax treatment. The level and design of the basic state pension, the role of state earnings-related pensions, and the design of means-tested benefits in retirement all have a major impact on the amount and form of private pension saving. There are also quite different types of pension saving. From our point of view, it is the difference between 'defined benefit' and 'defined contribution' pensions that matters. The latter are more straightforward, effectively acting like savings accounts which are directly attributable to individuals. They are savings accounts with severe restrictions, though, in terms of the age at which they can be accessed and the form in which income can be withdrawn. Defined benefit pension arrangements are more complex. They are employer-sponsored schemes in which the eventual pension in payment is not linked directly to an individual's contributions and the performance of her particular fund. Rather, the pension is usually defined according to some measure of final salary and years of service. For example, some schemes will offer an annual pension of one-sixtieth of final salary for every year worked, with the result that someone with 40 years in the scheme will receive two-thirds of their final salary as a pension. The tax treatment of defined benefit schemes needs to be considered in light of the fact that the value of the employer contribution in respect of each individual is not straightforward.

This is the context in which, in the UK, we have a tax regime for pensions which is close to a consumption tax. Contributions are made free of income tax, investment returns accumulate free of tax, and the pension in payment is taxed. The reality, however, diverges from a strict consumption tax in three important ways. First, there are limits on how much can be contributed to a pension in any year, and on how much can be accumulated in total before tax penalties apply. Second, while it is right to describe the income tax treatment of pension saving as close to EET, the NICs treatment of pension saving is quite different. Indeed, it differs according to whether the pension contribution comes formally from the employer or from the employee. Third, a quarter of the accumulated pension balance in a defined contribution scheme can be withdrawn as a lump sum free of tax. (A roughly equivalent rule works for defined benefit schemes too.) The result is that a quarter of contributions are effectively subject to a very generous EEE treatment for income tax purposes. We now look at each of these in turn.

Limits

In brief, the limits to the availability of tax relief for pension saving apply both to the amount that can be contributed in any one year and to the total that can be accumulated in the pension account before penalties are applied. These limits have been subject to some change and review. In late 2010, the most recent decisions were that tax relief should be available on contributions of up to £50,000 a year with a limit on the value of the accumulated pension balance of £1.5 million before penalties are paid.[12] This annual contribution limit in particular is much less generous than the £255,000 annual limit previously in place. The reason for the change is quite explicitly to raise revenue and, in particular, the reform represents an

[12] http://www.hm-treasury.gov.uk/consult_pensionsrelief.htm.

attempt to limit the responsiveness of taxable income to the income tax rate. Its timing, following the introduction of a new highest income tax rate of 50%, is no accident.[13]

Are limits of this kind desirable? There are three possible principled arguments in favour of limits in general. One is that a limit on the amount that can be saved in a tax-neutral environment may be desirable if we would like to tax bequests and other wealth transfers but cannot do so adequately. Then limits on tax-neutral accumulation up to some level that could be considered adequate for life-cycle savings may be one, albeit very much second-best, response. This argument, of course, bears much less weight in respect of pensions than for other forms of saving. A second argument refers back to concerns about ever being able to collect the tax. The tax authorities might have legitimate concerns if it were possible to place unlimited amounts of money into an EET vehicle, and then avoid domestic tax by taking up residence elsewhere. Of course, this is a general issue for consumption taxes, including VAT. Third, in the last chapter, we considered a range of relatively subtle arguments against a general presumption in favour of tax-neutral treatment. One reasonable response to these arguments could be to impose some limits on the availability of tax-neutral savings instruments. Note, though, that all these arguments would seem to apply more naturally to limits on the total amount that can be saved rather than limits on annual contributions.

Of course, if we were to reform savings taxation more fundamentally, it would be important that any limits on saving in tax-neutral pension vehicles be lined up sensibly with limits on other savings vehicles. If we were to allow unlimited access to vehicles with RRA (or, for cash accounts, TEE) treatment, limits applied only to pension saving would just lead to more savings in those other forms by those who are affected by the limits.

Within these limits, though, the tax regime for pensions is more generous than a pure consumption tax in respect of the NICs treatment and in respect of the tax-free lump sum. We now turn to these.

[13] These changes stand in place of alternative proposals laid out by the previous government which, broadly, would have restricted the rate of tax relief available to those paying the new 50% income tax rate. Restricting rates of tax relief is complex and sits very badly with attempts to achieve rational tax treatment.

NICs Treatment

As we have stressed, getting the taxation of savings right involves not only getting the income tax treatment right, but also getting the NICs treatment right. At present, NICs are charged on e*mployee* contributions into private pensions. They are not charged on pension withdrawals. This is a TEE regime. The situation is different for employer contributions. These are subject neither to employer NICs nor to employee NICs. Again, pensions in payment are not subject to NICs at all. This is an EEE regime.

This difference in treatment between employer and employee contributions creates a very substantial incentive for contributions, formally, to come from employers. For those facing the main rates of NICs—12.8% for employers and 11% for employees in 2010–11—a net contribution to a pension of £100 costs an employer £100 if he makes the contribution, but costs him nearly £127 if the contribution comes from the employee.[14] Looking back at Tables 14.2 and 14.3, this helps explain why employer contributions to pensions are much the most tax-favoured form of saving. It also helps explain why HMRC records (income tax relief on) employer contributions as two-and-a-half times as great as employee contributions.[15] Some might argue that encouraging saving through workplace pensions is a particularly effective way of raising personal saving, but it is not clear whether this warrants net saving incentives of the magnitude currently in the tax code.

Could we move to a full EET treatment of pensions for NICs as well as income tax? To do so would mean exempting employee as well as employer contributions from employer and employee NICs. There would then need to be an additional tax (NICs) payment on pensions in payment. If this were to reflect the main 2010–11 NICs rates in full, it would need to be set at about 21.1% on pensions in payment below the upper earnings limit for NICs.[16]

If we wanted to move in this direction, though, it would not be appropriate simply to start charging this full rate of NICs on pensions currently in payment. That would imply double taxation—NICs will have been levied on

[14] $100 \times 1.128 / (1-0.11)$.

[15] HMRC statistics, table 7.9, http://www.hmrc.gov.uk/stats/pensions/table7-9.pdf.

[16] Note that employee and employer NICs rates are multiplicative, not additive (assessed sequentially, not simultaneously): employee NICs are charged on gross earnings excluding employer NICs. This distinction is discussed in Section 5.3.2.

any employee contributions already made—and undermine the legitimate expectations of those who have saved up to now.

What one would need to do would be to start providing relief for employee contributions now and gradually phase in additional payments in retirement over an extended period. One attractive way to do this would be by date of birth. In other words, those reaching 65 before, say, 2015 would be unaffected. Then NICs could be imposed on private pension income in retirement at, say, 0.5% for those reaching 65 in 2016, 1% for those reaching 65 in 2017, 1.5% for those reaching 65 in 2018, and so on until a final target rate is reached (15% would be reached by 2045, 20% by 2055). Quicker phase-in would be possible, though anything short of 40 years to reach 21.1% risks some (albeit small) element of double taxation. In principle, one might consider it reasonable to phase this reform in more quickly to take account of the historic exemption from NICs of employer contributions, though inevitably those who had had to rely on their own contributions would lose out—and no doubt concerns would be expressed over 'retrospective' taxation.

Two points are worth making with regard to this proposal. First, because employee contributions would be moving from a TEE to an EET regime, it would cost the government money up front—though it would raise money in the long run by getting rid of the EEE treatment of employer contributions. Second, there can be no denying that reforms of this kind raise uncertainty about future taxes and place the tax treatment of savings at some political risk. If a government were to set out on the path of gradually increasing tax rates on pension income over a long period, there would clearly be a temptation for successor governments to deviate and to increase rates more quickly or tinker in other ways. There is no obvious way to tie the hands of future governments and reassure people they would not succumb to the temptation.

Moving to a full EET treatment of pensions for NICs as well as income tax still seems to us the most appropriate way forward, particularly in the context of our proposals in Chapter 5 to move towards integration of income tax and National Insurance contributions. It provides a sustainable and transparent rate schedule, does not require valuation of employer contributions to defined benefit schemes, and ensures that excess returns are taxed. But if the transition is seen as too painful, there is a partial alternative which might be more palatable, especially to governments concerned about short-term costs. This would be to maintain the current TEE NICs regime for employee pension contributions and to move to a TEE regime for employer contributions as well. Employer NICs are already virtually flat rate (other than the earnings threshold) and could readily be charged at a flat rate on any contributions made by the employer. From the employer's point of view, pension contributions would then be treated like any other form of remuneration paid to the employee. This solution would, however, be harder to implement with respect to charging *employee* NICs on *employer* pension contributions. The non-flat-rate structure of employee NICs would require employer contributions to be allocated to individuals. That is possible for defined contribution schemes, but difficult for defined benefit schemes.

The Tax-Free Lump Sum

Under current rules, part of a pension can be taken as a tax-free lump sum—a quarter of the accumulated balance in a defined contribution scheme (and a roughly equivalent rule applies for defined benefit schemes). The part taken as a lump sum in effect receives EEE income tax treatment, i.e. is fully tax exempt at every point.

The existence of such a 'bonus' is usually defended as being compensation for the fact that pensions are constructed to be a highly inflexible form of savings, available only after a certain age. If, for reasons of public policy, we do want people to lock money away for long periods, we are likely to have to provide them with a good reason for doing so. The case for a bonus of some sort would be strengthened if the other reforms we have suggested, opening up more opportunities for saving in a tax-neutral environment, were to be implemented. But encouraging withdrawal of a tax-free lump sum seems a perverse way of encouraging people to build up a pension if one of its main purposes is to provide a regular annual income (and keep people off reliance on means-tested benefits). The current system also provides a significantly bigger bonus for higher-rate taxpayers than for basic-rate taxpayers. And allowing a quarter of the accumulated sum to be taken tax free makes this very valuable for those with the biggest pension pots.

There are many alternative ways of incentivizing pension saving that do not have this perverse effect. One would simply be to reduce the rate of tax on pensions in payment by a quarter. This would have to go alongside a reduction in benefit withdrawal rates to be of value to all. This may be less salient, and therefore less effective in influencing behaviour, than the lump sum. A more salient alternative, which would be similar in effect, would be for government to top up pension funds at the point of annuitization. For a basic-rate taxpayer, a 5% top-up (20% of 25%) would be broadly equivalent in value to the tax-free lump sum.

14.3. THE OVERALL SYSTEM AND THE OPPORTUNITY TO SMOOTH

We have recommended ending taxation of interest income in cash accounts and introducing a rate-of-return allowance for direct holdings of equities and similar assets.[17] We have also recommended keeping and improving the EET treatment of pensions. Between them, these proposals, which would represent steps toward a savings-neutral tax system, would substantially improve the savings tax system in the UK.

One feature of these recommendations is that the combination of TEE/RRA treatment of cash and equities with an EET pension vehicle would also allow some people access to opportunities for the kind of tax-smoothing we described in Chapter 13. That is, they could choose which to use depending on their expected future consumption and earnings paths. Those expecting to face lower tax rates in retirement than during working life would use a pension. Anybody expecting the reverse would find it beneficial to save through the TEE and RRA regimes.

But the opportunity for smoothing would not extend to those with variable incomes during working life. Ideally, someone earning £50,000 this year and £20,000 next year should pay the same tax as someone earning £35,000 in each year. Under TEE or TtE regimes, they would pay more tax. If the person with variable earnings had access to an EET savings account such that they could place £15,000 into the account in the first year and withdraw

[17] In Chapter 16, we also run through how an RRA regime could apply to housing. In Chapter 19, we show how important it is in lining up the taxation of individuals and companies.

it in the second, then they would pay the same tax as the person with the stable earnings.

If we wanted to allow this—and we set out the pros and cons of allowing full smoothing in the previous chapter—there are two routes we could follow. One would be the introduction of a separate EET savings vehicle. This might allow taxpayers to place a certain amount of money into an account this year, with tax relief, and allow them to withdraw it, and pay tax on the withdrawal, at any point in the future. The second option would be to allow more flexible access to current pension vehicles. For example, a taxpayer might be allowed to access current pension savings at any age. In principle, this access might only be allowed subject to having a minimum (age-varying) total level of pension savings. This condition could help balance the value of the additional flexibility against the policy imperative of ensuring that as many people as possible have 'adequate' incomes in retirement, or at least incomes that take them off means-tested benefits.

Either route should be perfectly practicable and looks attractive from the point of view of getting the tax system closer to taxing a measure of lifetime income. The attractiveness of doing this depends on three considerations: first, the extent to which there is a case for maintaining a clearly differentiated treatment specifically for pension saving; second, the extent to which we are concerned about equity implications in the sense that perhaps only a minority of the better-off and better-educated might be able to take advantage of these opportunities; and third, the extent to which the additional flexibility around EET savings would lead to permanent loss of tax revenue, perhaps through movements abroad.

Finally, we should note that in order to allow the full smoothing that the combination of these savings tax treatments is aimed at providing, we should also consider the tax treatment of debt. At present, debt is given an earnings tax (TEE) treatment. Neither taking a loan nor paying it back makes any difference to tax paid. This clearly has the benefit of simplicity. The EET equivalent would involve taxing all cash inflows and deducting all outflows, hence adding the loan to taxable income for the year when it is taken out and then deducting all payments of interest and principal when repaid. The EET treatment would allow tax-smoothing in the sense that if I borrow when my earnings are low, I will be taxed at a low rate, or perhaps not at all. If I repay when my earnings are high, then the deduction against my income tax may be more valuable. Returning to the last example: instead of saving to cushion a fall in earnings from £50,000 to £20,000, suppose a taxpayer borrows to smooth consumption as earnings rise from £20,000 to £50,000. Under the TEE system, there is no smoothing and the borrower pays more tax than the person on £35,000 each year. Under EET, the loan of £15,000 is added to taxable income in year 1, but the repayment is deducted in year 2. In this case, the borrower is treated exactly as the person earning £35,000 in each year.

If the goal is to smooth, then logic pushes us towards allowing this kind of EET treatment for borrowing as well as allowing wider availability of EET treatment for saving. The relative complexity, or at least unfamiliarity, of this change to the taxation of borrowing, some of the arguments against free choice of savings vehicle, and the fact that means-testing implies that full smoothing for all is never likely to be practicable suggest to us that a focus on achieving this kind of total smoothing may not be a priority. But it could remain a long-term goal for tax reform.

14.4. CONCLUSIONS

The taxation of savings in the UK is distorting, inequitable, and complex.

Reforms in recent years have not been governed by any broad strategy or direction. There remain substantial differences between the ways in which different assets are taxed. Ordinary interest-bearing accounts are harshly taxed. There is, bizarrely, more limited availability of TEE tax treatment for cash than for equities. The taxation of capital gains continues to be contested and continues to provide substantial incentives to take returns as capital gains rather than as income. The taxation of pensions has been beset by uncertainty as governments worry more about tax revenue than maintaining the integrity of the system. And the treatment of employer contributions to pensions provides a substantial tax subsidy for saving in that form.

In these circumstances, a coherent package of reform is needed. In our view, the priority should be to move towards a system that is much more neutral in its treatment of savings as a whole—neutral between consumption now and consumption in the future—and one that limits the distortions between different types of assets. Getting there is not straightforward and does not mean treating every asset the same.

To reduce opportunities for tax avoidance, it is important to align the tax rates on earned income and on investment income in excess of the normal rate of return. This would remove numerous complexities and opportunities for avoidance. It requires National Insurance contributions to be charged on returns to savings in the same way as they are charged on earnings. We have shown specifically how this might be achieved for pensions.

Aligning the tax treatments of returns to savings in the form of income and of returns in the form of capital gains is also important. This is difficult to achieve under an income tax (TTE) treatment because there is a natural benefit to be had from the 'lock-in' effect of capital gains tax. In addition, the current system fails to index gains for inflation, offers a substantial additional tax-free allowance for capital gains, charges capital gains tax at below standard income tax rates, offers very generous 'entrepreneur's relief' to those owning their own business, and forgives CGT entirely at death.

The way we suggest achieving the desired neutral treatment is through a combination of a straightforward TEE system of taxation for ordinary bank and building society accounts, a reformed EET treatment of pensions, and the introduction of a rate-of-return allowance for holdings of shares and similar assets.

This combination of reforms would achieve a great deal more rationality in the savings tax system. The RRA system for shares would ensure that returns above the normal return, and only those returns, are taxed. These returns could be taxed at the full (income tax and National Insurance) rates applied to labour income. To ease the possible compliance burden of such a regime, we propose that equity ISAs remain in place for the vast majority of people, who have relatively small holdings of shares. In addition, those who do not choose to use the RRA would, by default, be subject to tax on the full returns.

Ordinary bank and building society accounts should just face a straightforward TEE system—saved out of taxed earnings and then no more tax applied. This is appropriate for assets on which 'supernormal' returns cannot be earned. Indeed, it would be inappropriate to apply an EET or RRA treatment to such assets because of the failure to tax financial services that this would imply.

The current consumption tax (EET) treatment of pensions should be maintained. This should be accompanied by the removal of the excessively generous, and distorting, treatment of employer contributions to pensions for NICs purposes. The tax-free lump sum is an odd method of providing an additional incentive for saving in a pension. There is a strong case for replacing it either with a reduction in the tax rate paid on pensions or with a government top-up to the fund that is annuitized.

The combination of reforms that we consider would result in a savings-neutral tax system for most taxpayers. It would increase taxes on some—those who benefit from generous CGT treatment, those who benefit from employer pension contributions, and, perhaps, those who are very lucky or skilled in their stock-picking. It would reduce taxes for others—those reliant on cash savings and those with substantial stocks of shares or similar assets held outside ISAs.

Finally, we have looked at the difficult issue of the degree of 'tax-smoothing' that the system should allow and at the impact of means-tested benefits on saving incentives. With a tax system in which tax rates increase with incomes, EET and RRA regimes have different implications for tax payments depending on the pattern of income receipts. EET regimes, such as the pension tax system, favour those saving when incomes (tax rates) are high to consume when incomes (tax rates) are lower. RRA (or TEE) regimes do the reverse. The free existence of both, alongside a consumption tax treatment of borrowing, would allow full tax-smoothing. That is, people with variable earnings would be able to arrange their affairs so as to pay the tax that they would have done had their earnings been the same in total and spread evenly across years. Full tax-smoothing would allow us to tax a measure of lifetime income.

Our proposals—allowing a combination of RRA and TEE treatment for some assets and an EET treatment of pensions—would get us some of the way towards a lifetime base. But they would help neither those who would benefit from an EET treatment of pre-retirement saving, nor those who need an EET treatment of borrowing in order to achieve smoothing. While reform to achieve a lifetime base may not be an immediate priority, there is a strong case for considering it a benchmark for future reform.

The interaction with the means-tested benefit system, though, creates formidable problems. If benefit entitlements are reduced in the face of accumulated savings, the incentive to save is reduced. Most people who are saving are not entitled to benefits while they contribute, and so ignoring savings contributions for benefit purposes does not create the desired neutrality. The effect can be that a saver with a relatively low lifetime income can face a high effective tax rate. While there are ways of bringing greater coherence to the current interactions between savings and means-tested benefits, none of them, as far as we can see, is likely to take us very far down the road to a savings-neutral system in respect of means-testing.