The effects of taxes and charges on saving incentives in the UK

Stuart Adam and Jonathan Shaw

Report launch, IFS, 16 February 2016

Institute for Fiscal Studies

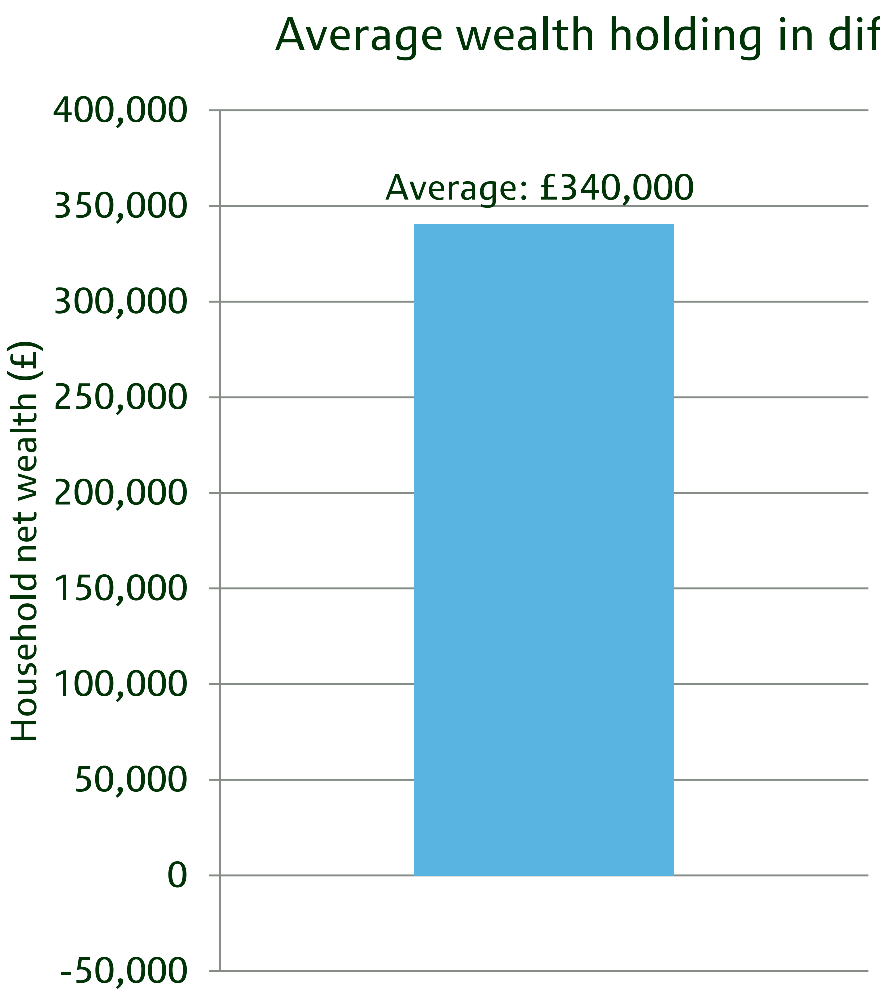
The current system

Jonathan Shaw

What we do

- Describe the forms in which wealth is held
- Set out the effects of taxation on current saving incentives
- Describe how things have changed in recent years
- Consider the implications of a number of future reforms
- Analyse the effect of two non-tax features
  - Employer matching of pension contributions
  - Fund charges

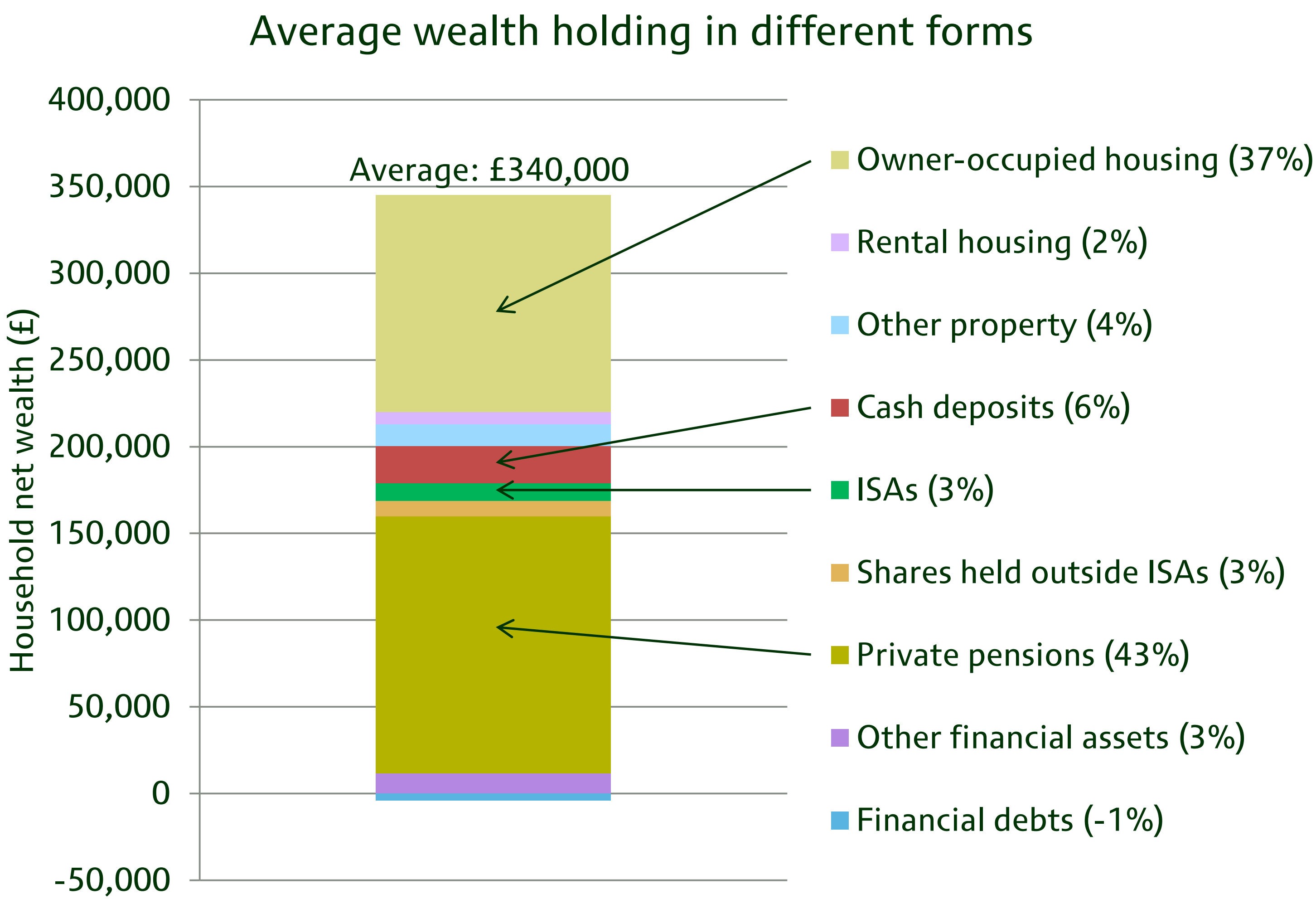
Wealth is mainly held in pensions and owner-occupied housing



Note: Weighted sample of all households interviewed in the WAS in 2010–12.
Source: Figure 2.3 in report.

Institute for Fiscal Studies

Wealth is mainly held in pensions and owner-occupied housing



Note: Weighted sample of all households interviewed in the WAS in 2010–12.
Source: Figure 2.3 in report.

A framework for thinking about the effect of taxation on saving incentives

- Three components of savings that may be taxed (T) or exempt (E)
  - Income saved
  - Returns generated
  - Funds withdrawn
- Thus
  - A regular bank account is TTE
  - ISA is TEE
  - Pensions are broadly EET

Measuring the effect of taxation on saving incentives

- Effective tax rate (ETR)
  - Percentage reduction in the annual real rate of return on the asset
  - ETRs are expressed relative to a TEE (ISA-treatment) baseline
- ‘Required contribution’
  - The amount one would have to save in order to match the final wealth from investing 100p in the TEE benchmark
- Higher numbers mean weaker incentives under both measures

Institute for Fiscal Studies

Which assets do we include?

- Assets we consider:
  - ISAs (cash and shares)
  - Cash deposit accounts
  - Employee and employer pension contributions
  - Owner-occupied housing and rental housing
  - Taxable shareholdings
- Some assets we exclude:
  - Assets in one's own business
  - Employee share schemes
  - National Savings products
  - Life insurance products

Institute for Fiscal Studies

Assumptions

- Real return of 3% for all assets and an inflation rate of 2%
  - Aim is to facilitate comparison of the effects of taxes
- For assets that yield both capital gains and income, we assume that capital gains match inflation and the real return accrues as income
- Capital gains and income are above the relevant allowances
- Which taxes do we include?
  - Included: income tax, National Insurance contributions (NICs), capital gains tax (CGT) and means-tested benefits/tax credits
  - Excluded: corporate taxes, stamp duties, inheritance tax and council tax
- Focus on 2015-16 tax system

There is wide variation in how different assets are treated for a basic-rate taxpayer

ETRs and required contributions for a basic-rate taxpayer

Asset	*ETR (%)*	*Required contrib. (p)*

Source: Table 4.2 in report.

Institute for Fiscal Studies

There is wide variation in how different assets are treated for a basic-rate taxpayer

ETRs and required contributions for a basic-rate taxpayer

Asset		*ETR (%)*	*Required contrib. (p)*
ISA (cash or shares)	Any horizon	0	100

Source: Table 4.2 in report.

There is wide variation in how different assets are treated for a basic-rate taxpayer

ETRs and required contributions for a basic-rate taxpayer

Asset		*ETR (%)*	*Required contrib. (p)*
ISA (cash or shares)	Any horizon	0	100
Cash deposit account	1 year	33	101
	10 years	33	110
	25 years	33	127

Source: Table 4.2 in report.

Institute for Fiscal Studies

There is wide variation in how different assets are treated for a basic-rate taxpayer

ETRs and required contributions for a basic-rate taxpayer

Asset		*ETR (%)*	*Required contrib. (p)*
ISA (cash or shares)	Any horizon	0	100
Cash deposit account	1 year	33	101
	10 years	33	110
	25 years	33	127
Employee pension contribution	10 years	-21	94
	25 years	-8	94

Source: Table 4.2 in report.

There is wide variation in how different assets are treated for a basic-rate taxpayer

ETRs and required contributions for a basic-rate taxpayer

Asset		*ETR (%)*	*Required contrib. (p)*
ISA (cash or shares)	Any horizon	0	100
Cash deposit account	1 year	33	101
	10 years	33	110
	25 years	33	127
Employee pension contribution	10 years	-21	94
	25 years	-8	94
Employer pension contribution	10 years	-123	70
	25 years	-49	70

Source: Table 4.2 in report.

Institute for Fiscal Studies

There is wide variation in how different assets are treated for a basic-rate taxpayer

ETRs and required contributions for a basic-rate taxpayer

Asset		*ETR (%)*	*Required contrib. (p)*
ISA (cash or shares)	Any horizon	0	100
Cash deposit account	1 year	33	101
	10 years	33	110
	25 years	33	127
Employee pension contribution	10 years	-21	94
	25 years	-8	94
Employer pension contribution	10 years	-123	70
	25 years	-49	70
Owner-occupied housing	Any horizon	0	100

Source: Table 4.2 in report.

Institute for Fiscal Studies

There is wide variation in how different assets are treated for a basic-rate taxpayer

ETRs and required contributions for a basic-rate taxpayer

Asset		*ETR (%)*	*Required contrib. (p)*
ISA (cash or shares)	Any horizon	0	100
Cash deposit account	1 year	33	101
	10 years	33	110
	25 years	33	127
Employee pension contribution	10 years	-21	94
	25 years	-8	94
Employer pension contribution	10 years	-123	70
	25 years	-49	70
Owner-occupied housing	Any horizon	0	100
Rental housing	10 years	30	109
	25 years	28	122

Source: Table 4.2 in report.

Institute for Fiscal Studies

There is wide variation in how different assets are treated for a basic-rate taxpayer

ETRs and required contributions for a basic-rate taxpayer

Asset		*ETR (%)*	*Required contrib. (p)*
ISA (cash or shares)	Any horizon	0	100
Cash deposit account	1 year	33	101
	10 years	33	110
	25 years	33	127
Employee pension contribution	10 years	-21	94
	25 years	-8	94
Employer pension contribution	10 years	-123	70
	25 years	-49	70
Owner-occupied housing	Any horizon	0	100
Rental housing	10 years	30	109
	25 years	28	122
Taxable shareholdings	1 year	12	100
	10 years	10	103
	25 years	7	105

Source: Table 4.2 in report.

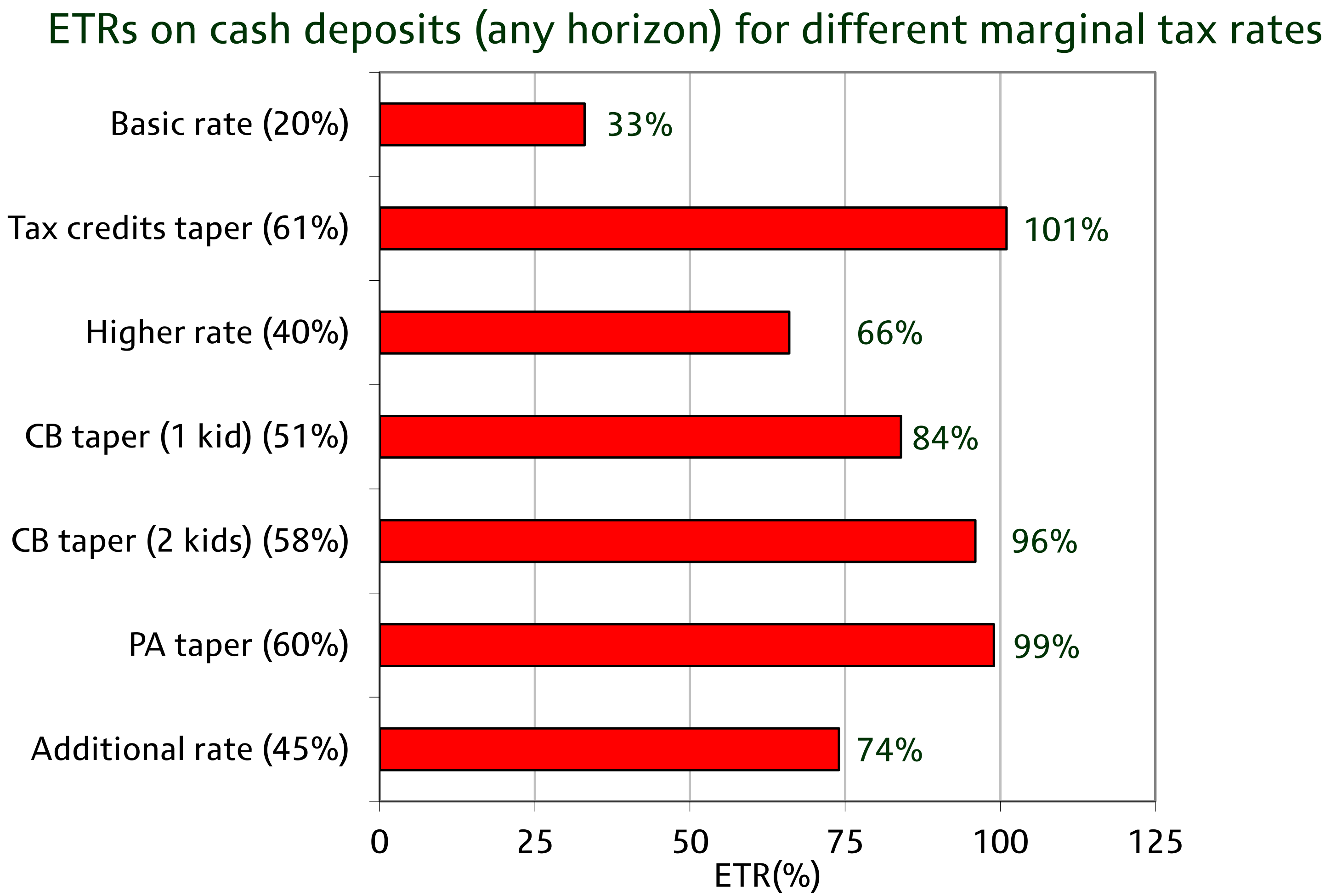
Taxpayers face different marginal rates

UK adult population in 2015-16

All adults	52.7m
Non taxpayers (0%)	23.0m
Basic-rate taxpayers (20%)	24.7m
Higher-rate taxpayers (40%)	4.7m
Additional-rate taxpayers (45%)	0.3m

- But there are complications
- Personal allowance taper between £100k and £121k creates 60% rate (250k-400k individuals)
- Means-testing of benefits
  - Child benefit taper between £50k and £60k creates 51% rate for 1-child families and 58% rate for 2-child families (300k individuals)
  - Tax credits taper (3.9m individuals) creates 61% rate for basic-rate taxpayers

Incentives to save are generally weaker for individuals facing higher marginal rates



Source: Based on Table 4.6 in report.

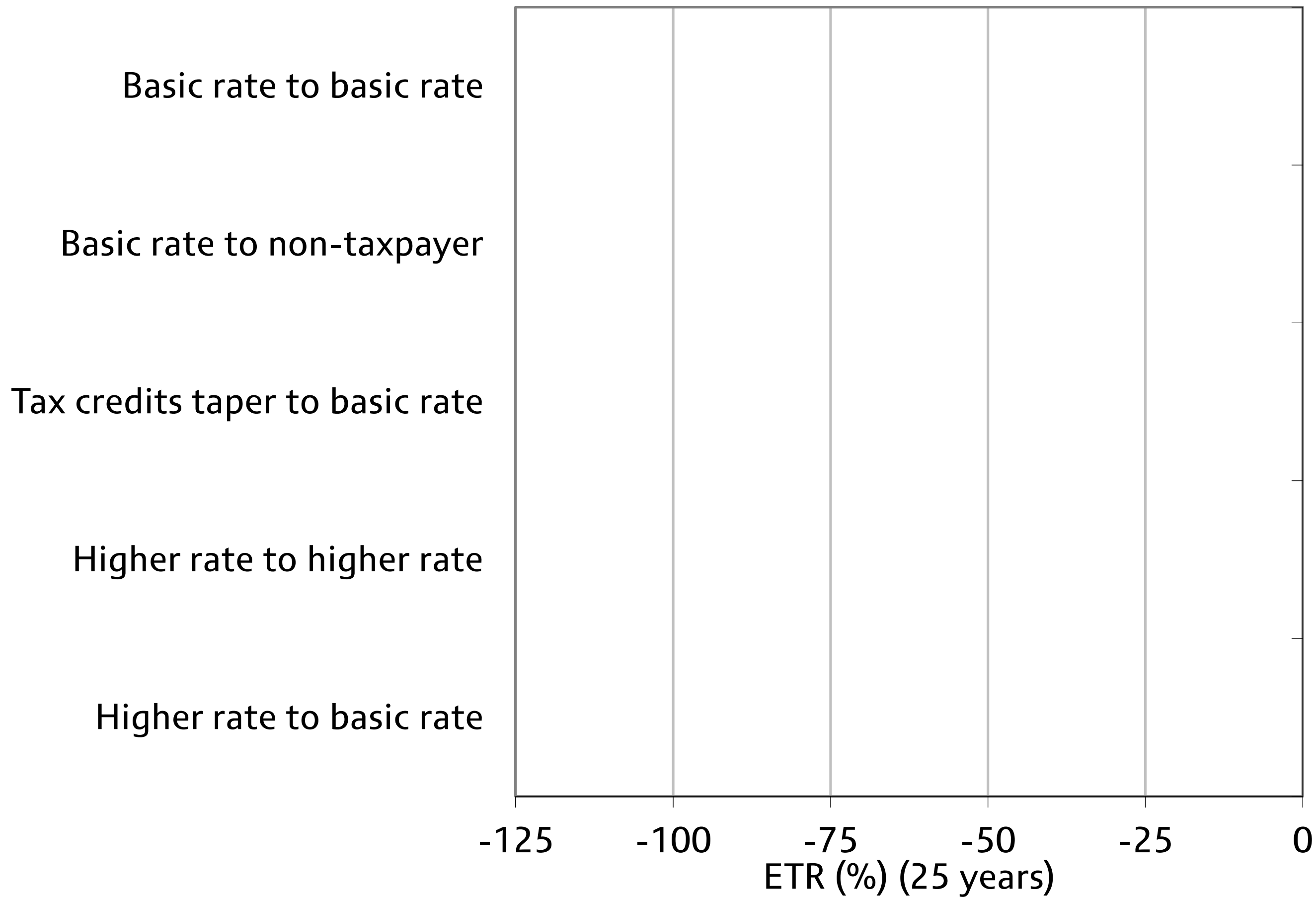
Institute for Fiscal Studies

Story is different for pension contributions

- For employee pension contributions, the incentive to save is stronger for individuals facing higher marginal rates
- But movements between tax rates likely to be particularly important
- Simulations based on previous work suggest that
  - Basic-rate taxpayers spend almost half of retirement as non-taxpayers on average
  - Higher-rate taxpayers are typically basic-rate taxpayers in retirement

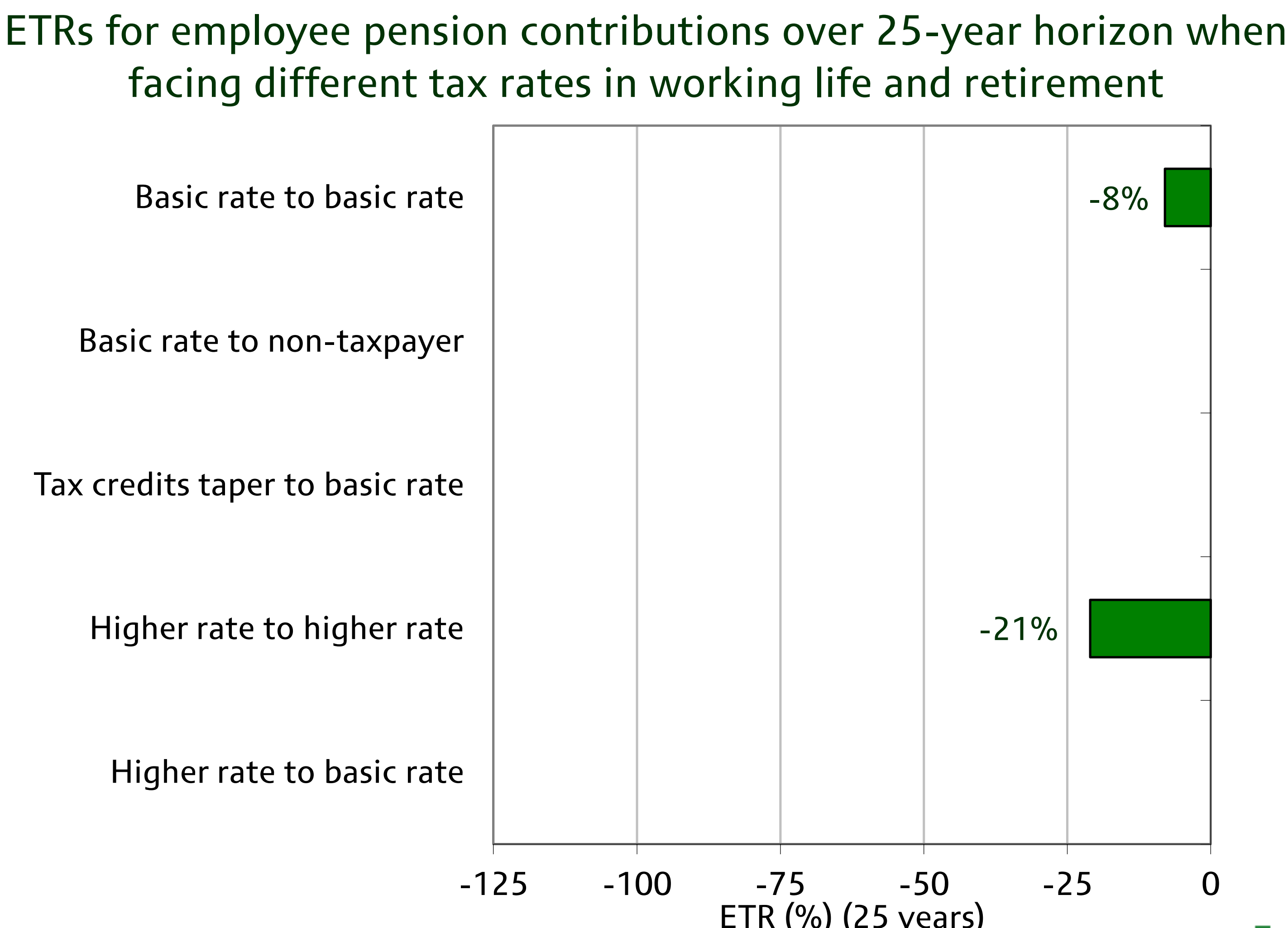
Having different tax rates in work and retirement can dramatically affect incentives

ETRs for employee pension contributions over 25-year horizon when facing different tax rates in working life and retirement



Source: Based on Table 4.10 in report.

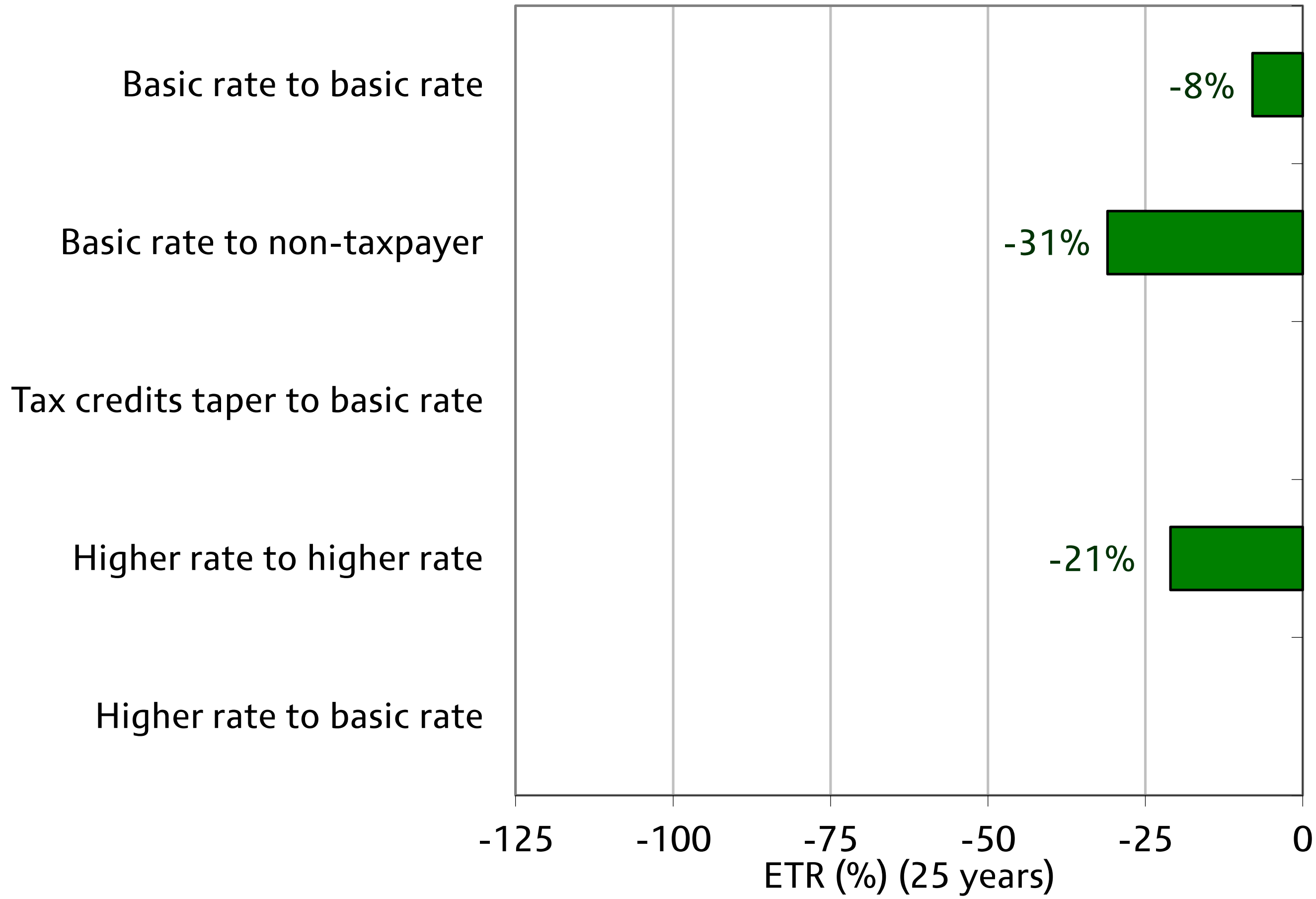
Having different tax rates in work and retirement can dramatically affect incentives



Source: Based on Table 4.10 in report.

Having different tax rates in work and retirement can dramatically affect incentives

ETRs for employee pension contributions over 25-year horizon when facing different tax rates in working life and retirement

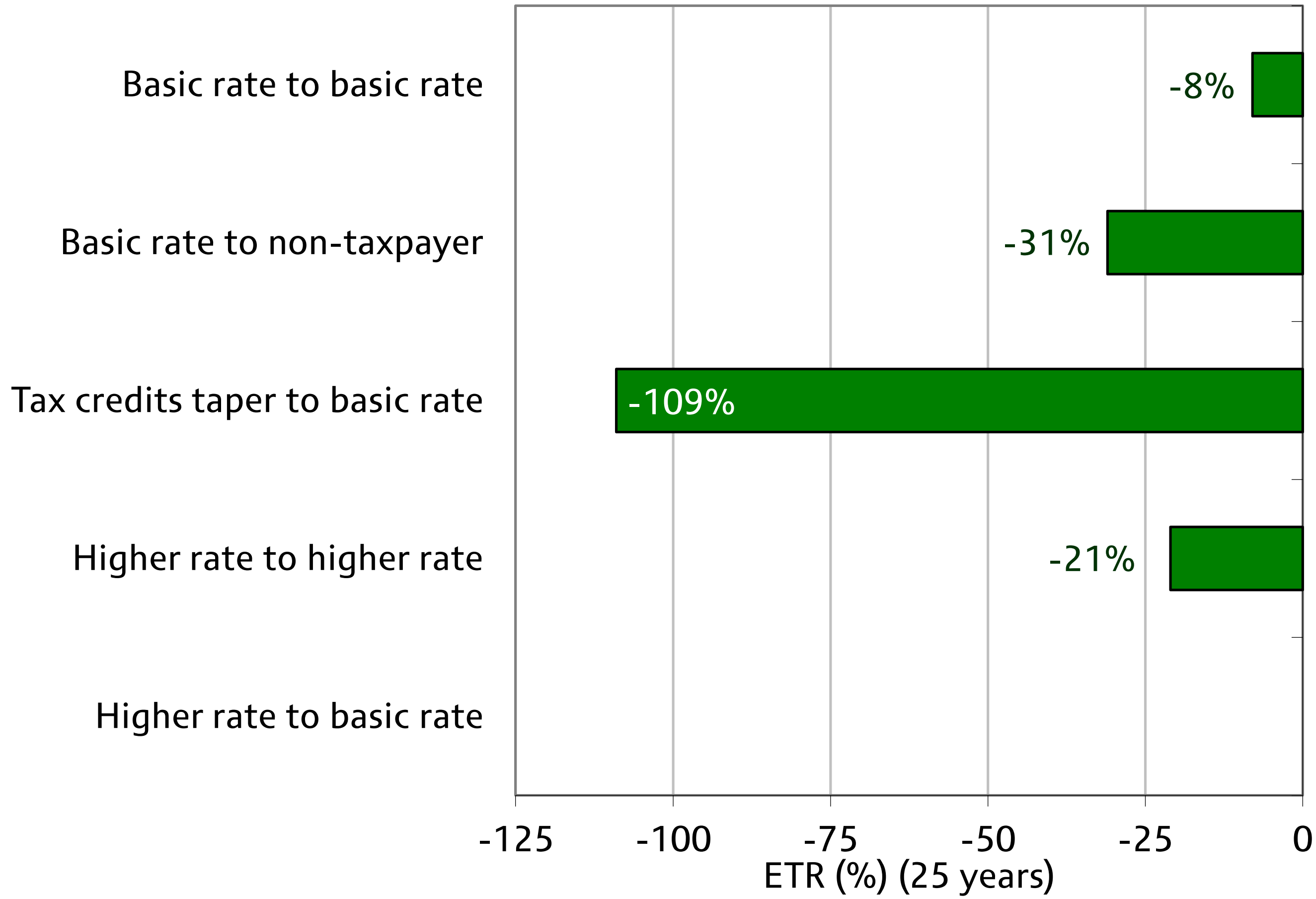


Source: Based on Table 4.10 in report.

Institute for Fiscal Studies

Having different tax rates in work and retirement can dramatically affect incentives

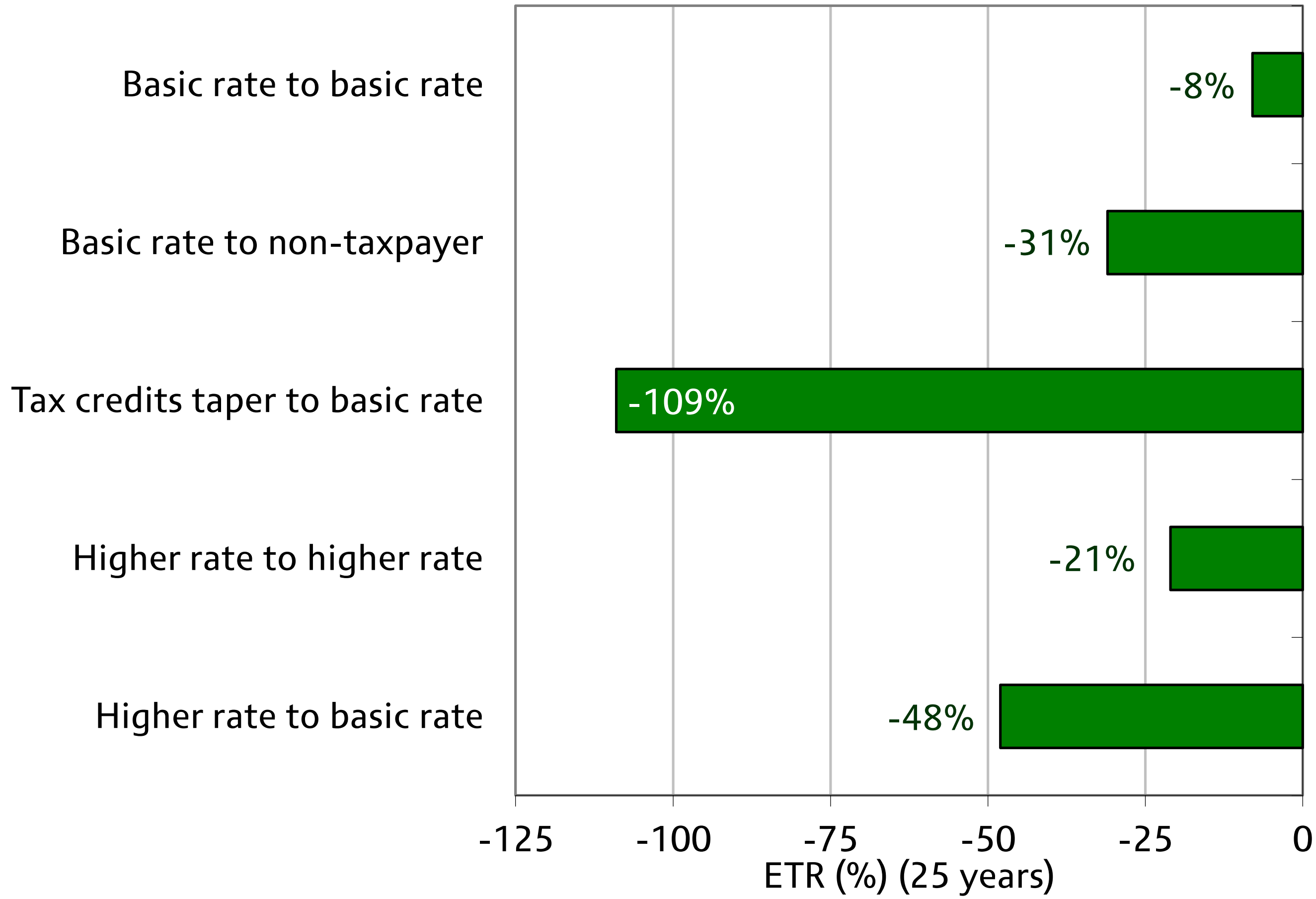
ETRs for employee pension contributions over 25-year horizon when facing different tax rates in working life and retirement



Source: Based on Table 4.10 in report.

Having different tax rates in work and retirement can dramatically affect incentives

ETRs for employee pension contributions over 25-year horizon when facing different tax rates in working life and retirement



Source: Based on Table 4.10 in report.

Effect of recent reforms

- Incentive measures have barely changed since 2008-09
- But their applicability has changed a lot
- Limits for saving in different assets
  - Substantial increase in ISA limits
  - Large reductions in pension limits
- Changes in the number of non-, basic-rate and higher-rate taxpayers
  - Big increases in personal allowance
  - Big reductions in higher-rate threshold
- Extra marginal rates
  - 45% additional rate introduced
  - Personal allowance taper introduced
  - Child benefit withdrawn
- Sets the stage for even bigger reforms to come

Institute for Fiscal Studies

Future reforms and non-tax aspects

Stuart Adam

Outline

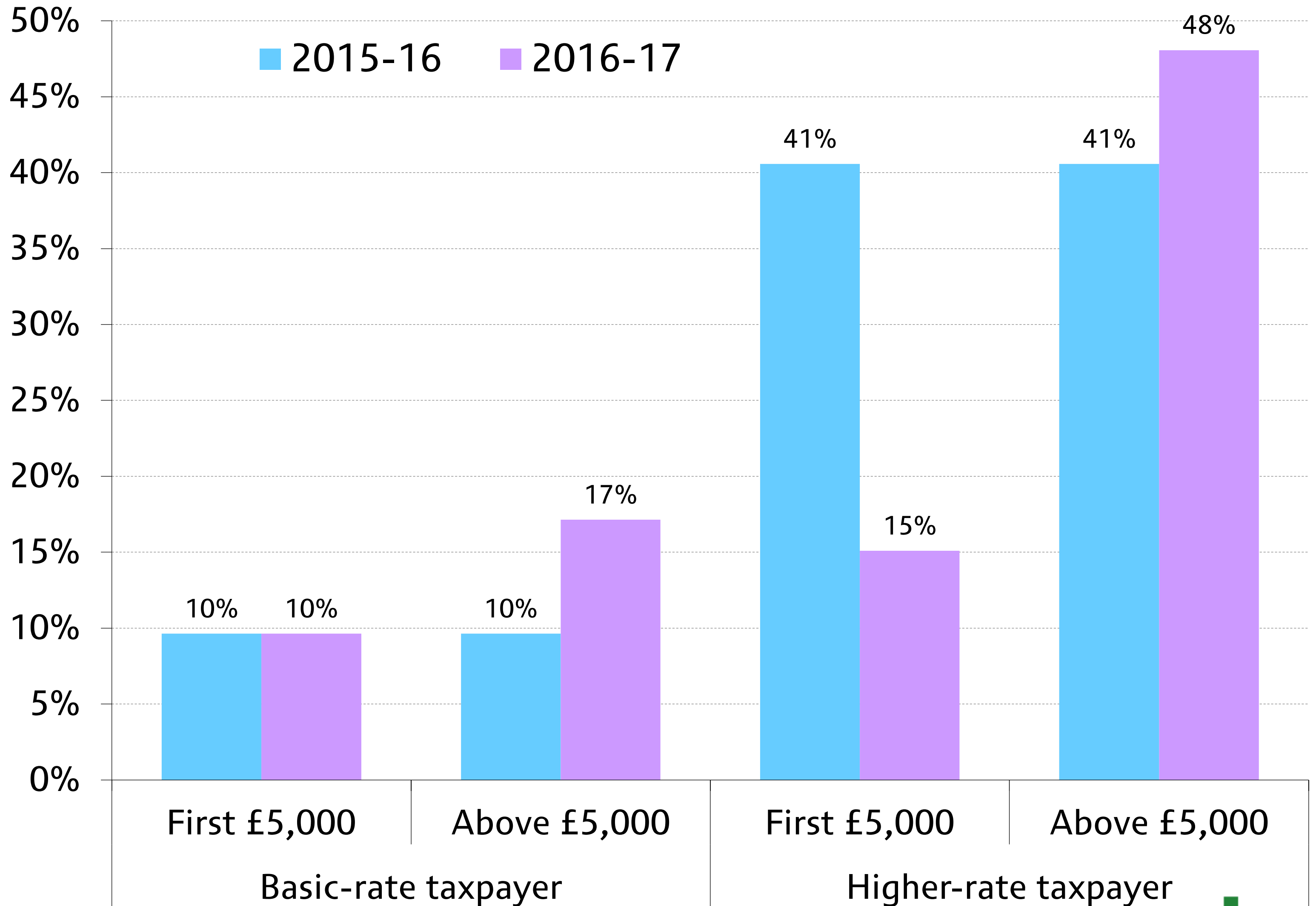
- Future reforms, announced or being considered, to taxation of:
  - Interest
  - Dividends
  - Rental housing
  - Pensions
- Universal credit

- Two non-tax factors in saving incentives:
  - Employer matching of pension contributions
  - Charges and fees

Personal savings allowance

- From 2016–17, no tax on first £1,000 of interest income for basic-rate taxpayers, £500 for higher-rate, £0 for additional-rate
- No tax on interest income for 95% of taxpayers
  - More than 16m people taken out of tax on interest
  - And many with low incomes will stop being wrongly taxed
- Cash ISAs only valuable if expect that in future:
  - Might be additional-rate taxpayer
  - Will have lots of cash savings
  - Interest rates will be much higher
  - Policy will change again

ETR on 10-year investment in shares



Institute for Fiscal Studies

The benefits of diversification

- From 2016–17 there will be separate allowances for:
  - Interest
  - Dividends
  - Capital gains
  - …as well as the income tax personal allowance

- If use all of them, can receive over £28,000 a year free of tax

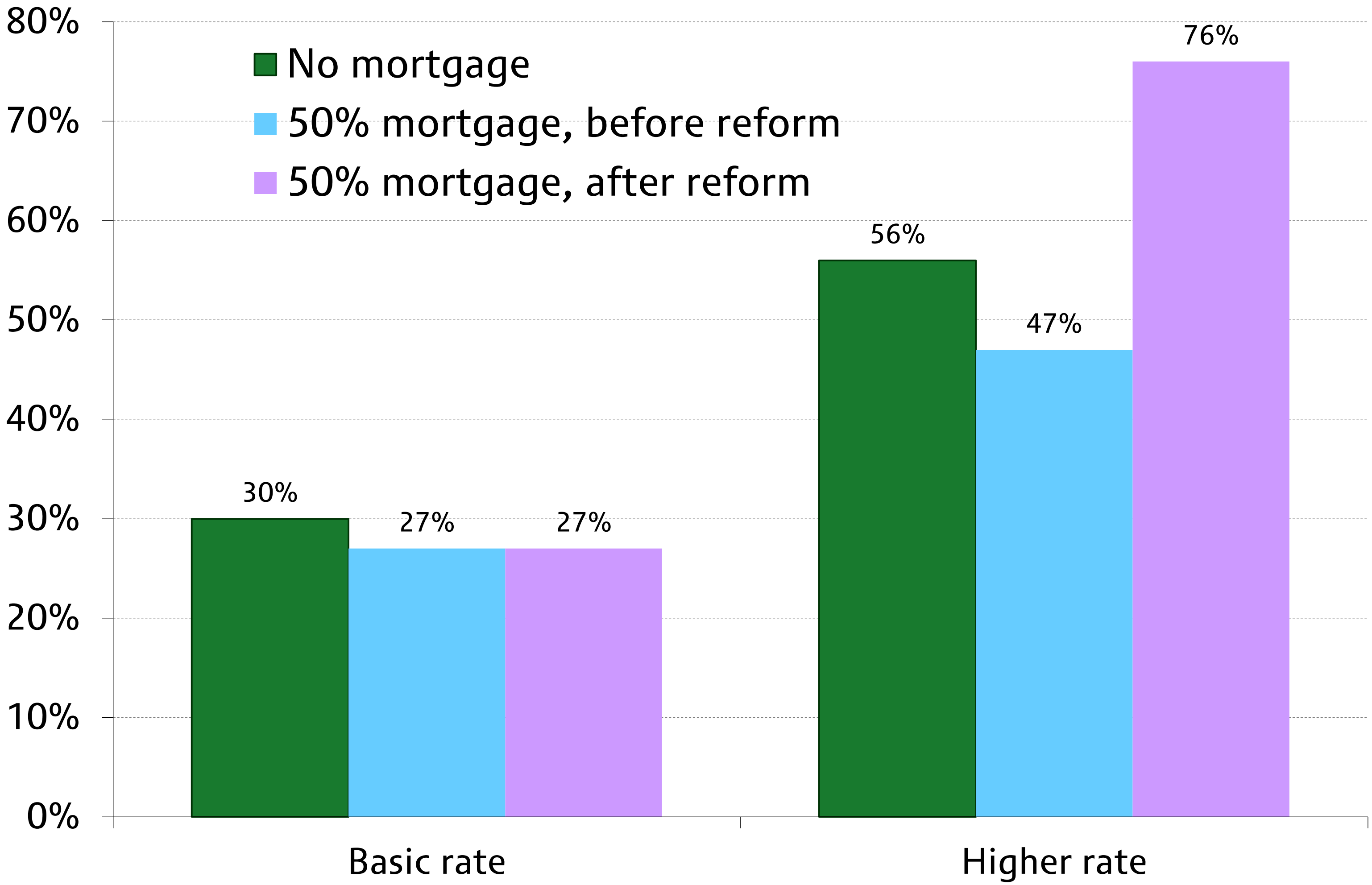
- Why favour people who receive money in a variety of forms?

Mortgage interest relief for rental property

- Deductibility of landlords' finance costs to be replaced by a tax credit equal to 20% of costs
  - Phased in over 4 years from April 2017

- George Osborne, July 2015 Budget speech: 'landlords have a huge advantage in the market as they can offset their mortgage interest payments against their income, whereas homebuyers cannot.'

ETR on 10-year buy-to-let investment



Institute for Fiscal Studies

Mortgage interest relief for rental property

- Deductibility of landlords' finance costs to be replaced by a tax credit equal to 20% of costs
  - Phased in over 4 years from April 2017
- George Osborne, July 2015 Budget speech: 'landlords have a huge advantage in the market as they can offset their mortgage interest payments against their income, whereas homebuyers cannot.'
- Exacerbates tax bias towards owner-occupation
- On top of inheritance tax main residence allowance and 3ppt SDLT increase except for main residences
  - Not included in our calculations

Possible reforms to pension taxation

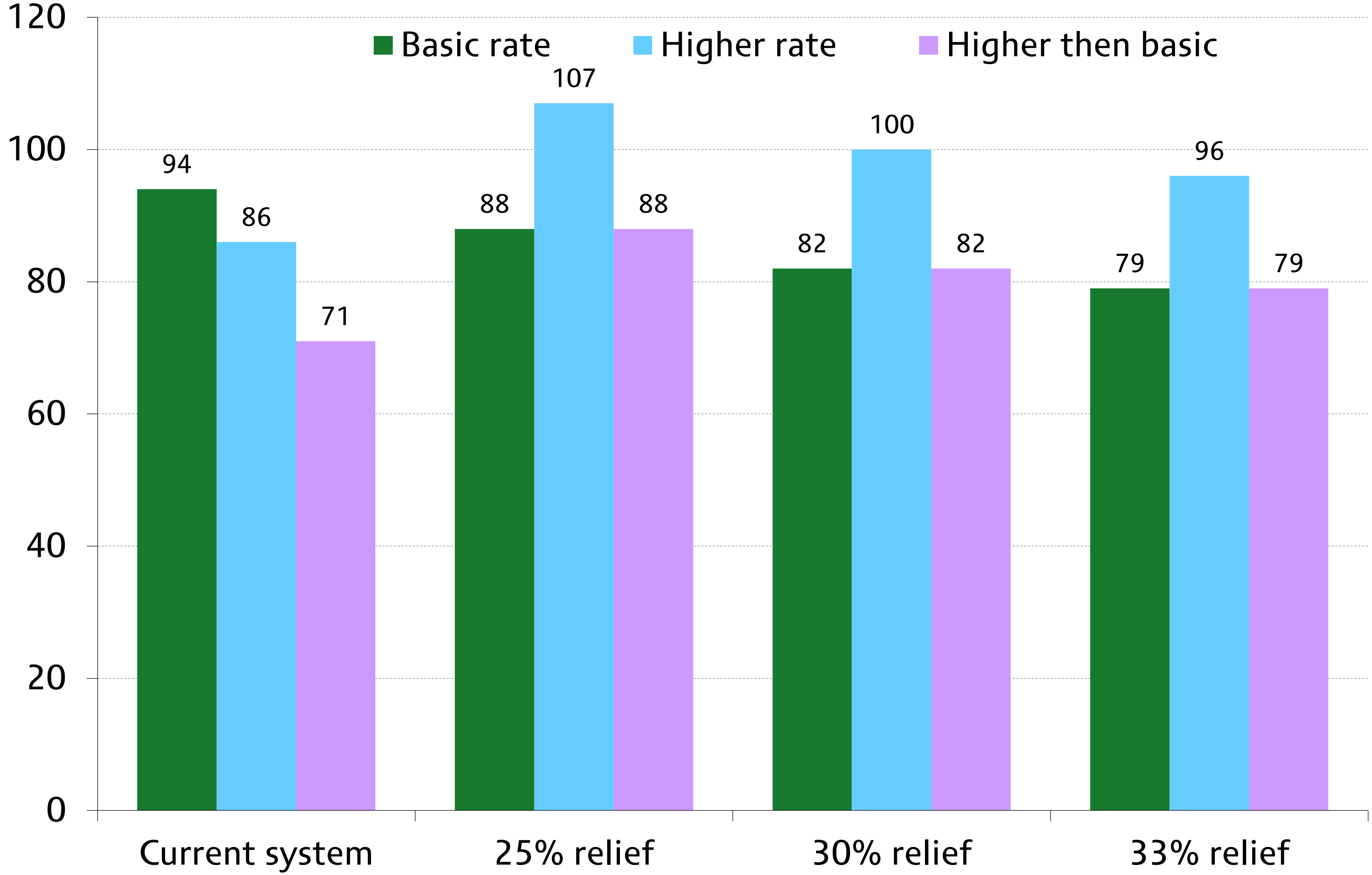
- Budget expected to follow up on consultation on pension taxation

- Two main options for major reform:

1. Replace income tax relief at marginal rate with flat-rate relief
   - We model rates of 25%, 30% and 33%
   - Assume 25% tax-free lump sum remains in place
2. TEE: no income tax relief on contributions or tax on pension income
   - Presumably with upfront match to replace tax-free lump sum: we model 0%, 5% 10% and 20%

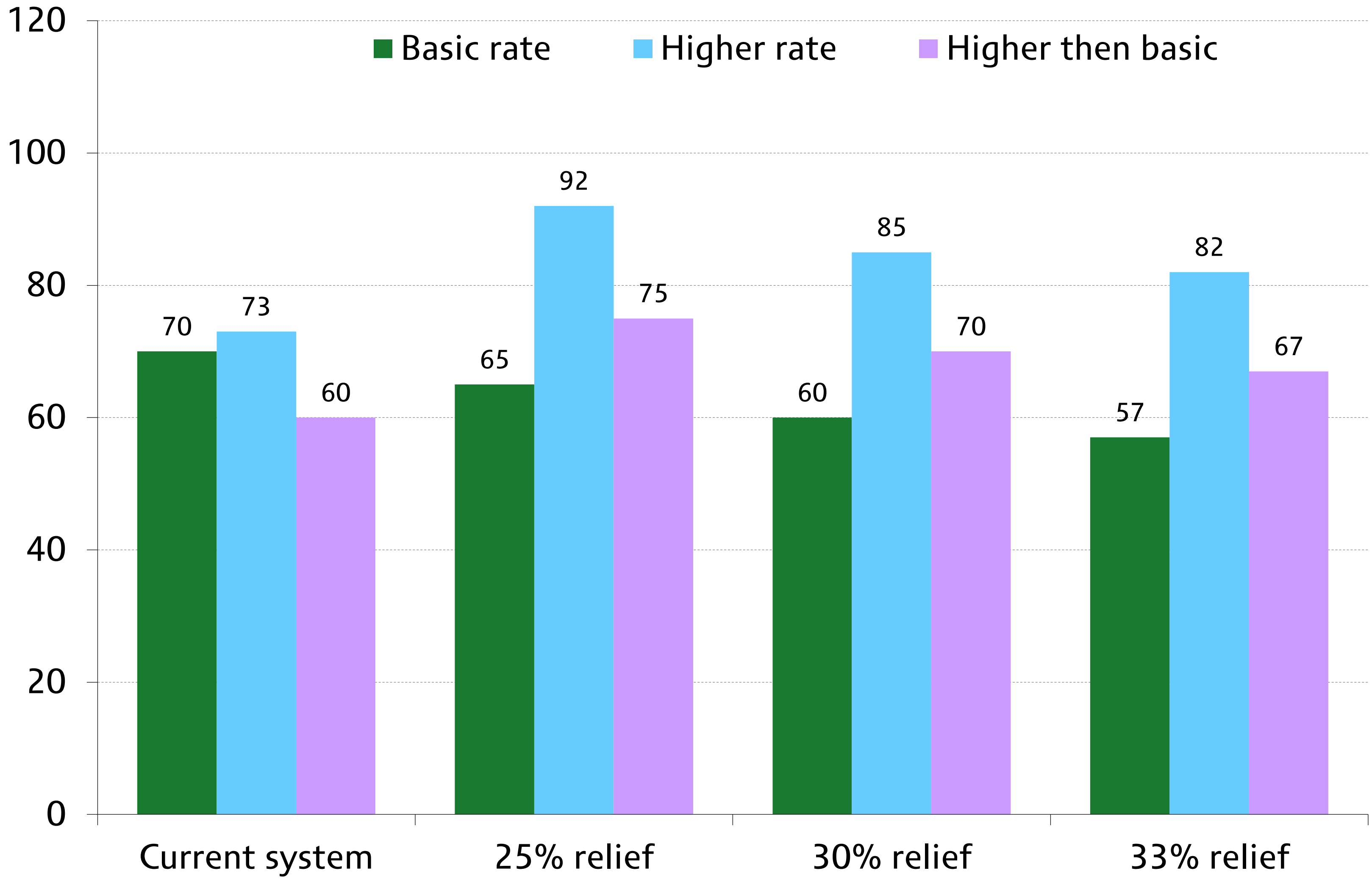
- We assume no changes to NICs regime

Employee pension contribution required to match 100 in an ISA: effect of moving to flat-rate relief



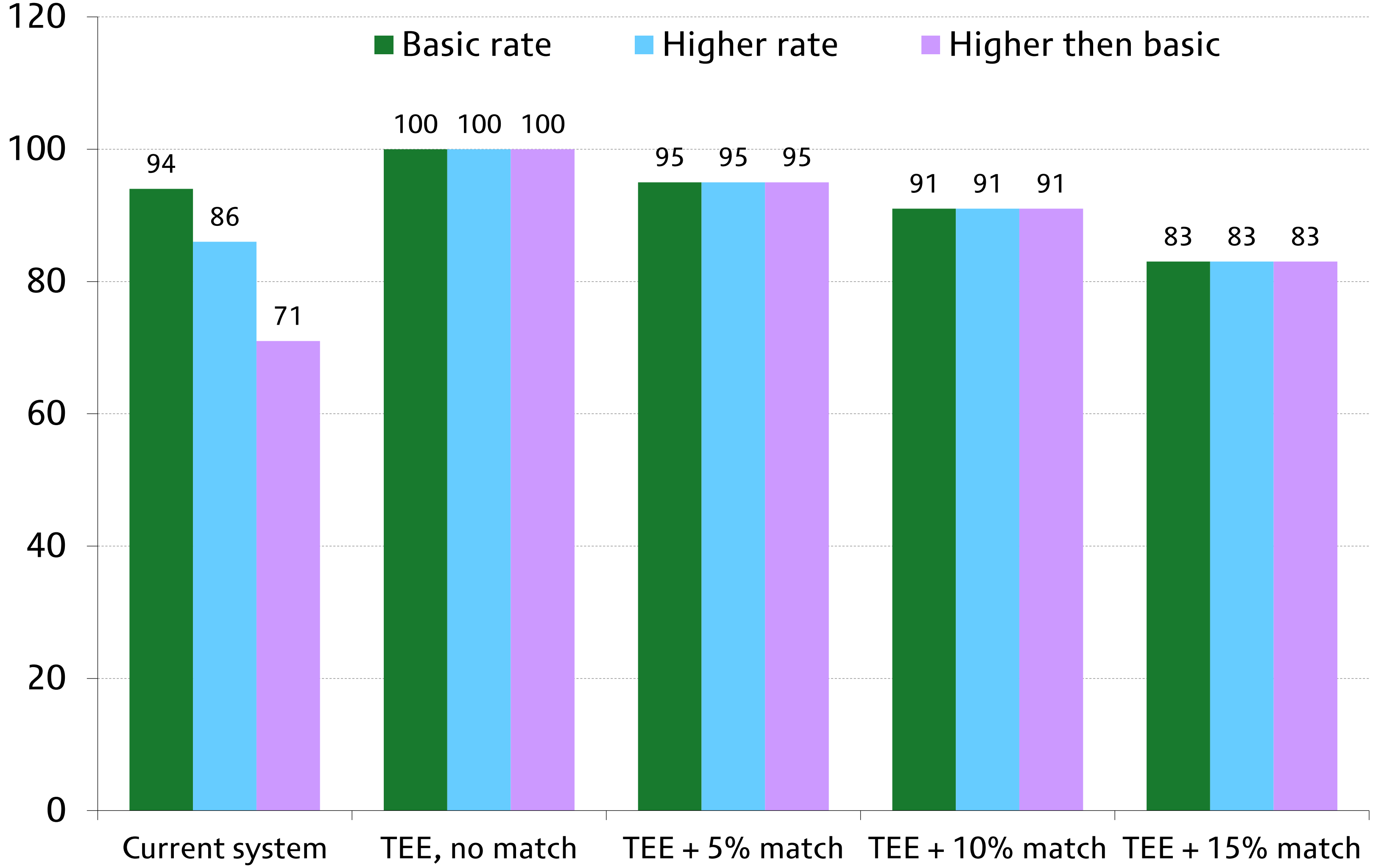
Institute for Fiscal Studies

Employer pension contribution required to match 100 in an ISA: effect of moving to flat-rate relief

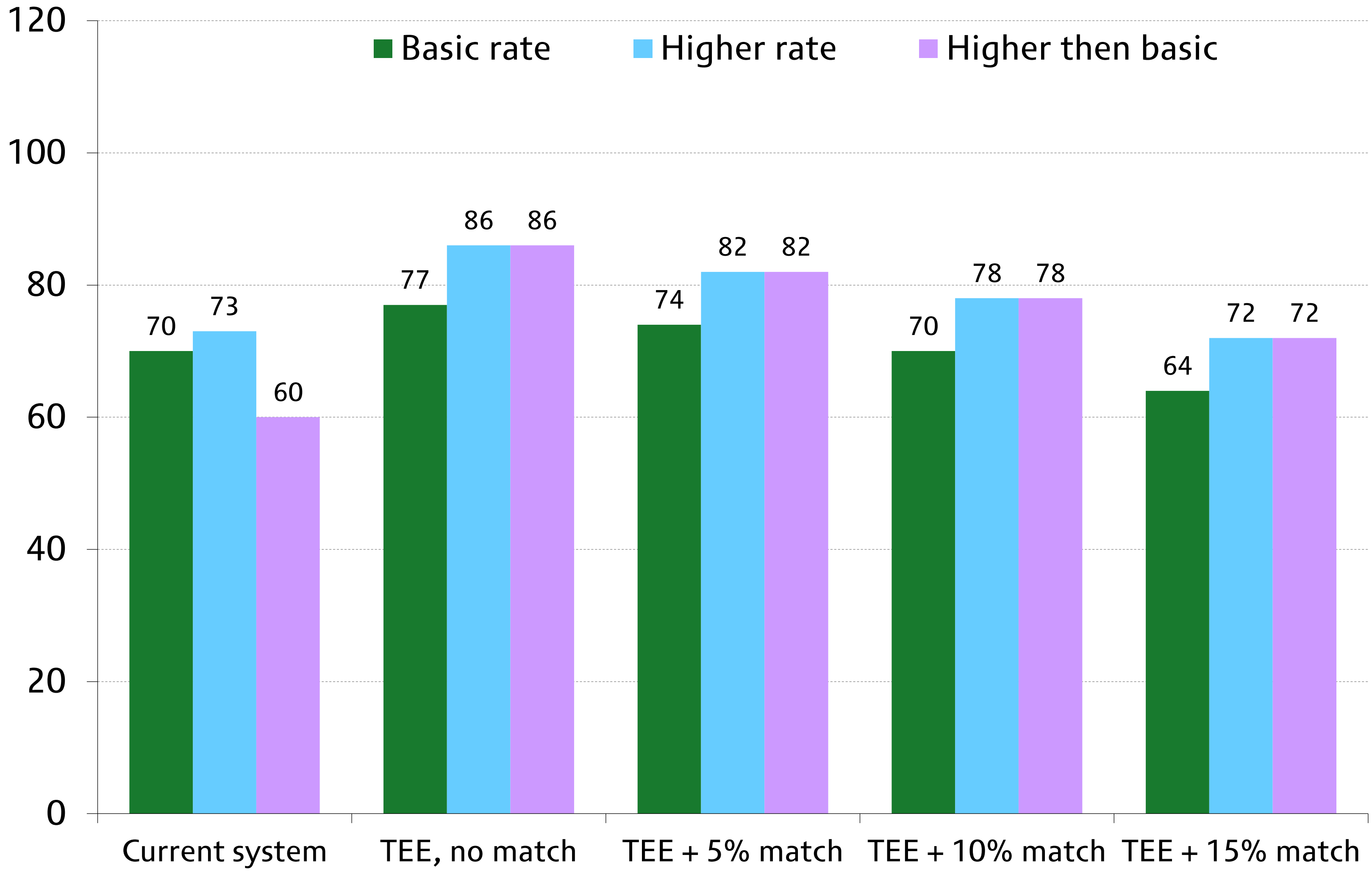


Institute for Fiscal Studies

Employee pension contribution required to match 100 in an ISA: effect of moving to TEE regime



Employer pension contribution required to match 100 in an ISA: effect of moving to TEE regime



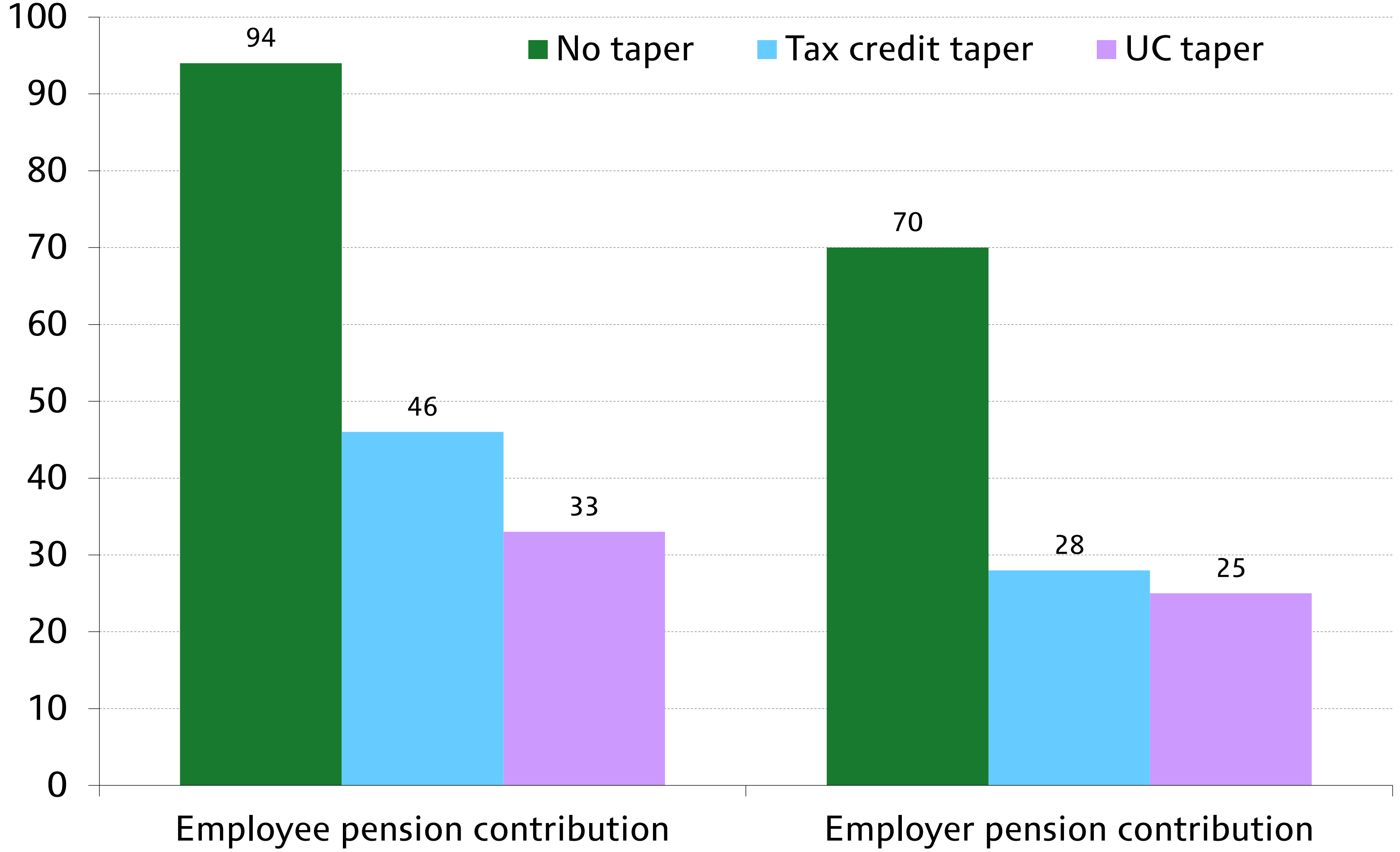
Institute for Fiscal Studies

Universal credit

- UC replacing six means-tested working-age benefits and tax credits
  - Currently in the early stages of roll-out
- Each £1 of pension contributions increases entitlement by 52p for basic-rate taxpayers facing UC withdrawal
  - vs. 41p under tax credits ➔ stronger incentive to contribute to pension
  - …if in a position to save while requiring means-tested support

Contribution required to match 100 in ISA

Basic-rate taxpayer



Institute for Fiscal Studies

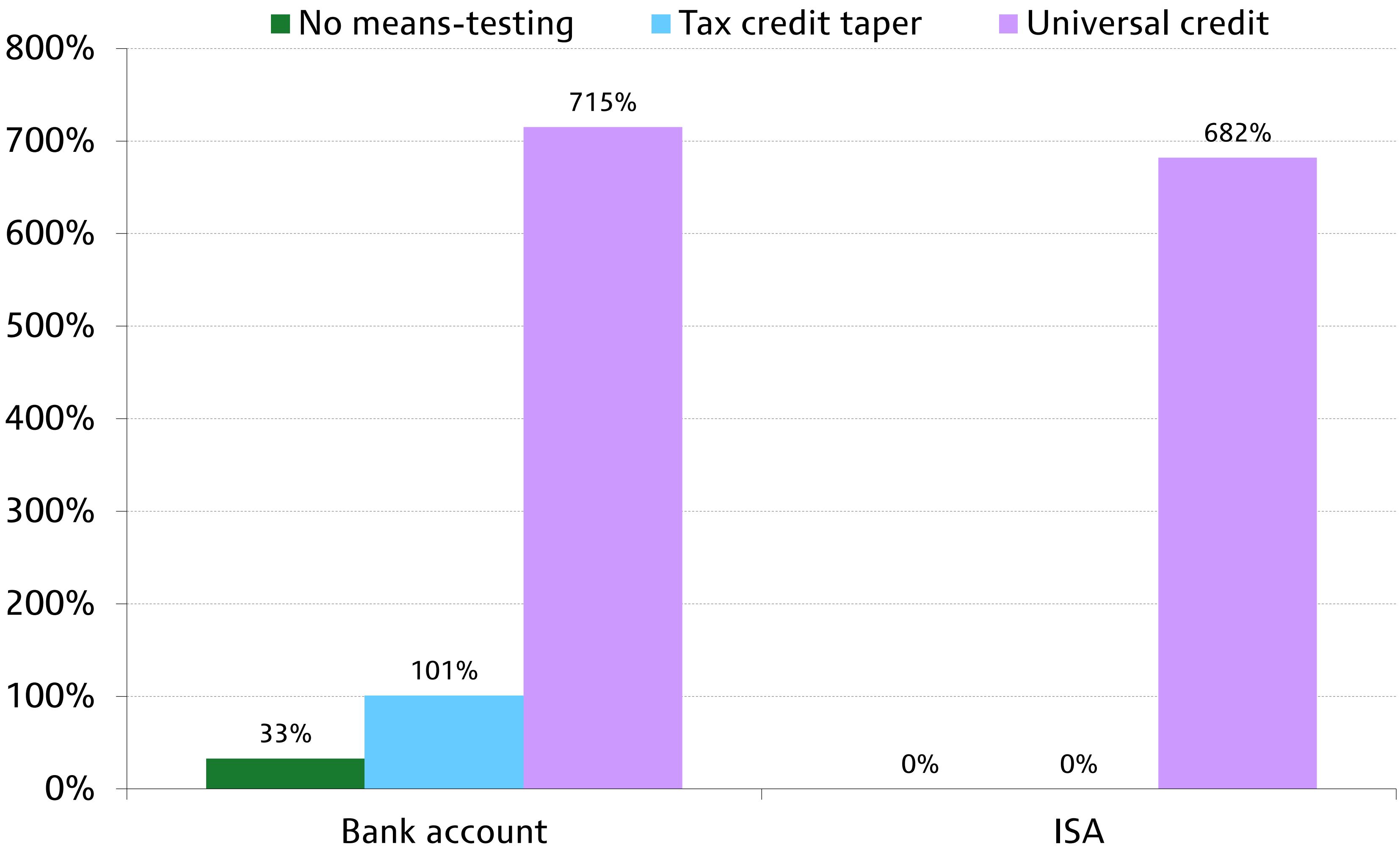
Universal credit

- UC replacing six means-tested working-age benefits and tax credits
  - Currently in the early stages of roll-out
- Each £1 of pension contributions increases entitlement by 52p for basic-rate taxpayers on UC taper
  - vs. 41p under tax credits ➔ stronger incentive to contribute to pension
  - …if in a position to save while requiring means-tested support
- First £6,000 of (non-pension, non-housing) assets ignored…
  - So no disincentive to save up to that amount
- …but assets between £6,000 and £16,000 reduce UC sharply…
  - Assumed to earn 21% annual return
  - Each £1 of assumed return reduces entitlement by £1
- …and assets above £16,000 remove entitlement completely

➢ Strong disincentive to save >£6,000 if expect to be on UC

Effective tax rates on cash savings above £6,000

Basic-rate taxpayer



Institute for Fiscal Studies

The direction of policy

Government's apparent vision for savings tax policy:

- Can save substantial amounts tax-free in a variety of forms
  - High ISA limits + additional allowances for interest, dividends and capital gains
- Owner-occupied housing tax-free
  - Ever more favoured relative to rental sector
- Increased pension flexibility within much reduced contribution limits
  - Contributions (especially by employers) remain generously subsidised
  - Lots of uncertainty about how this will be done

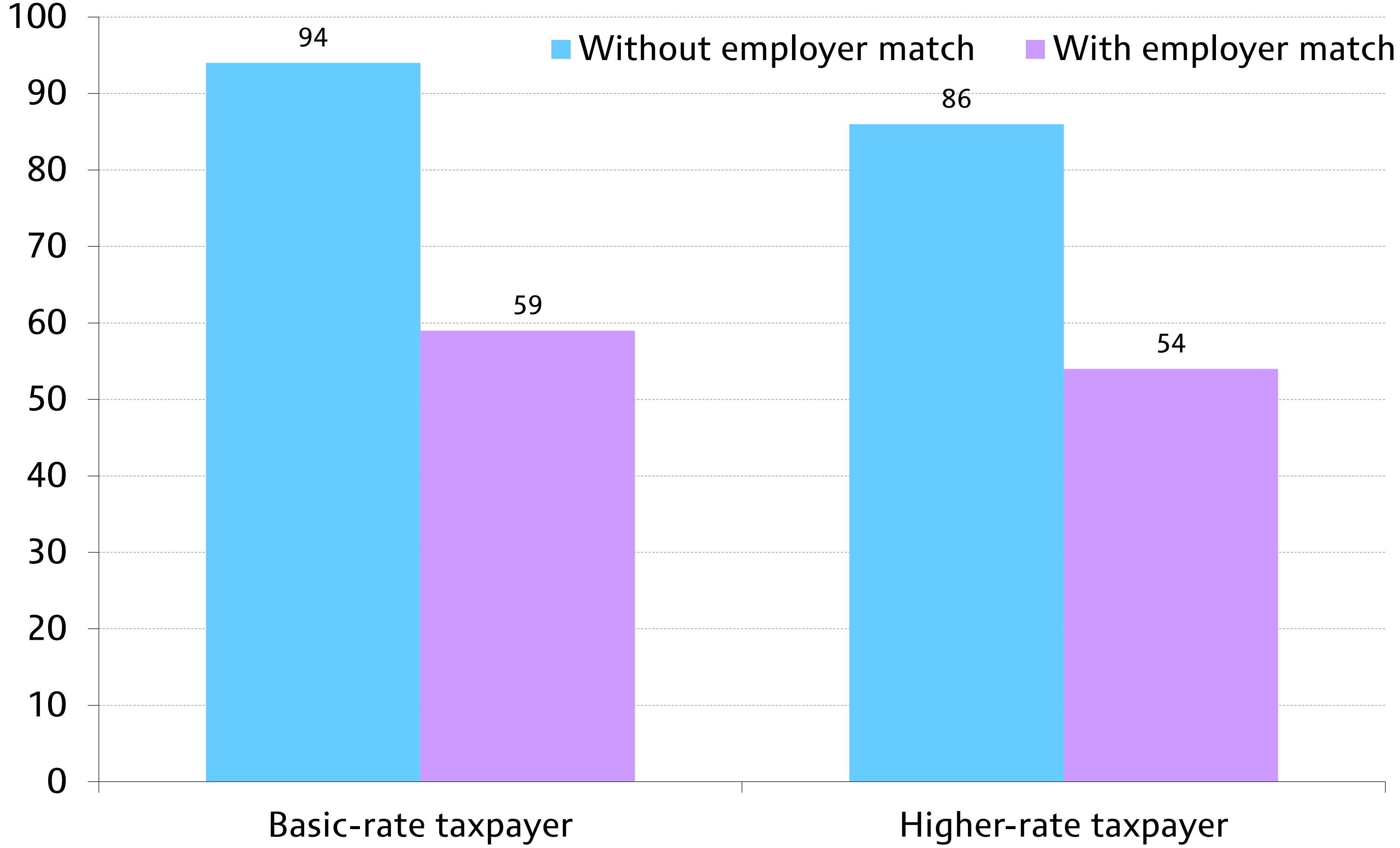
Questions remain about this approach, e.g. why so heavily favour

- Employer over employee pension contributions
- Owner-occupation over rental housing
- Splitting returns across different income sources

Employers matching pension contributions

- So far assumed employer contributions are in lieu of higher salary
- But employers will sometimes offer, *for a given salary*, to make a contribution if the employee does too
  - Don't make corresponding offers for other savings vehicles!
  - Strong incentive to save in a pension
- Auto-enrolment forces employers to do this unless employee opts out
  - Being phased in between October 2012 and April 2019
- Default scheme requires employers to pay in 3% of earnings if employee contribution + tax relief is at least 5% of earnings
  - '4-3-1' formula for basic-rate taxpayers; effectively 3-3-2 for higher-rate
  - Incentive for employee to pay in minimum; no incentive to pay in more

Employee pension contribution required to match 100 in ISA under auto-enrolment default



Institute for Fiscal Studies

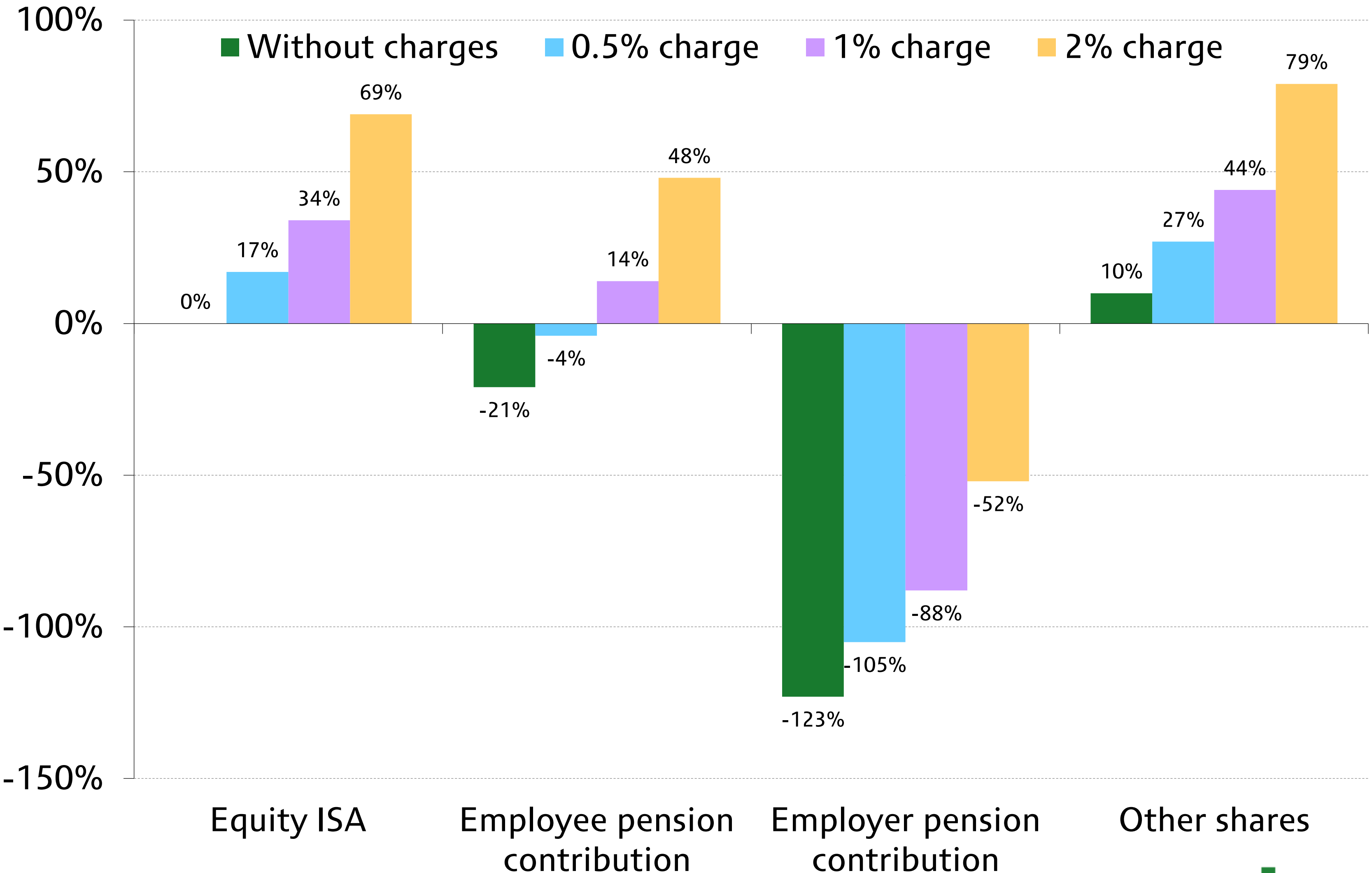
Charges and fees

- Consider range of illustrative annual charges from 0% to 3% of fund value
  - Comprehensive official data on distribution of charges no longer collected
  - Maximum for default auto-enrolment pension is 0.75%
  - Highest charges can be thought of as incorporating transaction costs

- Apply to pensions, equity ISAs and other equity funds
  - Charges on housing more complicated: lawyers’ fees, etc.
  - Charges on cash savings tend to be implicit in low interest rates

‘Effective tax rates’ including charges

Basic-rate taxpayer, 10-year investment



Institute for Fiscal Studies

Summary

- Effect of taxation on savings incentives varies widely
  - Between asset types – pensions most favoured, rental housing least
  - By amount saved – heavier taxation above thresholds
  - Between individuals with different marginal tax rates
- Means-testing matters as well as taxes
  - Universal credit has dramatic effects on saving incentives
  - How far will people respond to these?
- Charges can be more important than taxes
  - 1% charge broadly comparable to basic-rate tax on returns
  - Mustn't forget hidden charges
- All this, plus frequency of reform, makes it hard for savers to make good choices

The effects of taxes and charges on saving incentives in the UK

Stuart Adam and Jonathan Shaw

Report launch, IFS, 16 February 2016