PENSIONS POLICY INSTITUTE

PPI

Towards a Lifetime of Saving: Consultation response

Submitted by the Pensions Policy Institute in response to the Conservative Party consultation document *Towards a Lifetime of Saving* (July 2004)

10 September 2004

Summary

- It is not clear whether the LiSA would replace or supplement existing tax incentives for pension saving

- Any new savings incentives may not increase saving among low earners

- Savings incentives are an inefficient way of helping low earners

- A LiSA would not be attractive for 'lifecycle' saving, but neither is it sufficient to provide a pension

The role of the Pensions Policy Institute

1. The Pensions Policy Institute (PPI) promotes the study of pensions and other provision for retirement and old age. The PPI is unique in the study of pensions, as it is independent (no political bias or vested interest); focused and expert in the field; and takes a long-term perspective across all elements of the pension system. The PPI does not make policy recommendations, but exists to contribute facts and analysis to help all commentators and policy decision-makers.

2. This response concentrates on the potential use of a Lifetime Savings Account (LiSA) to provide retirement income.

It is not clear whether the LiSA would replace or supplement existing tax incentives for pension saving

3. The consultation document does not make explicit whether LiSAs would be available as an addition to the existing system of tax relief on pensions, or replace it.

4. The UK already provides tax relief on pension savings, and in 2003/4 £11bn of tax revenue was foregone on pension saving[1]. If LiSAs were introduced in addition to this, the overall cost of savings incentives would increase. This additional cost would have to be funded by raising taxes, or reducing expenditure elsewhere.

5. If LiSAs replaced the existing system of tax reliefs, it is not clear how the change in the system of incentives would be managed. For example, there could be difficulties in integrating matching contributions with Defined Benefit pension schemes[2].

Additional savings incentives may not increase saving among low earners

6. The available evidence suggests that rather than increasing overall levels of saving in the UK, the availability of tax relief leads individuals to save more in tax-preferred pensions than in other forms of saving. Similar findings have been made for other UK savings incentives, such as PEPs and TESSAs, and ISAs[3].

7. The complexity of tax relief is one reason why individuals may not take advantage of the existing incentives to save. Although in principle a matching contribution appears to be simpler than tax relief, there are still a number of complexities. These include:
   - The rate of matching. If it is not £-for £ it is harder to explain.
   - The level of saving that attracts a matched contribution
   - The inability to access matched funds before age 65
   - The rate at which funds must be rebuilt to avoid losing some or all matched funds.

   These complications will continue to prevent some individuals from fully understanding how the system operates.

[1] PPI calculation based on Inland Revenue figures adjusted for new ONS estimates of contributions to private pension schemes
[2] Booth and Cooper (2003) *Simplifying the Taxation of Pensions* IEA Current Controversies Paper No. 13
[3] For example, as described in Sandler (2002) *Medium and Long Term Retail Savings in the UK: A Review* The Stationery Office

8. There are other barriers, apart from complexity, that will limit the impact of any system of savings incentives. In particular, people with low incomes may not be able to afford to save even if large incentives are available. And if people are in debt, they may be best advised to pay off debt before saving.

Incentives are an inefficient way of helping low earners

9. The structure of a LiSA, with matched contributions rather than paying tax relief at the marginal rate[4] **may** be attractive to individuals who do not save, but it would **definitely** be attractive to individuals who already save in vehicles. This is acknowledged in the consultation report (page 30) but there are some specific consequences.

10. The cost of the scheme will be high relative to any achieved increase in overall savings levels. A large proportion of the cost will be 'deadweight' in that a matched contribution will be paid to someone who would have saved anyway. These are more likely to be higher earners (and/or their families) - who already receive most of the existing tax relief on private pensions[5] and ISAs – than low earners. Lower earners are also those most likely to have to make withdrawals, and so lose the value of the matched contribution.

11. Further savings incentives – even matched contributions - are therefore likely to be an inefficient way of increasing the retirement income of low income individuals.

A LiSA would not be attractive for 'lifecycle' saving …..

12. Within a LiSA, the matched contribution is not actually 'owned' by the saver until age 65. This age limit on receiving the match limits the use of the account for meeting the 'lifecycle' needs of many people. The consultation paper suggests that a LiSA would be attractive for 'lifecycle' saving, such as for a specific purpose (a house deposit) or for a 'rainy day'. But the matched contribution is lost if savings are withdrawn before age 65 *and not replaced*. So there is no incentive to save for someone who is saving for a particular purchase unless he or she is able to save even more after the purchase. Most people not already saving are unlikely to be in this position.

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[4] Non-taxpayers can also receive tax relief at the basic rate of tax on pension contributions up to £3,600 a year

[5] 55% of tax relief on individual and employee pension contributions is received by 2.5 million higher rate tax payers - PQ Steve Webb 11 February 2004 House of Commons Hansard Column 1490W

… but neither is it sufficient to provide a pension

13. The age limit for receiving the matched contribution in a LiSA suggests that it is designed to increase retirement income. However, the limits on the amount of saving eligible for a matched contribution illustrated in the consultation paper are unlikely to provide a significant source of retirement income. The relatively modest lump sum amounts that could be provided by a LiSA would provide small pension income. For example, an individual saving £20 a month over 20 years would only be able to buy a weekly income of £24[6].

[6] Based on a lump sum of £17,263 (Table 5.1) used to buy a male single life level annuity at age 65. Annuity rate information taken from the FSA's Comparative Tables (www.fsa.gov.uk/tables) as at 10 September 2004, and is the highest rate with unrestricted availability. © The Financial Services Authority. Weekly amount rounded to the nearest £1 a week.