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# Budget 2014: pensions and saving policies

Carl Emmerson

ESRC ECONOMIC & SOCIAL RESEARCH COUNCIL

# Pensions and saving policies

- Two general saving policies
  - Individual Savings Accounts (ISAs) made more generous
  - 10% income tax rate on savings income cut to 0% and band extended
- Two pensions policies
  - more flexible treatment of defined contribution (DC) pensions
  - voluntary NICs for additional state pension income



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# Individual Savings Accounts

- Most household saving is held in relatively tax-advantaged forms
  - by March 2013 total of £443bn invested in ISAs
  - 14.6m taken out in 2012–13 and average contributions of £3,900
- Autumn Statement 2013 set ISA contribution limits from April 2014 of £11,880 with up to £5,940 for cash ISAs
- Budget 2014 announced a single limit of £15,000 from 1 July 2014
  - with complete transferability between cash and equity ISAs
  - small increase in range of assets that can be held in ISAs to follow
- Taxing interest income is inefficient
  - provides justification for increasing cash ISA limits
- Case for increasing equity ISAs less clear
  - although benefits from a single limit and complete transferability
- Beneficiaries mainly the rich

# 0% income tax rate on savings income

- From April 2015 starting rate of income tax on savings to be cut from 10% to 0% and the band widened from £2,960 to £5,000
  - benefits those whose total income is above £10,500 but their non-savings income is below £15,500
  - estimated cost of £320m in 2016–17
- Strong case on efficiency grounds for not taxing interest income
- Most gainers around the middle of the income distribution
  - though biggest cash gains go to wealthy people
  - pensioners gain, on average, more than working-age families
- Challenge for policy is incomplete take-up
  - some potential beneficiaries will still pay tax at 20%
  - government thinks reform will significantly improve take-up



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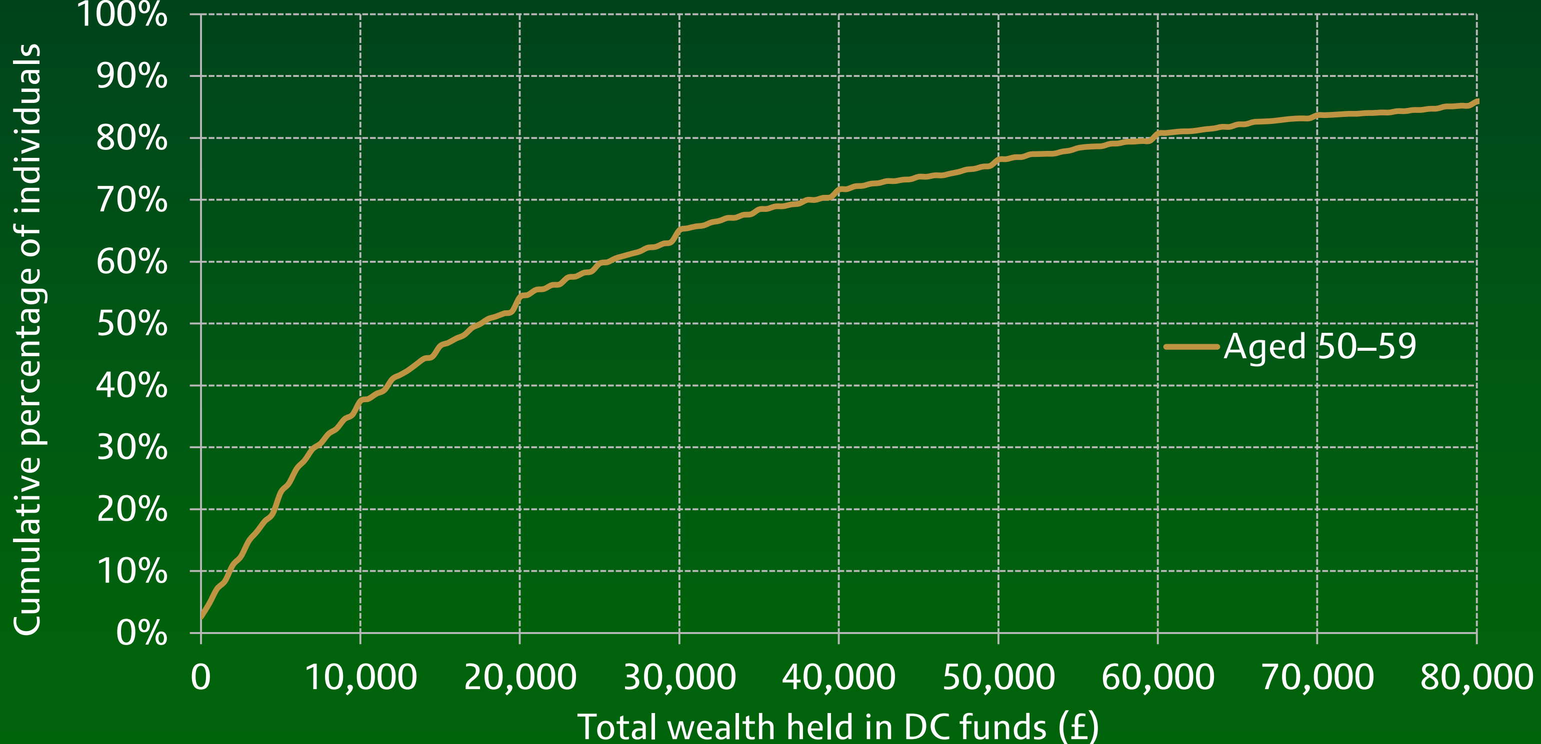
# Defined contribution pensions

Distribution of DC pension wealth among the 30% of 50 to 59 year olds with at least one DC pension pot






Source: Figure 4 of Crawford and Tetlow (2012), using data from the Wealth and Assets Survey (http://www.ifs.org.uk/bns/bn127.pdf).

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# Current treatment of DC pensions

- If aged 55 or over, pension income taxed at marginal income tax rate if it comes from:
  - **annuity**: insurance product that provides a guaranteed income stream until death
  - **capped drawdown**: only allowed to take up to 120% of what you could get through an annuity
  - **flexible drawdown**: if you have a secure income of over £20k a year then you can draw as much as you like
- Other withdrawals are taxed at 55% (including those at death without annuitisation), unless aged 60 or over and
  - have total pensions worth less than £18k
  - or, for up to two pensions, the pension fund is under £2k

# More generous treatment of DC pensions

- From April 2014
  - capped drawdown on up to 150% of possible annuity income
  - flexible drawdown for those with a secure income over £12k p.a.
  - small pots defined as up to £10k and up to 3 small pots per person
- From April 2015
  - from age 55 withdrawals allowed and taxed at marginal rate
  - consultation on whether 55% rate at death should be reduced
  - those with DC pensions to get free impartial advice at retirement
  - consultation on whether to increase age 55 in line with SPA
- End of compulsory annuitisation for DC pensions
  - presumption that greater flexibility is a good thing
  - but might there be some advantages of compulsory annuitisation?

# Might compulsory annuitisation be a good thing?

Answer 1: Moral hazard

- Concern that individuals might exhaust their pension pots knowing they could receive means-tested benefits in retirement
- Government points out that single-tier pension reduces this problem
  - those receiving a full single-tier pension not eligible for pension credit
- But
  - not all receive this level of state pension: most of those reaching the state pension age (SPA) before April 2016 plus some after this date
  - council tax benefit and, for renters, housing benefit also widespread
- Forcing individuals to annuitise reduces this problem



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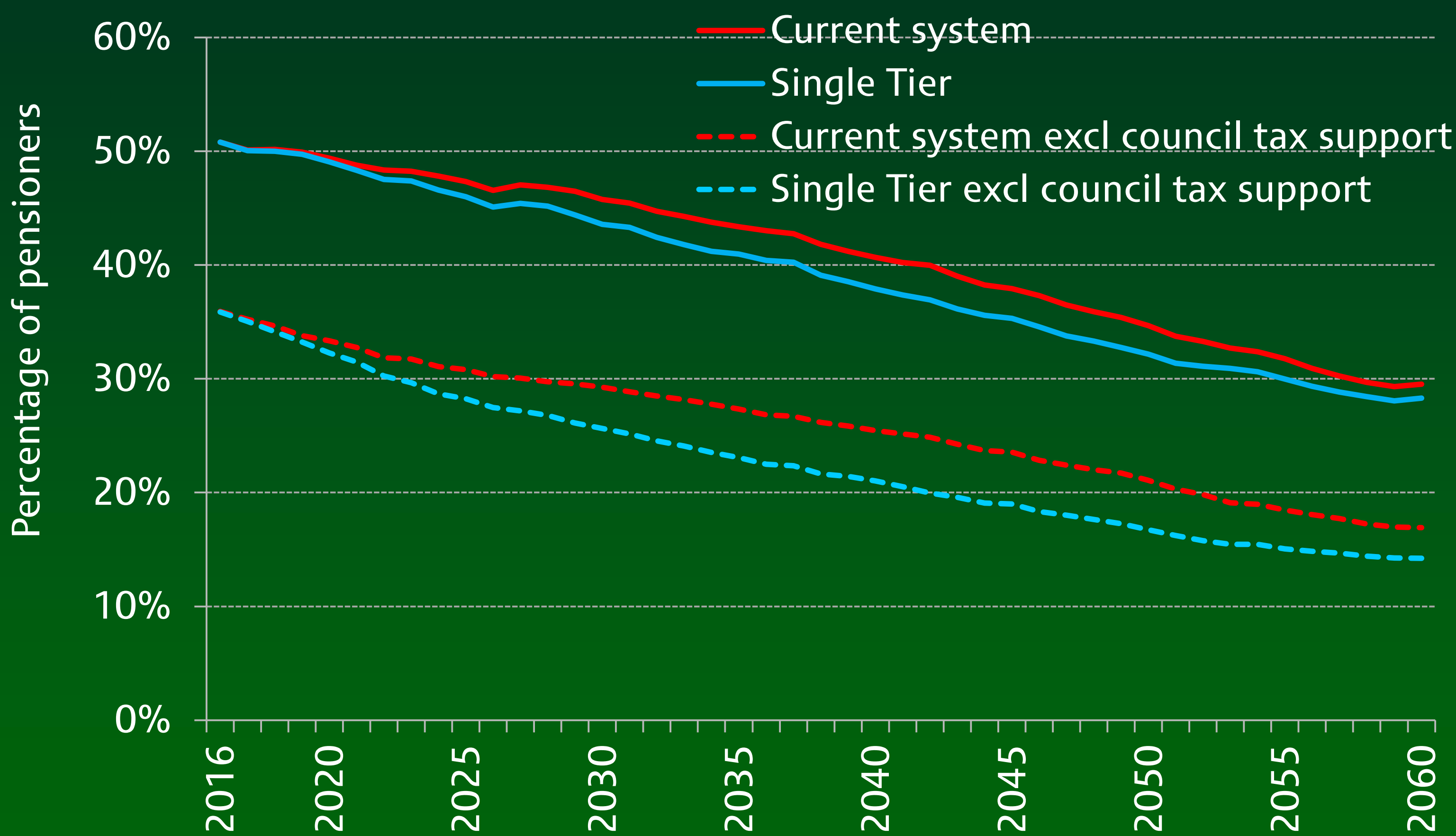
# Projected eligibility for any means-tested benefit






Source: Chart 4.2 of DWP Single-Tier Impact Assessment, October 2013.

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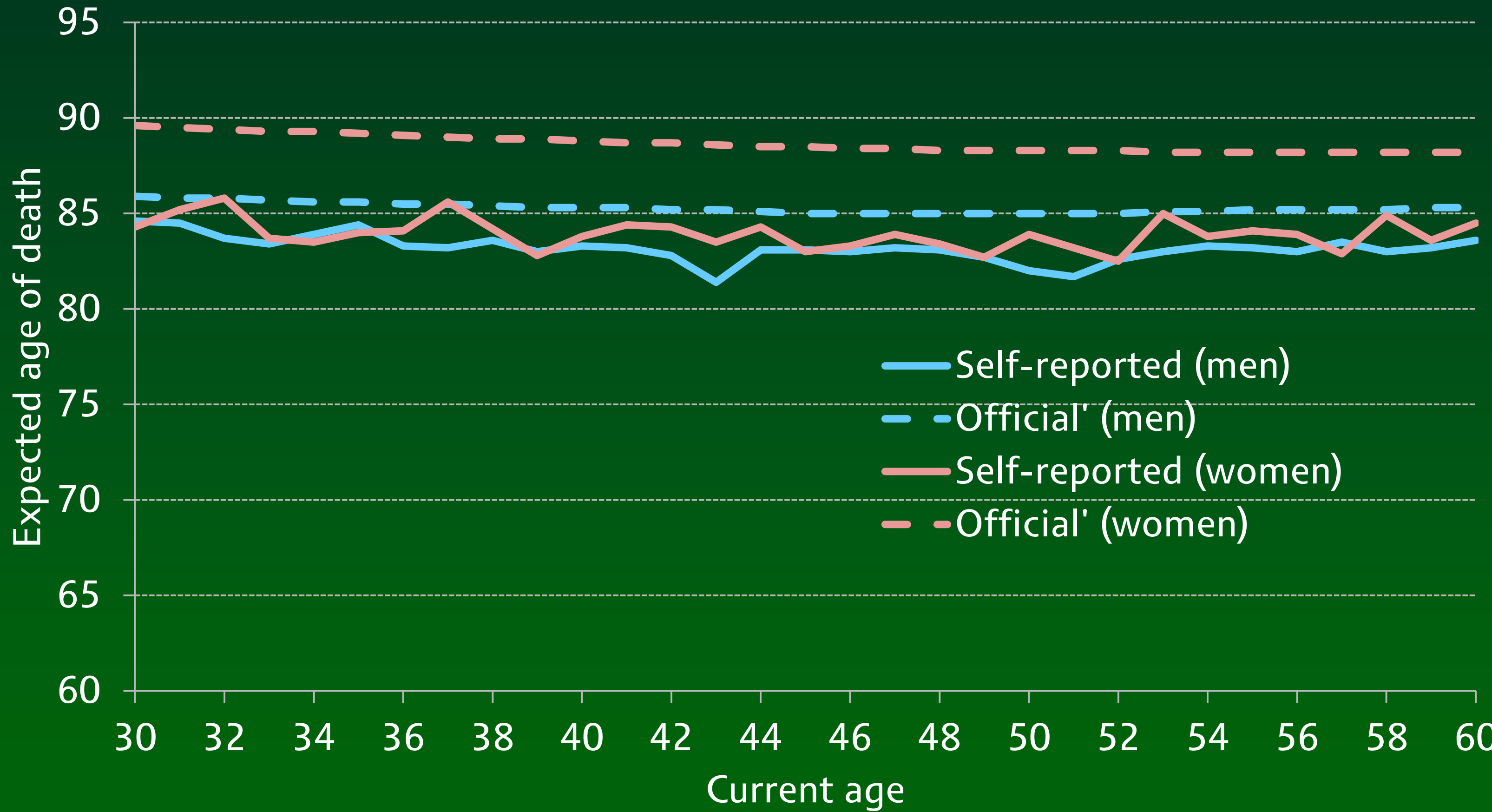
# Might compulsory annuitisation be a good thing?

Answer 2: Myopia

- Possible concern that individuals might blow their pension pot
  - lack self-control?

# On average life expectancy underestimated






Source: Crawford and Tetlow (2002), IFS Report R73, Figure 2.2

# Might compulsory annuitisation be a good thing?

Answer 2: Myopia

- Possible concern that individuals might blow their pension pot
  - lack self-control?
  - men aged 50–60 on average underestimate cohort life expectancies by around 2 years, women by around 4 years
- Understandable desire not to patronise people, but we do have
  - automatic enrolment into workplace pensions
  - and we don't allow pensions to be drawn before age 55
- Forcing individuals to annuitise reduces this problem

# Might compulsory annuitisation be a good thing?

Answer 3: Adverse selection

- Those wanting to purchase a voluntary annuity might disproportionately be those who expect to live a long time
  - insurance companies respond by reducing annuity rates
  - demand falls to just those with very high expected longevity
- Many priced out of annuity market
  - can lead to market collapsing, although has not happened in Ireland since their 1999 reform
- Some UK evidence of this: Finkelstein & Poterba (1998) find that annuitants live longer than average and that this is more true in the voluntary annuity market than the compulsory one
  - perhaps most likely outcome is that those buying annuities will receive lower rates
- Forcing individuals to annuitise reduces this problem



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# Should DC pension saving be tax-favoured?

- Currently private pension saving subsidised by the taxpayer
  - employer contributions escape employer and employee NICs
  - up to 25% of a pension pot (up to £312,500) can be taken entirely free of income tax
- When individuals are forced to purchase an annuity (or have restricted drawdown) a tax incentive might be needed to encourage pension saving
- Without restrictions on how DC pension saving is used why subsidise it?
  - case for subsidy certainly reduced



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# Issues for DB schemes

- Currently DB scheme members can transfer rights to a DC scheme
  – increased flexibility for DC schemes would make this more attractive
- For unfunded public sector schemes this would increase near-term government borrowing
  – estimated £200 million for each 1% of members who did this
  – for this reason government to restrict this option heavily for all public sector schemes
  – but no long-run impact on public finances, so no good reason to restrict this
- For private sector DB schemes
  – government would like members to be allowed greater flexibility but is concerned about potential instability for scheme sponsors
  – consulting on whether also to restrict these transfers: perhaps one safe option is to allow them for only those currently below, say, age 45

# Voluntary NICs

- Those reaching SPA before April 2016 will be able to pay additional NICs in return for up to £25 of weekly state pension
  - indexed to the CPI with 50% inherited by spouse on death
- NICs charge designed to be actuarially fair: varies by age, 65 year old will pay £890 for £1 per week of income
  - for comparison: RPI joint life annuity = £1,720 per £1 week of income
- Offer open for 18 months from October 2015
  - boosts revenues in 2015–16 and 2016–17 by £0.4bn, increases state pension spending for next 20 years
- Assumed take-up rate of 2-3%
- If actuarially fair likely to be disproportionately taken up by healthy, well-informed people with cash
  - take-up could be much higher than this, most likely at a net long-run cost to the public finances

# Conclusions

- Good reasons not to tax interest income
  - cut to savings rate from 10% to 0%, and extension of its band and the extension to cash ISA limits both improve efficiency of tax system
- Voluntary NICs for state pension will benefit some
  - but risk that many with high life expectancies take up the offer at cost to the public finances
- Reform to DC pensions very radical and announced without consultation
  - some to benefit from greater flexibility: for example those with low life expectancy could draw pension to spend or bequeath
  - some losers: some might find themselves priced out of the annuity market, plus those who held shares in annuity companies yesterday
- Without compulsory annuitisation why such generous tax treatment?
  - cost to taxpayer will rise if DC schemes now seen as more attractive



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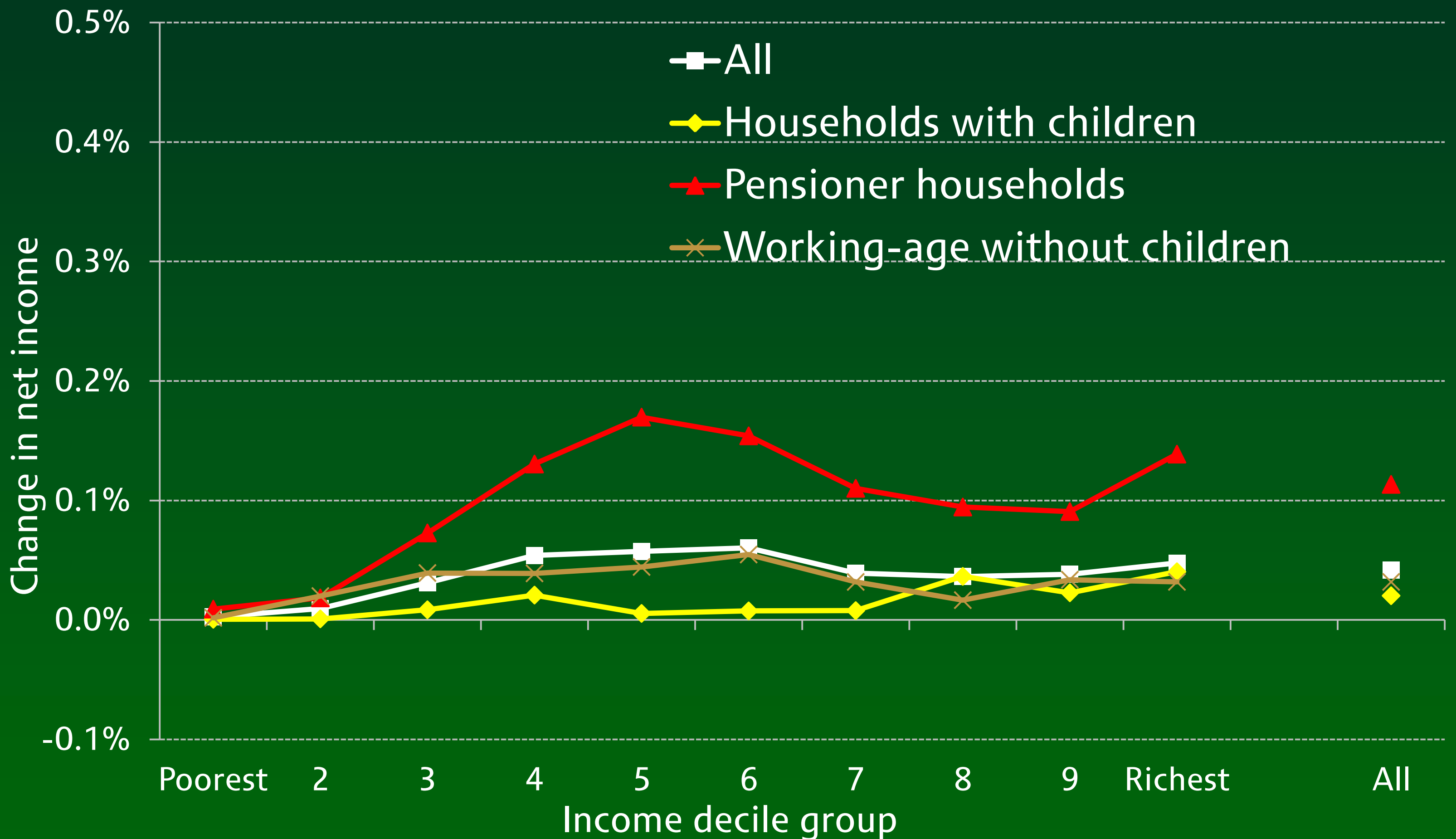
# Impact of abolishing 10% savings rate and increasing starting band to £5,000 in April 2015




Assumes full take-up of means-tested benefits tax credits and the savings rate of income tax.



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