

Fiscal sustainability analytical paper:

Private pensions and savings: the long-term
effect of recent policy measures

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Office for Budget Responsibility

Abstract

In recent years, the Government has made a number of significant changes to the tax treatment of private pensions and savings and introduced a variety of government top-ups on specific savings products. In doing so, it has generally shifted incentives in a way that makes pensions saving less attractive – particularly for higher earners – and non-pension savings more attractive – often in ways that can most readily be taken up by the same higher earners. This paper shows how the effect of decisions on the public finances over the medium term may be different over longer horizons.

Over the five-year periods covered in Budgets and Autumn Statements, the estimated yield from reducing generosity on private pensions slightly exceeds the estimated cost of increasing it for other savings. But some of the private pensions measures only bring forward receipts from the future, whereas the cost of some of the savings giveaways will continue to rise over the long term. Our central estimate suggests the small net gain to the public finances from these measures over the medium-term forecast horizon becomes a small net cost in the long term and this result holds under alternative assumptions. Cumulated over a period of 50 years we estimate that small cost would add 3.7 per cent of GDP to public sector net debt.

In producing this paper we have drawn on the help and expertise of officials from HM Revenue and Customs and the Treasury, to whom we are most grateful. The analysis, views and conclusions in this report represent the collective view of the three independent members of the OBR's Budget Responsibility Committee.

1 Introduction and context

Introduction

- 1.1 Each year since 2011, the Office for Budget Responsibility (OBR) has published a *Fiscal sustainability report (FSR)*, in which we consider the fiscal consequences of *past* government activity, as reflected in the assets and liabilities on the public sector's balance sheet, and the consequences of *future* government activity, through the use of long-term demographically driven projections beyond our latest medium-term forecast horizon.
- 1.2 Due to the uncertainty that followed the result of the 23 June referendum on the UK's membership of the European Union, we decided to cancel the *FSR* that we had planned to publish on 12 July. We felt it was likely that some of the conclusions would not be informative at that time. We have instead published some elements of the analytical work that would have featured in July's *FSR* as 'fiscal sustainability analytical papers'. This working paper forms part of that series. As with the papers published in late July, it will also help inform our first *Fiscal risks report*, which we plan to publish next year.
- 1.3 In this analytical paper, we present:
- the **main tax-related private pensions policy measures** that have been announced since 2010;
 - the **main tax-related savings policy measures** that have been announced over the same period;
 - illustrative **long-term estimates of the costs and yields** associated with those measures, and the uncertainties to which they are subject; and
 - some **conclusions** that can be drawn from this analysis.

Context

Financial wealth and the tax system

- 1.4 The tax system affects the post-tax returns an individual can expect from investing in different financial assets. The Government is therefore able to influence individuals' incentives – and so behaviour – by changing the tax treatment of private pensions and savings products. Broadly speaking, pensions in the UK are taxed only when they are drawn as income in retirement, while savings are taken from income or gains that has already been taxed, though interest earned on savings are also liable for tax.

Total wealth of British households

- 1.5 Every other year, the Office for National Statistics (ONS) publishes its ‘wealth and assets survey’.¹ This provides a snapshot of the assets and liabilities of households in Great Britain. The latest, relating to July 2012 to June 2014, estimated the aggregate total net wealth of all private households in Great Britain at £11.1 trillion (equivalent to six times the UK’s national income in 2014). The distribution of total wealth across different households varied greatly, with the median household estimated to have total wealth of £225,100.
- 1.6 Table 1.1 shows the breakdown, in order of size, across private pensions (£4.5 trillion in the latest survey), net property assets (£3.9 trillion), financial assets (£1.6 trillion) and physical assets (£1.2 trillion).² Each has increased since the first survey, which related to 2006 to 2008, with the increase greatest for pensions and financial assets. There has been a 53 per cent increase in net financial wealth over the period and a 55 per cent increase in private pension wealth. Together, they now account for 54 per cent of total wealth, up from 47 per cent in 2006 to 2008.

Table 1.1: Aggregate household wealth by category

	£ billion (per cent)			
	July 2006 to June 2008	July 2008 to June 2010	July 2010 to June 2012	July 2012 to June 2014
Private pension wealth	2,886 (34)	3,470 (39)	3,530 (37)	4,459 (40)
Property wealth (net)	3,537 (42)	3,379 (38)	3,528 (37)	3,927 (35)
Financial wealth (net)	1,043 (12)	1,091 (12)	1,305 (14)	1,596 (14)
Physical wealth	961 (11)	1,016 (11)	1,081 (11)	1,152 (10)
Total wealth	8,426 (100)	8,955 (100)	9,444 (100)	11,134 (100)

Structure of the paper

- 1.7 Chapter 2 of the paper presents some background on private pensions before looking at the main tax-related policy announcements in this area since 2010. Chapter 3 follows the same format for savings. Chapter 4 brings both sets of measures together and presents our estimates of their long-term cost or yield. We show how tax giveaways on savings measures slightly exceed tax takeaways from pensions measures over the five-year periods covered by the Budgets and Autumn Statements in which they were announced. By contrast, over the longer term there is likely to be a significant net cost from these measures.
- 1.8 This paper focuses on the main tax-related measures that affect the incentives on working-age individuals to accumulate wealth. We do not consider the longer-term spending implications of the state pension or wider pensions policy measures such as the triple-lock

¹ The definition of wealth used in the survey is an economic one: gross total wealth is the value of accumulated assets while net total wealth is the value of accumulated assets minus the value of accumulated liabilities.

² Net property wealth is the total value of properties owned by a household, including their main residence, after deducting outstanding liabilities, such as the value of a mortgage. Physical wealth includes the value of all the household’s possessions, including vehicles. Net financial wealth is the amount of money held in financial assets and cash after deducting financial liabilities, such as credit card debt and student loans. Private pension wealth is the value of a household’s total wealth accumulated in every pension category except the state pension.

on uprating of the state pension or changes in demographics.³ Nor do we consider wider tax measures that are likely to affect savings and investments decisions, such as those affecting the housing market.⁴ We discuss some potential effects of the policy measures covered in the paper on housing and the wider economy in Chapter 4.

³ We analyse demographic pressures on state pension spending in our *Fiscal sustainability reports*, which we updated in July 2016 in *Population projections and pensions spending update*, available on our website.

⁴ For example the restriction on the tax deductibility of finance costs for landlords announced in the July 2015 Budget would raise disproportionately more revenue if interest rates rise beyond the forecast period. That would further affect the incentive to invest in buy-to-let housing relative to savings and pensions.

2 Private pensions

Introduction

2.1 This chapter:

- reviews the **evidence on private pensions** in Great Britain;
- sets out the **tax treatment of private pensions**; and
- summarises the **main policy measures affecting private pensions** that have been announced since 2010.

Private pension wealth

2.2 The £4.5 trillion of private pension wealth in the latest survey is split evenly between assets held by those that have begun to draw down income (£2.3 trillion) and those that have not (£2.2 trillion). Private pensions mainly fall within three types:

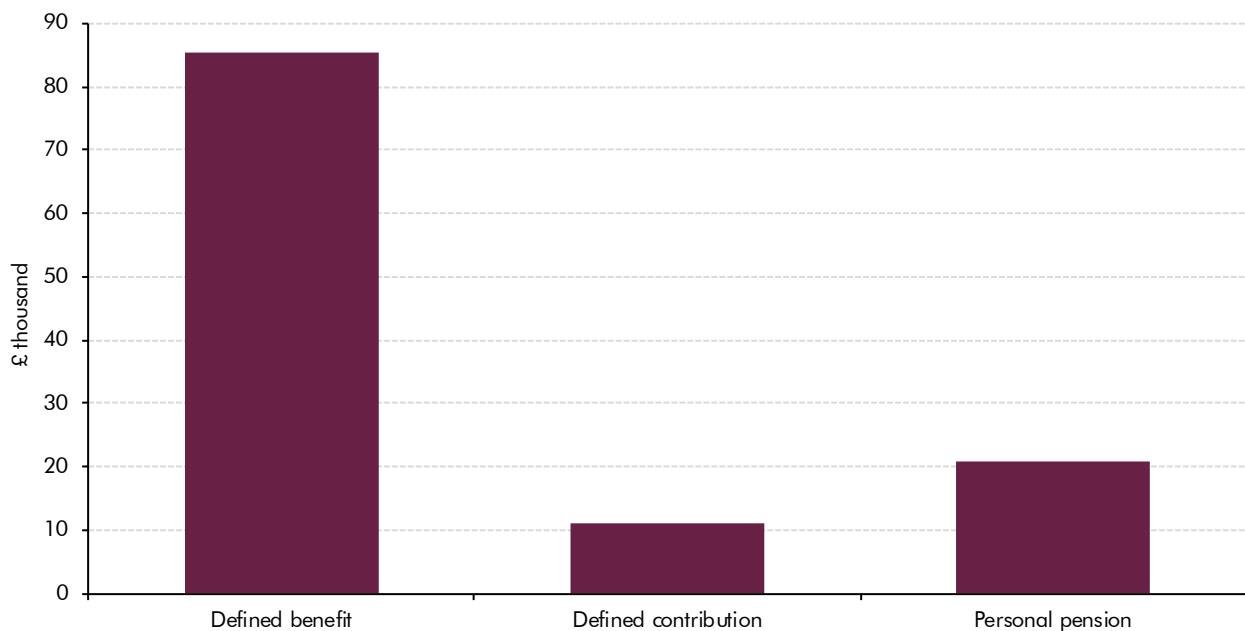
- **defined benefit** (DB) occupational pensions pay a secure income for life, with the employer responsible for ensuring there is enough money set aside to meet their obligations. DB pensions are typically provided by the public sector or by large private employers. The pension income an individual receives depends on factors like their final salary and years of service – this is how the benefit is ‘defined’. The measures we consider in this paper do not affect DB pensions;
- **defined contribution** (DC) occupational pensions build up a pension pot via contributions that can be made by individuals and their employers. These are invested in stocks and shares, bonds or other investment vehicles with the aim of increasing the size of the pension pot over the years before retirement. The amount of pension income they generate depends on the value of the pot at retirement and how it is converted into pension income (typically via an annuity – a financial product that pays a guaranteed amount for the rest of the individual’s lifetime). It is the contribution rate, not the end benefit, that is ‘defined’; and
- **personal pensions** (PP) are a type of DC pension that is typically arranged by an individual independent of an employer, for example by the self-employed.

2.3 The latest ONS wealth and assets survey reports that 76 per cent of households and 35 per cent of individuals in Great Britain had private pensions, implying that usually only one individual in any household has one. The value of DB schemes is typically much higher than

Private pensions

DC schemes. Chart 2.1 shows that the median size of current private pension wealth – i.e. those where individuals are still contributing to the scheme⁵ – in DB schemes is around eight times higher than in DC schemes and around four times higher than for personal pensions. In recent years the number of DB pension schemes in the private sector have fallen as companies turn to more DC schemes.

Chart 2.1: Median value of private pension wealth by type

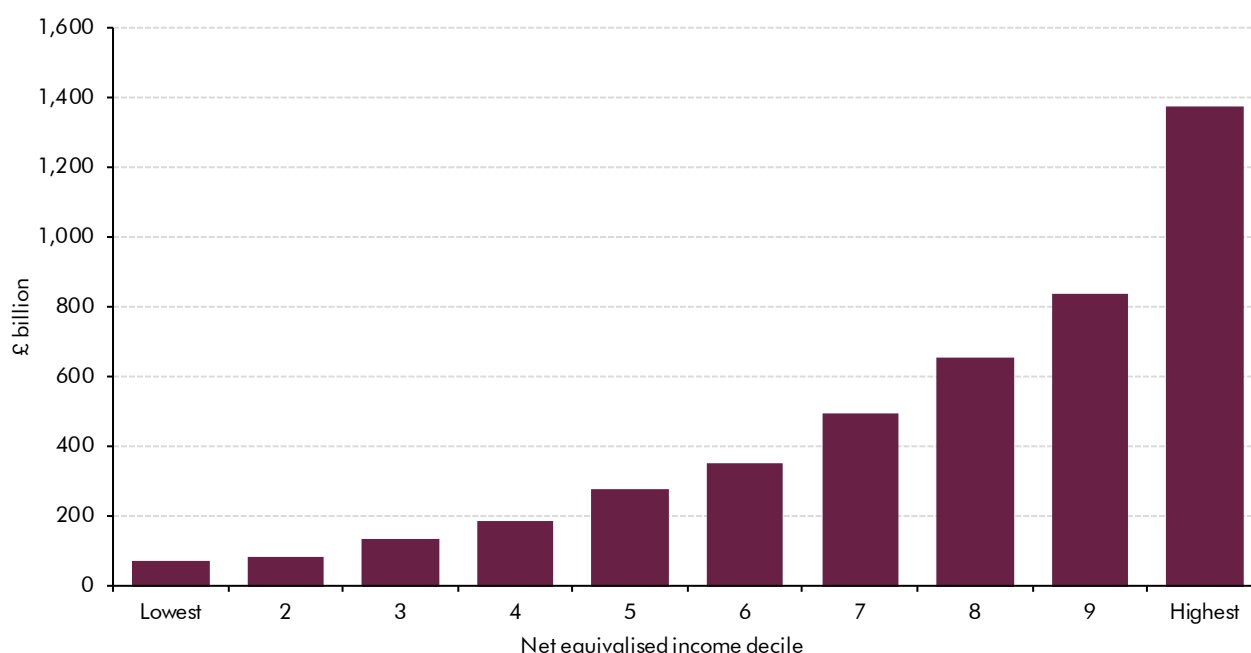


Source: Wealth and Assets Survey, ONS, 2015

2.4 Chart 2.2 shows the private pension wealth held by households across the income distribution. The income deciles – each representing a tenth of all households – are measured in terms of 'net equivalised income'. Equivalisation is a technique that adjusts a household's actual income to take into account its size and composition, making comparisons between them more meaningful. The chart shows how heavily skewed private pension wealth is towards those with the highest incomes.

⁵ Among households that had stopped contributing to their pensions, but were not yet drawing an income from them, the pattern was similar: median wealth in DB pensions was £46,700 while it was £10,300 in DC pensions.

Chart 2.2: Distribution of aggregate household private pension wealth



Source: Wealth and Assets Survey, ONS, 2015

The tax treatment of private pensions

- 2.5** For each private pension type the current tax system allows most contributions to be made out of pre-tax income, making them exempt from tax. So, when an individual makes a contribution from their monthly salary, tax and national insurance contributions (NICs) are only applied to their remaining salary. Any investment growth in a pension pot is also typically exempt from taxation – unlike capital gains made on stocks and shares held outside a pension (or other tax-exempt vehicle). Tax is due when an individual draws down on the pension in retirement, although not on all income drawn down since up to 25 per cent can be taken as a tax-free lump sum.
- 2.6** Employers typically contribute to occupational pensions on their employees' behalf too. For example, for those in DB pension schemes, the employer is responsible for ensuring sufficient funds are set aside to meet the defined obligations. Employer contributions are paid before the employer NICs liability is calculated, so employers pay less in NICs on pension contributions than on the rest of an employee's compensation.
- 2.7** The Pensions Act 2008 requires all employers to contribute to the pensions of their eligible employees unless the employees opt-out of the scheme – known as 'auto enrolment'. From October 2018 onwards, the minimum amount employers must contribute to these pensions will be 3 per cent of an individual's earnings. They can contribute more if they wish. Auto-enrolment will be mainly in DC pension schemes.
- 2.8** With the taxation of pensions income taking place when it is drawn down rather than when it was originally earned, for most individuals less tax would be paid by saving through a pension than via most other savings vehicles. The extent to which an individual's tax burden

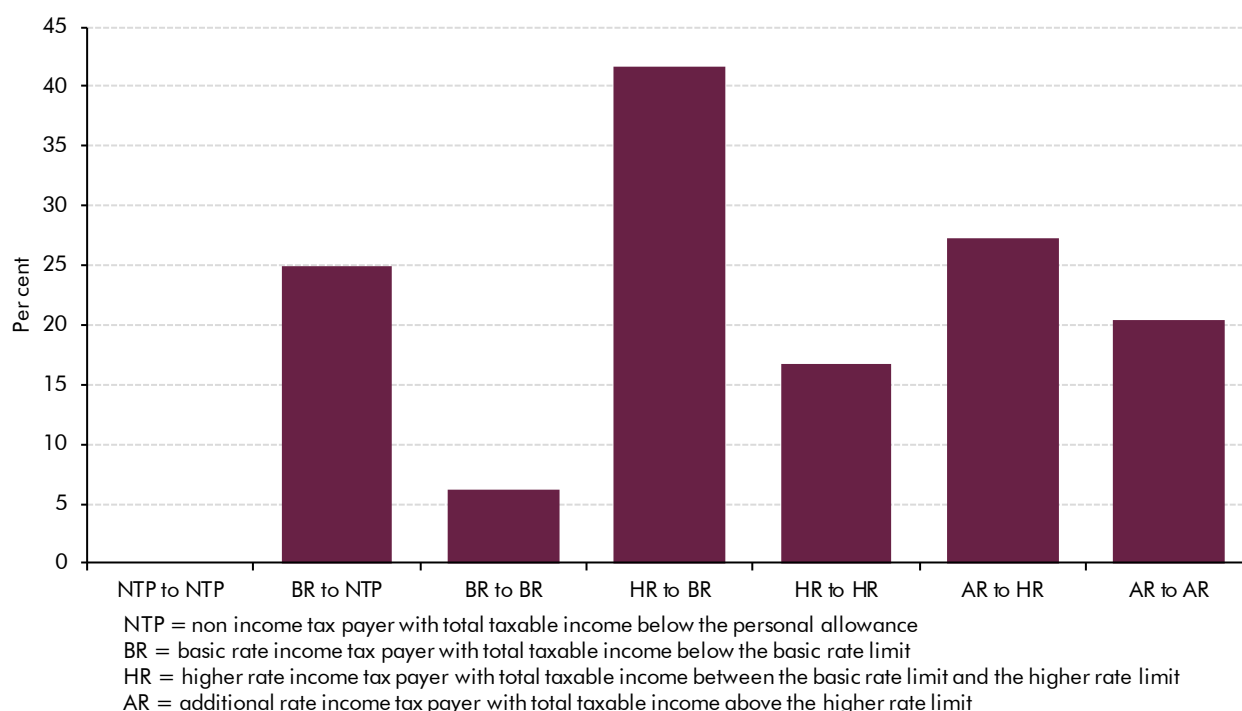
is reduced depends on which income tax band they are in when making pension contributions and which they will be in when drawing down the pension income. For example, if someone who pays income tax at the basic rate makes a £100 contribution to their pension, they would only give up £80 of current income, because that £100 would have been taxed at 20 per cent if taken as income now but is not taxed as a pension contribution. If we ignore investment growth and inflation, that £100 contribution could be withdrawn in retirement with £25 tax-free and £75 subject to income tax. If that £75 was also taxed at the basic rate of 20 per cent, the total pension income including the tax-free lump sum would be £85 – 6 per cent higher than the £80 of current income foregone.

2.9 It is worth mentioning that an individual's pension pot can also be boosted by contributions from their employer. These are not subject to NICs and their inclusion in our analysis would further increase the returns to pension saving. However, we omit them on the basis that contributions would vary by individual, making like-for-like comparisons difficult.

2.10 Chart 2.3 repeats this calculation – always excluding any investment growth in the pension pot and employer contributions – for the main possible pairings of working-age and retirement-age tax statuses. It shows that:

- the biggest lifetime tax saving would be for **individuals whose working-age earnings are taxed at the higher rate (40 per cent), but whose retirement income would be taxed at the basic rate**. That is likely to be the case for a significant proportion of the 4.4 million individuals whose earnings are currently taxed at the higher rate. For these individuals a £100 contribution still yields £85 in retirement, but at a cost of only £60 of current income foregone – a saving of 42 per cent;
- the system generates smaller, though still significant, tax savings for **basic rate taxpayers whose income drops below the personal allowance in retirement** (25 per cent) and for additional rate taxpayers that drop to the higher rate (27 per cent);
- for **individuals that stay in the same tax bracket**, the savings are greater for those paying tax at higher marginal rates because the tax-free lump sum is worth more if it would otherwise have been taxed at 40 or 45 per cent; and
- only **individuals whose incomes are below the personal allowance** in both their working life and retirement do not gain anything from the tax treatment of pensions saving.

Chart 2.3: Private pensions: comparing future returns against current income



Source: OBR

The main private pensions measures since 2010

2.11 Table 2.1 recreates the 'scorecard'⁶ costings of the five major policy measures affecting private pensions that have been announced since the creation of the OBR in 2010. Taken together, the effect on the public finances has been to boost revenues within the period covered by each scorecard and forecast. But the effect within the scorecard period has not always been representative of the longer-term effects of these policies, which we have highlighted in our *Economic and fiscal outlook (EFO)* reports at the time. Given the slow build-up of pension assets and steady subsequent withdrawal of them over an individual's lifetime, the effect of changing pensions tax incentives will often take many years to play out.

⁶ The Treasury presents a table in each Budget and Autumn Statement that reports the estimated cost or yield from all the new policy measures announced in that statement. It is known as the 'scorecard'.

Table 2.1: Main private pensions measures announced since 2010

	Scorecard period	£ million					
		Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
December 2012							
Pensions: restrict tax relief	2012-13 to 2017-18	50	200	475	705	1035	1125
March 2014							
Pensions: reduce withdrawal tax rate from 55% to marginal income tax rate	2014-15 to 2018-19	-5	320	600	910	1220	N/A
March 2015							
Annuities: secondary market	2015-16 to 2019-20	0	535	540	-130	-120	N/A
Pensions: lifetime allowance to £1m from 2016-17, and index with inflation from 2018-19	2015-16 to 2019-20	60	300	420	550	590	N/A
July 2015							
Pensions tax relief: restrict for gross income over £150,000 from 2016-17	2015-16 to 2019-20	-70	260	425	900	1180	1280

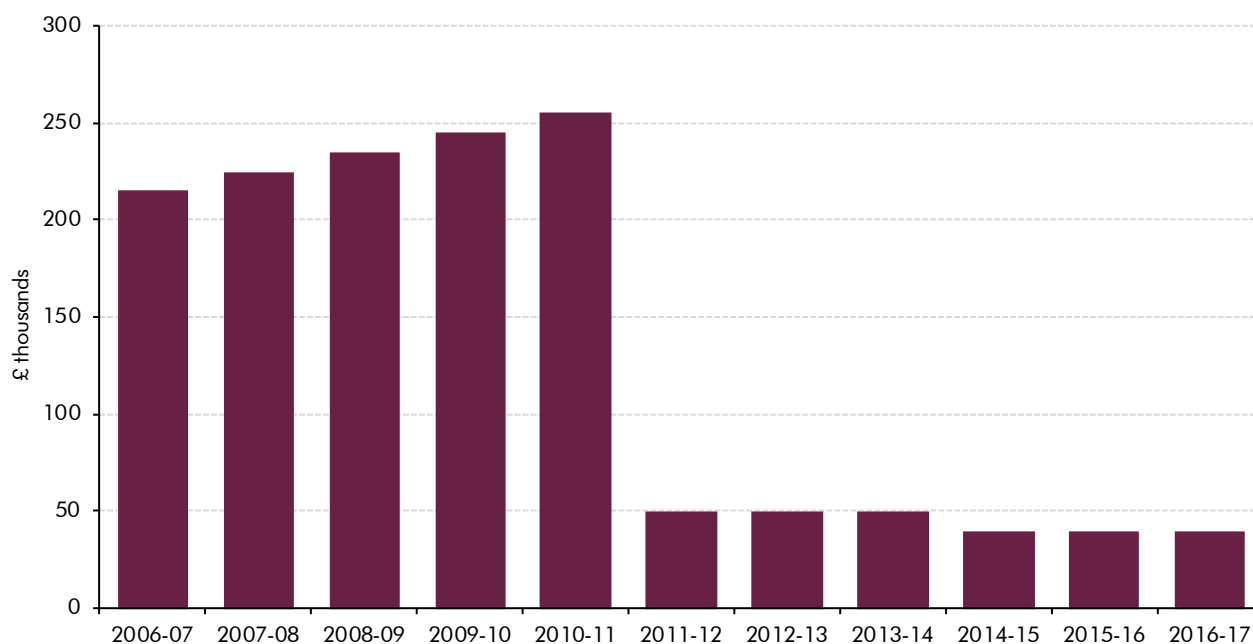
Restrictions to the pensions annual allowance

2.12 The annual allowance (AA) sets how much an individual can contribute each year to pension pots before contributions can no longer be made out of pre-tax income. Chart 2.4 shows it had been steadily increasing until it reached a peak of £255,000 in 2010-11. It was reduced to £50,000 in that year, then again to £40,000 in 2014-15. The AA is flexible over a rolling three-year period, so that if part of it is not used in one year it can be added to the following year (i.e. with the limit at £40,000, if £35,000 of contributions were made in each of the first two years, a £50,000 contribution could be made out of pre-tax income in the third year). From 2016-17, the Government has introduced a taper that progressively reduces the AA for those earning over £150,000. The taper stops at earnings of £210,000, by which point the AA has been reduced to £10,000.⁷

2.13 The December 2012 announcement lowered both the annual allowance – to £40,000 – and the lifetime allowance. The AA restriction was expected to raise £1.5 billion over the six years to 2017-18. The July 2015 taper announcement was expected to raise a further £4 billion over the six years to 2019-20. Receipts from the earlier measure have underperformed, partly due to lower-than-expected average earnings growth and inflation, but possibly also due to the costing underestimating the extent to which individuals would find ways to avoid hitting the limit. We requested that an adjustment to reflect that possible behavioural response was made in the July 2015 taper costing before certifying it as reasonable and central. Even so, we assigned that costing a ‘very high’ uncertainty rating, partly to reflect the difficulty of estimating the extent to which individuals would deploy tax planning to avoid its effects.

⁷ This paper only considers measures announced in Budget and Autumn Statements since the creation of the OBR in 2010. The 2011-12 reductions in the AA and LTA were the culmination of changes originally announced in Budget 2009.

Chart 2.4: Pensions annual allowance



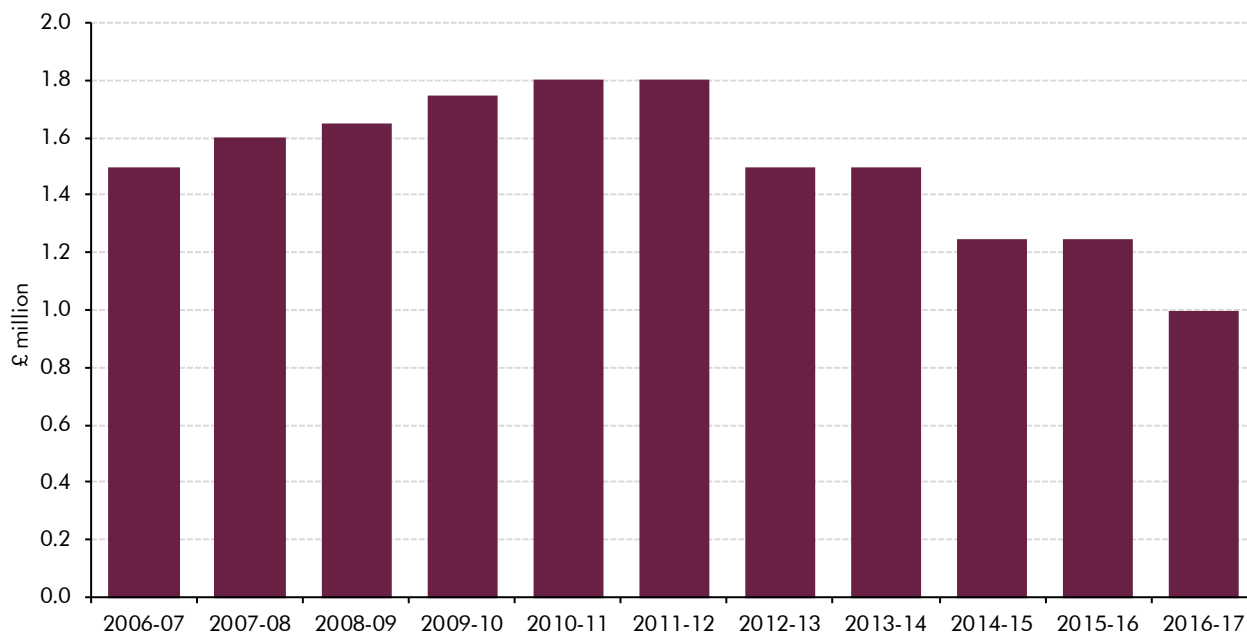
Source: OBR

- 2.14** All else equal, lower annual contributions would lead to smaller taxable pension pots in the future. These measures therefore shift some tax receipts forward, with the boost to receipts levelling off over time. Our estimate of the longer-term effects of this measure is set out in Chapter 4.

Restrictions to the pensions lifetime allowance

- 2.15** The lifetime allowance (LTA) was introduced in 2006 in order to restrict the amount of tax-relieved contributions that an individual can accumulate in their pension pots. Chart 2.5 shows that the LTA was originally set at £1.5 million, increasing to £1.8 million in 2010-11. Since then it has been reduced through a succession of policy measures, reaching £1 million from 2016-17.
- 2.16** The December 2012 measure that reduced the LTA from £1.5 million to £1.25 million was expected to raise £2.1 billion over the six years to 2017-18. The March 2015 measure reducing it further to £1 million was expected to raise £1.9 billion over the five years to 2019-20. As with the AA, receipts from the earlier measure have underperformed, due to lower-than-expected earnings growth and possibly the costing underestimating the ability of individuals to find ways to avoid hitting the limit. We assigned the March 2015 measure a 'medium-high' uncertainty rating.

Chart 2.5: Pensions lifetime allowance



Source: OBR

- 2.17 The longer-term effects of LTA restrictions should be similar to those of the AA. Lowering lifetime contributions should mean smaller future pension pots, so the measures bring some tax receipts forward with the impact levelling over time. Our estimate of these effects is set out in Chapter 4.

Pensions flexibility

- 2.18 The Budget 2014 pensions flexibility measure – ‘pensions: reduce withdrawal tax rate from 55% to marginal income tax rate’ – gives individuals with DC pensions the flexibility to withdraw their funds from age 55, subject to tax paid at their marginal rate rather than the 55 per cent charge that was previously in place. The measure was originally announced in March 2014, then amended in December 2014. It was estimated to raise £3.1 billion over the four years to 2018-19. All the revenue raised reflects the expected behavioural response of individuals with DC pension pots. It was assumed that around 30 per cent of those eligible would take up the opportunity. In our March 2014 *EFO* we described this package as being “*subject to considerable uncertainty*”. In our December 2014 *EFO*, the first in which we attached uncertainty ratings to every costing, we gave the second measure a ‘very high’ rating.
- 2.19 Data from HMRC show that there was stronger than expected initial take-up, probably reflecting pent-up demand from those on the threshold of retirement. Following that initial burst of activity, outturns over the rest of 2015-16 slowed in line with the original estimate.
- 2.20 The estimates that we present in Chapter 4 show that the scorecard costing of this measure is not representative of its longer-term effect. It raises revenue across the scorecard period as early withdrawals are subject to income tax, but this is at the expense of tax that would

have been paid when those same funds were drawn down in the future. Pension funds can only be drawn down once, so every early withdrawal reduces the amount of taxable withdrawals in future years.

Annuities: secondary market

- 2.21 Following the introduction of pensions flexibility for those yet to draw down their pension, the Government announced in March 2015 that it would also provide greater flexibility for those already receiving pension payments. The measure was designed to allow people already receiving income from an annuity to sell that income stream to a third party, taking the value as either a lump sum or transferring the lump sum to an alternative retirement income product by charging the individual's marginal rate of tax, rather than the previous penalty charge of 55 per cent.
- 2.22 The original costing was expected to raise £1.1 billion across 2016-17 and 2017-18 as individuals who took up the option to sell their annuity would pay income tax on the proceeds of any sale. It was assumed that any individual expected to sell their annuity would do so within the first two years, so there would be no revenue gain beyond that. In July 2015, the Government announced a one-year delay to the implementation of the policy.
- 2.23 We assigned this measure a 'very high' uncertainty rating in our March 2015 EFO, noting that *"any estimates on how potential buyers will view the risk associated with this product and set their preferred discounts are particularly uncertain"*. We also thought it was possible that *"potential buyers will view this as a risk that cannot be priced, in which case no secondary market would develop and the effect of the policy would be nil"*. As the implementation date approaches – it is due to come into effect from April 2017 – this high level of uncertainty remains.
- 2.24 The longer-term effect of this measure is similar to the earlier pensions flexibility measure. Those individuals that choose to take advantage will generate an up-front revenue gain but that will be at the expense of revenue from pension income that would otherwise have been due in later years. Unlike the pensions flexibility measure, that subsequent cost can be seen within the scorecard period because of the assumption that all those that want to take up the offer will do so relatively quickly.

3 Savings

Introduction

3.1 This chapter:

- reviews the **evidence on savings wealth** in Great Britain;
- sets out the **tax treatment of savings**; and
- summarises the **main policy measures affecting private savings** that have been announced since 2010.

Savings wealth

3.2 Households in Great Britain are estimated to hold £1.6 trillion in non-pension financial wealth. Table 3.1 breaks that down into the main financial assets, the percentage of households that have them and their median value. It shows that almost every household (98 per cent) has at least one type of formal financial asset, with the median household holding an asset or assets worth £13,700.

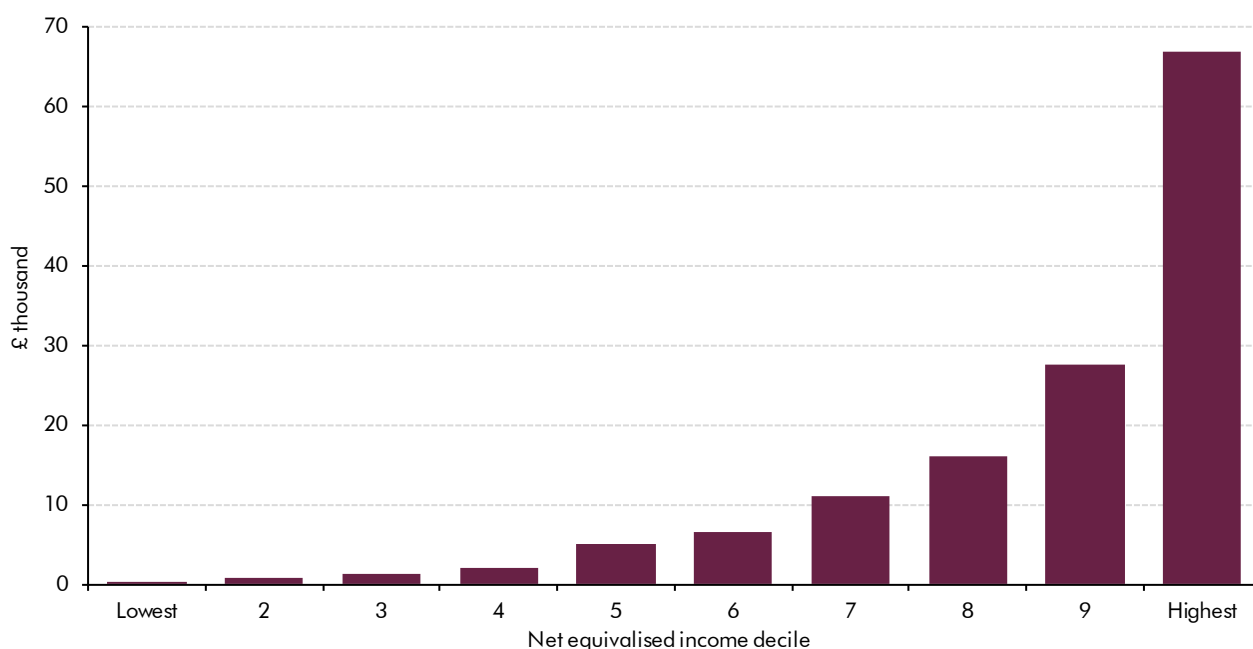
3.3 Looking just at savings, 57 per cent of households had a savings account, with the median value £4,200. ISAs are held by slightly fewer households (48 per cent), but the median value is much higher (£10,000). ISAs have existed since the 1999-2000 tax year, with the annual limit that can be saved into an ISA rising from £7,000 then to £11,520 in the 2013-14 tax year that aligns with the latest ONS wealth and assets data. The only limit on the overall value of an individual's savings in an ISA is the previous years' annual limits, so it is quite striking that the median household with an ISA has less in it than could have been saved within the 2013-14 annual limit. That accords with HMRC data for 2013-14 that show only 10 per cent of ISA subscribers invested up to the limit that year.

Table 3.1: Household holdings of selected financial assets (2012 to 2014 survey)

	Percentage with (per cent)	Median value (£)
Current account	91	1,200
Savings account	57	4,200
ISAs	48	10,000
National savings certificates and bonds	23	900
Insurance products	6	20,000
Fixed term bonds	10	25,000
Unit/ investment trusts	5	25,000
UK bonds/ gilts	1	20,000
Any formal financial asset	98	13,700

3.4 Table 3.1 also shows that median values are much higher for the four asset types at the bottom that are held by far fewer households. This will be one factor behind the distribution of wealth that is presented in Chart 3.1, which is heavily skewed towards those with the highest incomes. While the 10 per cent of households with the highest incomes have net financial assets with a median value of close to £70,000, for the 10 per cent with the lowest incomes it is close to zero. This distribution is relevant when considering the savings measures covered in this chapter, which generally incentivise increased saving – for example, it is clear that many households’ income levels mean they may not be able to save more even if they were willing to do so because of the changed tax incentives.

Chart 3.1: Median household net financial wealth by net equivalised income decile



Source: ONS

Tax treatment of savings

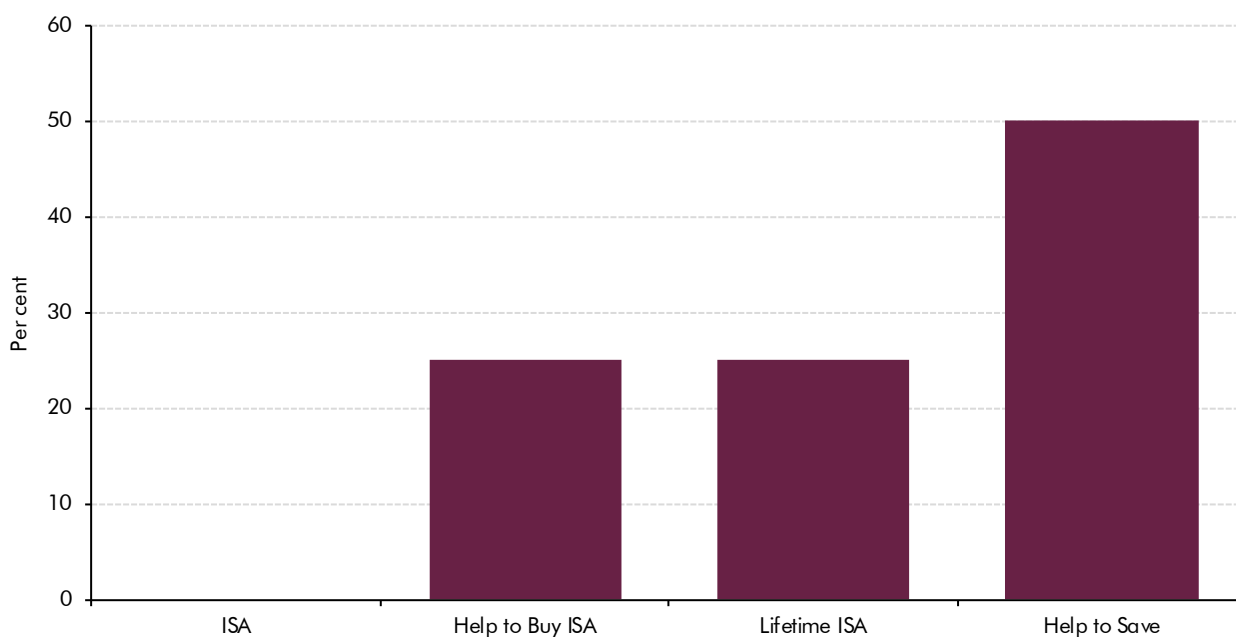
3.5 The tax treatment of savings products is broadly the reverse of that for private pensions discussed in Chapter 2. Earned income is taxed before it can be deposited in a savings

product, but when this investment is withdrawn it is not subject to income tax. In the case of ISAs (individual savings accounts), investment growth or interest income on the savings is tax-free too. From this year, the Government has introduced a 'savings allowance' that plays an equivalent role to the personal allowance for income tax. For basic rate income tax payers, the allowance means their first £1,000 of savings income will now be tax-free.

3.6 Chart 3.2 illustrates the savings equivalent to Chart 2.3 for private pensions. It represents the post-tax return from different savings products relative to current income. For simplicity, we assume no investment growth or inflation in the calculation. It shows that:

- for saving into a standard **ISA**, every £100 that is deposited or invested out of post-tax current income returns £100 on withdrawal, so there is no tax advantage (in contrast to pensions saving). Prior to the introduction this year of a savings allowance, ISA saving was treated more generously than non-ISA saving because interest income was not taxed. With the introduction of that allowance, that difference only remains for very high levels of savings;
- £100 saved in either a **lifetime or help to buy ISA** would attract a £25 top-up from the Government, a return of 25 per cent relative to current income. While generous, for those that drop a tax band in retirement it is still less generous than the tax treatment of pension contributions. For those that remain in the same tax bracket after retirement, the lifetime ISA with a 25 per cent top-up is more advantageous. This only applies to individual contributions. If employer contributions were taken into account, depending on the matching ratio, for many the pension will give a greater rate of return; and
- the most generous option is the **help to save** product for those on low incomes, where a £50 government top-up means £100 of saving returns £150 in future income, a 50 per cent return on current income. As this product is aimed at those on low incomes, many who are eligible may not be able to take advantage of it.

Chart 3.2: Savings: comparing future returns against current income



Source: OBR

Main savings measures since 2010

3.7 Table 3.2 recreates the 'scorecard'⁸ costings of five major policy measures affecting savings that have been announced since 2010. These measures have sought to increase the incentive to save at a cost to the Exchequer in terms of either forgone tax receipts or additional public spending. The longer-term effect of these measures could be different to that over the scorecard period. In particular, they would be higher if interest rates were to rise to more historically normal levels in the longer term. The costs shown in Table 3.2 were estimated on the basis of historically low interest rates.

Table 3.2: Main savings measures announced since 2010

	Scorecard period	£ million					
		Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
March 2014							
ISAs: equalise stocks and shares and cash ISA limits and increase to £15,000	2014-15 to 2018-19	-5	-80	-230	-395	-565	N/A
March 2015							
Help to Buy: ISA	2015-16 to 2019-20	-45	-230	-415	-640	-835	N/A
Savings tax: allowance and ISA flexibility	2015-16 to 2019-20	-15	-1030	-565	-640	-765	N/A
March 2016							
Help to Save	2016-17 to 2020-21	0	0	0	-20	-70	N/A
Lifetime ISA and raise ISA limit to £20,000	2016-17 to 2020-21	neg	-170	-330	-590	-850	N/A

⁸ The Treasury presents a table in each Budget and Autumn Statement that reports the estimated cost or yield from all the new policy measures announced in that statement. It is known as the 'scorecard'.

Savings allowance

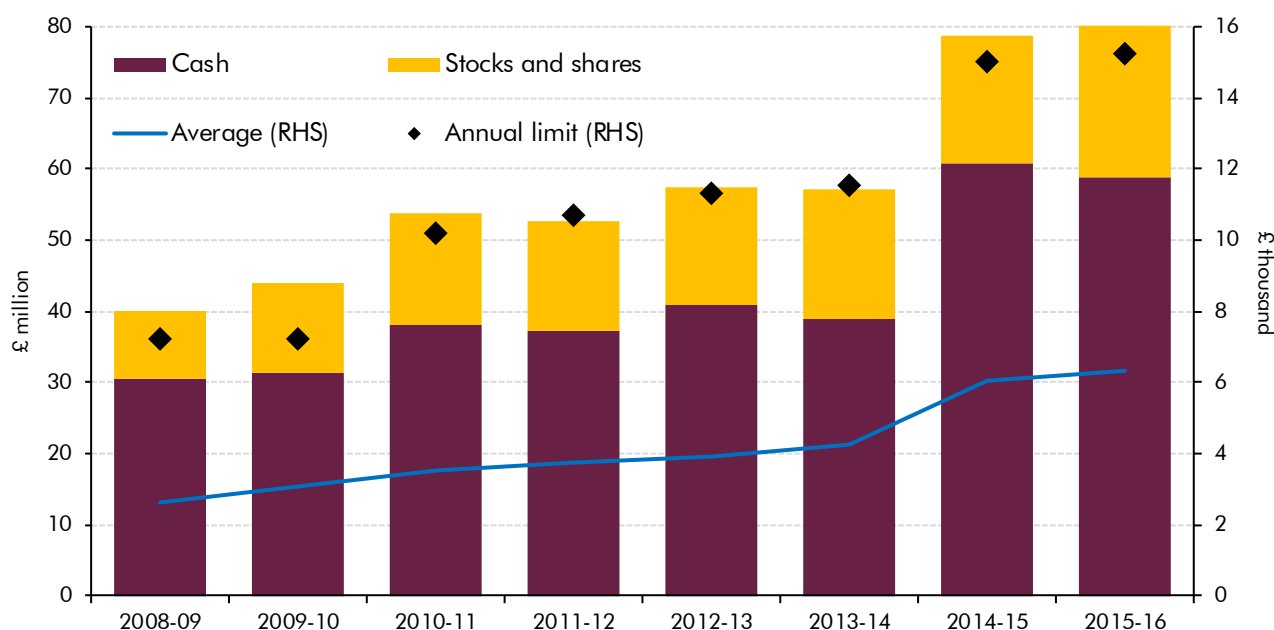
- 3.8 The savings allowance was announced in March 2015 and came into effect in April 2016. It allows a basic rate income tax payer to earn £1,000 of interest on their savings (£500 for higher rate payers) before tax is due. In effect, this makes these savings tax-equivalent to those in an ISA. Additional rate payers receive a zero-savings allowance. At the Bank of England's present effective rate on household retail deposits (around 1 per cent), a basic rate tax payer could have up to £100,000 of savings before tax is due.
- 3.9 The measure was estimated to cost £3 billion in the five years to 2019-20 (with a small cost in the year before its implementation because it was pre-announced, giving taxpayers the chance to arrange their savings behaviour in the most tax-efficient manner). We assigned it a 'medium-high' uncertainty ranking. Beyond the scorecard period, the longer-term cost of the savings allowance would increase if interest rates rise, shielding larger sums from tax. For example, for a basic rate tax payer with £10,000 of savings that earn interest at 1 per cent, the allowance would cost £20 in forgone income tax. This would rise to £80 if the interest rate was 4 per cent.

Increases in ISA subscription limits and new ISA products

ISA limits

- 3.10 Chart 3.3 shows that the annual amount an individual can save in an ISA went up from £7,200 in 2009-10 to £15,000 in 2014-15 and will be increased to £20,000 from 2017-18. It also shows that increases have consistently led to larger amounts being saved in ISAs. For example, total ISA investments increased from £57 billion in 2013-14 (when the ISA subscription limit was £11,520) to £79 billion in 2014-15. The average amount invested per account increased from £4,250 to £6,064.
- 3.11 HMRC's figures for 2013-14 show that almost 10 per cent of ISA subscribers invested up to the limit in that year. It is this subset of ISA subscribers that might be expected to increase their ISA saving when the subscription limit is raised.

Chart 3.3: ISA subscription limits and total amounts invested



Source: HMRC

- 3.12** The March 2014 measure raising the limit to £15,000 and permitting it to be used in its entirety for cash ISAs was estimated to cost £1.3 billion over the five years to 2018-19. Taking the limit up further to £20,000 was announced as part of the lifetime ISA measure discussed below. It was only expected to cost £30 million over five years, given the smaller number of ISA savers that were expected to be already subscribing to the 2016-17 limit of £15,240 and have sufficient spare cash available to save even more into their ISA.
- 3.13** The longer-term cost of these measures is likely to continue rising beyond the scorecard period for two reasons. First, the cost builds up as the stock of savings shielded from tax rises each year (as of end-March 2016, the market value of all adult ISAs had reached £518 billion, up from £287 billion ten years ago). Second, if interest rates were to increase towards historically normal levels, the amount of tax forgone on interest income would increase.

Help to buy ISA

- 3.14** In March 2015, the Government announced the introduction of a 'Help to buy ISA', which was launched in December 2015 and will be available until November 2019. It allows first-time home buyers to benefit from a 25 per cent government top-up when purchasing a house. The value of the house cannot exceed £250,000 outside London or £450,000 in London. Up to £200 a month can be saved, with a minimum of £1,600 required to receive the top-up and a maximum of £12,000 (so a maximum top-up of £3,000). Government contributions must be claimed by December 2030.
- 3.15** The measure was originally estimated to cost £2.2 billion over the five years to 2019-20. That cost represents additional public spending. In our March 2016 forecast, we revised down our estimate of the cost to £1.7 billion over that period due to lower expected interest

rates and a methodological change to capture the effect of rising house prices on the proportion of first-time buyer property transactions that will be below the scheme caps (which are fixed in cash terms).

- 3.16 In our March 2015 *EFO* we gave this a ‘very high’ uncertainty ranking. We judged that there was “*considerable uncertainty around the behavioural impact – in particular the take-up within the target population*”. For example, the house price limit might restrict demand in some parts of the country, particularly if house prices continue to rise.
- 3.17 The recent media coverage that savers using this product will only be able to access the government top-up when completing their house purchase, rather than earlier in the house-buying process, might further affect take-up though it is in line with the original scheme outline. Take-up is also likely to have been reduced by the introduction of the lifetime ISA, which was factored into the estimated cost of that measure. The scheme has got off to a slower start than expected as recent official statistics show that only £1 million of government contributions were paid in 2015-16 and £13 million in the first 4 months of 2016-17.⁹
- 3.18 Given the cap on the government top-up and time limit on access to the scheme, it will continue to add to public spending until the closure of the scheme in 2030. But unlike the savings allowance or ISA limits measures, the cost would not be very sensitive to any increase in interest rates towards historically normal levels.

Lifetime ISA

- 3.19 In March 2016, the Government announced the introduction of the lifetime ISA (LISA) that will allow savers to invest up to £4,000 a year and receive a 25 per cent top-up from government. The full amount saved, including interest, can be withdrawn without charge for either a first-time house purchase (up to a value of £450,000) or for retirement income from the age of 60. All other withdrawals will be subject to a charge of 25 per cent plus the loss of any growth in the government contribution. Those between the ages of 18 and 40 are eligible to open an account, but the government top-up will continue for account holders up to the age of 50. The scheme’s rules mean that an 18-year old could invest £128,000 over 32 years and receive £32,000 of government contributions.
- 3.20 Take-up of the LISA is expected to come from four main groups: those affected by the lowering of the pensions’ annual allowance and lifetime allowance (described in Chapter 2); current non-employer sponsored personal pension savers for whom this is a better deal; existing ISA users that may choose to switch from other products; and prospective first-time house buyers.
- 3.21 The expected cost of the LISA is mostly the additional public spending associated with the 25 per cent government top-up, although there is expected to be a small tax cost from new ISA savers attracted to the LISA. There is also a near-term tax gain from those individuals that

⁹ https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/556455/H2B_ISA_stats_sept_16_final.pdf

opt for the LISA over pension saving (because LISA contributions are made out of post-tax income, unlike pension contributions), but this is offset in the longer term by the loss of the tax that would have been due when those pension savings were drawn down. The attractiveness of the LISA relative to pension saving will differ across individuals depending on their current tax status and their expected tax status in retirement (as was shown in Chart 2.3). Ignoring employer contributions, for those that are basic rate taxpayers in work and in retirement, the LISA is more beneficial from a purely tax perspective. But for those who expect to drop from higher rate to basic rate in retirement, it is more attractive to make pension contributions. If employer contributions were taken into account, depending on the matching ratio, for many the pension will give a greater rate of return.

- 3.22 We assigned this measure a ‘very high’ uncertainty ranking in our March 2016 *EFO* mainly due to uncertainty around the behavioural response of prospective savers. The number of people choosing to take up the LISA, how much they choose to save and when they choose to withdraw were estimated on the basis of little information. As with the help to buy ISA, rising house prices may limit demand in some parts of the country.
- 3.23 The scorecard costing, which peaks at £830 million in 2020-21, is not representative of the longer-term impact of the measure as the government top-up continues until the saver reaches the age of 50.¹⁰ The estimates we present in Chapter 4 suggest that the cost will not reach a steady state until around 10 years after implementation.

Help to save

- 3.24 In March 2016, the Government announced the introduction of a regular savings account into which it will top up an individual’s savings at a rate of 50 per cent. ‘Help to save’ accounts will be available to those on low incomes that are in receipt of either working tax credits or its equivalent in universal credit. The maximum monthly contribution limit is £50 and it has a 2-year term until maturity, so an individual that saves £2,400 over two years would receive £1,200 from government. Individuals can then choose to save for a further 2-year term. Second term accounts would not mature until beyond the scorecard period, so the cost peaks at around £100 million in 2022-23 when the first group of second term accounts begin to mature.
- 3.25 The estimated cost mainly arises from the additional public spending associated with the government contribution. It was estimated to rise to just £70 million in 2020-21 due to relatively low take-up.¹¹ The uncertainty around both take-up and the time that individuals hold onto savings were among the main reasons for the ‘high’ uncertainty ranking that we assigned to this measure.

¹⁰ We have split out the cost of the lifetime ISA from the published estimate, which included a measure to raise ISA limits to £20,000.

¹¹ The saving gateway was a measure similar to help to save that was first announced by the then Labour Government in 2001. Two pilot schemes were undertaken and it was due to be introduced fully in 2010 but this was cancelled by the then new Coalition Government in its June 2010 Budget. The Institute for Fiscal Studies was involved in evaluating the pilot schemes and found no evidence of an increase in overall savings.

4 Long-term costs and yields

Introduction

4.1 In Chapters 2 and 3 we described ten private pension and savings measures that have been announced since 2010 and how they could have different long-term effects from those estimated over the 5-year periods covered by each published costing. In this chapter:

- we **extend each costing to 2034-35** to show how they could affect the public finances in the long term;
- **illustrate the main sensitivities** to which these long-term costings are subject; and
- describe some of the **potential indirect effects on the wider economy** that could be associated with private pensions and savings measures.

4.2 Since our December 2014 *EFO* we have been assigning subjective uncertainty rankings to each policy costing. Before then we highlighted measures we felt were particularly uncertain and why. Many of the measures we cover in this note have a relatively high uncertainty ranking, often stemming from the costing being sensitive to the behavioural response of taxpayers, which can be difficult to estimate accurately. It follows that extending costings to the long term amplifies this uncertainty. The analysis presented here is a relatively simple extrapolation of the effects on our medium-term forecast, quantifying the effect of each policy once it reaches a steady state.

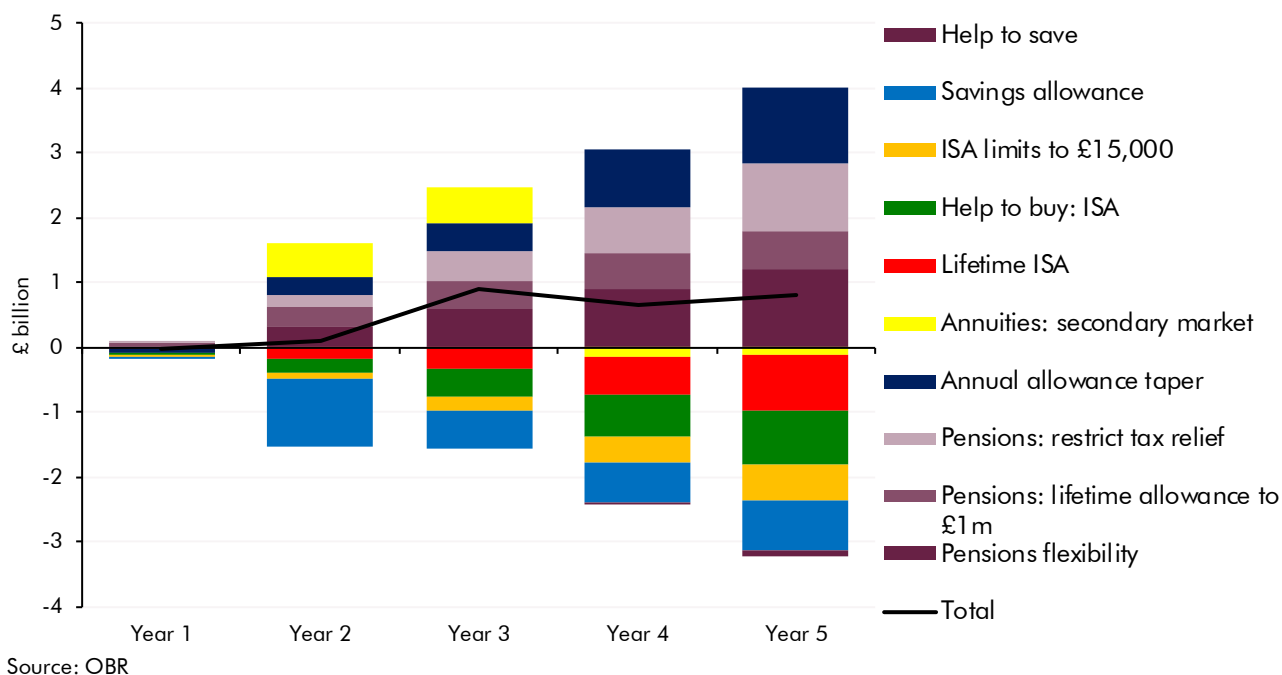
Central estimates of long-term costs and yields

Published medium-term costings

4.3 Tables 2.1 and 3.2 showed the medium-term scorecard costs and yields from the private pensions and savings policies we consider in this paper. Chart 4.1 combines these and presents their aggregate estimates by scorecard year (rather than actual year) to illustrate how the effects of these measures tended to build up over the forecast periods that they initially affected.¹² The pattern over these five year periods was a rising yield in the case of the pensions measures (reaching around £4 billion in the fifth year) and a rising cost for the savings measures (reaching around £3 billion by year five). The net effect on this scorecard-year basis was a yield of around £1 billion a year from year three.

¹² For example year 1 in Chart 4.1 represents 2012-13 for 'Pensions: restrict tax relief', 2015-16 for 'Help to buy: ISA', 2016-17 for 'Help to save' and so on.

Chart 4.1: Combined scorecard costs and yields



Modelling the long-term effects

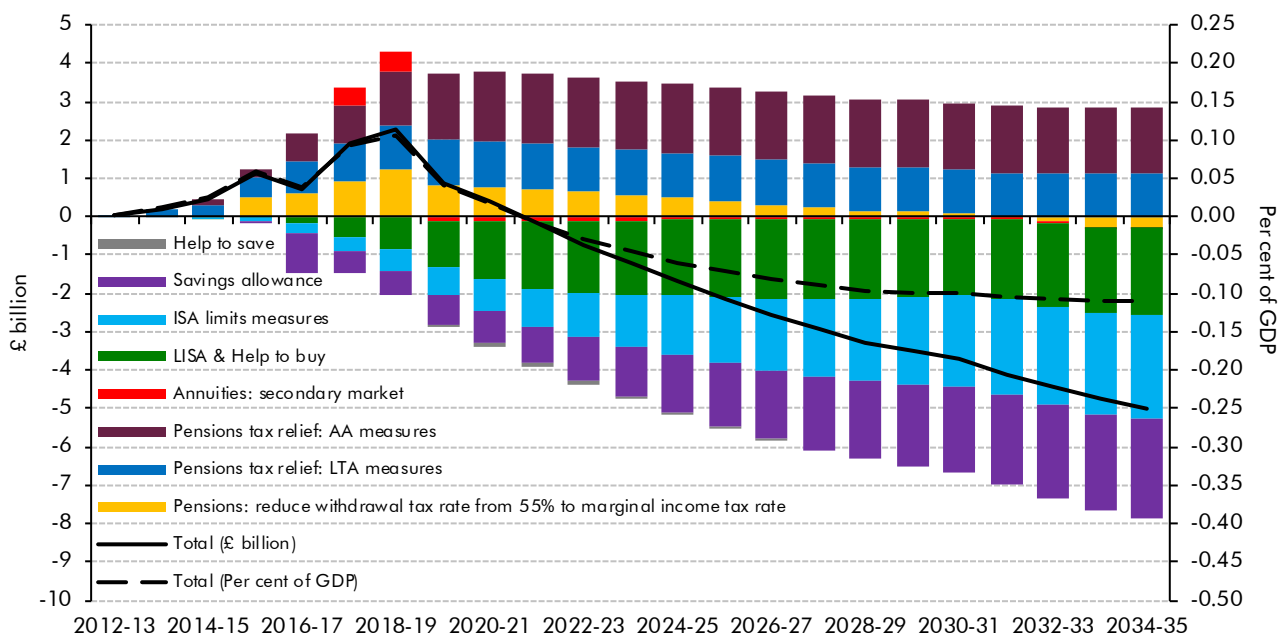
- 4.4** To arrive at our long-term estimates we have in most cases either extended the outputs from the original models or grown the medium-term scorecard estimates by appropriate economic variables. For pensions measures this is typically average earnings while for savings measures it is the path of interest rates on household bank deposits. Policy parameters that have an effect over the longer horizon – such as the time-limited availability of some of the savings measures – have also been incorporated. Beyond the scorecard period for each measure, we have assumed that rates and thresholds are uprated in line with earnings (as we typically do for most elements of our long-term fiscal projections).
- 4.5** For both average earnings and the deposit rate, we have used our March 2016 *EFO* forecast to 2020-21. Beyond that we have used our 2015 *FSR* assumption for average earnings growth of 4.5 per cent a year and assumed that deposit rates rise to 3 per cent by 2034-35. That would return deposit rates to the average of the past 20 years. We test our results to different assumptions in the sensitivity analysis section of this chapter.
- 4.6** Growing the measures restricting the annual allowance and the lifetime allowance for defined contribution pensions by long-term average earnings increases the yield over time. This is because we would expect greater amounts of tax relief to be restricted by these measures as earnings increase. The extent of this depends on assumptions about policy parameters, notably whether rates and thresholds are assumed to rise with earnings or prices or are fixed, which we also discuss later in the chapter. One factor working in the opposite direction is that we would expect final pension pots to be smaller than in the absence of these measures. That would reduce income tax receipts when pensions are drawn down, which we have reflected in the long-term costing.

- 4.7 As described in Chapter 2, both the pensions flexibility and secondary annuities measures are expected to raise money initially by encouraging either early withdrawals of pensions funds or cashing in annuities on a secondary market. Both of these actions would be subject to income tax, but in each case they would also reduce the amount of future pension earnings that would also have been subject to income tax.
- 4.8 The long-term estimates have been modelled by extending the original costings approach. The yield from the secondary annuities measure was expected to fall quickly since those already in retirement that want to cash in their annuity would be expected to do so quickly. After that, it was assumed that annuitants who had not already sold would not do so later, while new retirees that chose to buy an annuity would not subsequently choose to sell. It will take much longer for the flexibility measure to reach steady-state as the affected group are those below retirement age and who would have been expected to draw down pension income for a much longer period in the absence of the measure.
- 4.9 For the savings measures, the cost in the medium term described in Chart 4.1 is generally defined by the number of individuals that take up new products or allowances. Over the longer term, it is driven by the level of deposit rates. The costs, particularly for the increase in ISA limits and the savings allowance, are highly sensitive to deposit rates. Since 2009, these have fallen to historic lows, which helped explain the relatively low medium-term costs of these measures. By assuming deposit rates rise back to their 20-year average, our central long-term estimate shows the cost rising significantly.

Estimating the long-term effects

- 4.10 Chart 4.2 presents our central long-term cash estimates for the ten measures. The net effect on the public finances is positive in the early years, peaking at £2.3 billion in 2018-19 before turning negative from 2021-22 – the year after our March 2016 forecast horizon. This net cost continues to rise in cash terms, reaching £5 billion by 2034-35. Expressed as a share of GDP – a more relevant metric when considering fiscal sustainability – the net cost builds up until it reaches a steady state toward the end of the period of just over 0.1 per cent of GDP. If that steady-state effect was to continue to the end of our usual long-term projection horizon of 50 years, that seemingly small cost would add 3.7 per cent of GDP to public sector net debt.

Chart 4.2: Combined long-term costs and yields



Source: HM Treasury, HMRC, OBR

4.11 In our 2014 *FSR* we considered the effect on welfare spending if large numbers of people made early pensions withdrawals, exhausted their pensions savings and became more reliant on state benefits in later years. This behaviour might be down to placing a greater weight on short term rather than future consumption or simply underestimating their life expectancy and future expenditure requirements. We concluded that any effects would be relatively modest given the small share of total spending made up of income-related benefits for pensioners and the changes to pension credit as part of the introduction of the new single-tier pension.¹³

Sensitivity analysis

Interest rates and earnings growth

4.12 The long-term costings presented in the previous section are based on our central assumptions about earnings growth and deposit rates. In this section we test the sensitivity of our results to higher or lower assumptions for each. We test all combinations of these assumptions. In normal times, earnings growth and deposit rates would be expected to be positively correlated. Both are affected by inflation, while in real terms high earnings growth might suggest the economy is overheating and prompt monetary policymakers to raise interest rates to cool it down. As such, the high-high and low-low combinations might be considered more likely alternative scenarios and the high-low combinations as lower probability risks.

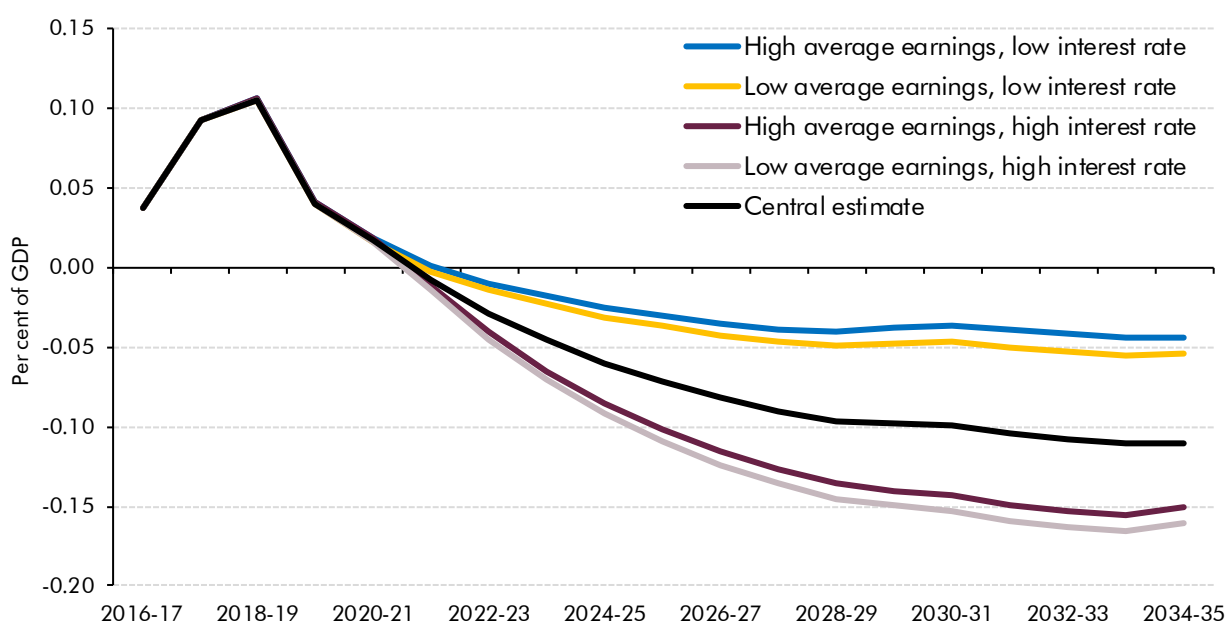
4.13 The alternative assumptions that we use are:

¹³ See Box 3.1 of our 2014 *FSR* for a fuller discussion of these potential effects.

- for **average earnings** growth we vary the assumption by 1 percentage point in either direction to provide illustrative ‘high’ and ‘low’ scenarios; and
- for **household deposit rates** we vary the assumption between a ‘low’ scenario where they rise slowly to just 1.5 per cent (roughly where long-term bond yields currently imply markets expect interest rates to be) and a ‘high’ scenario where they rise to 4.1 per cent (the average interest rate over the 15 years between the start of inflation targeting in the early 1990s).

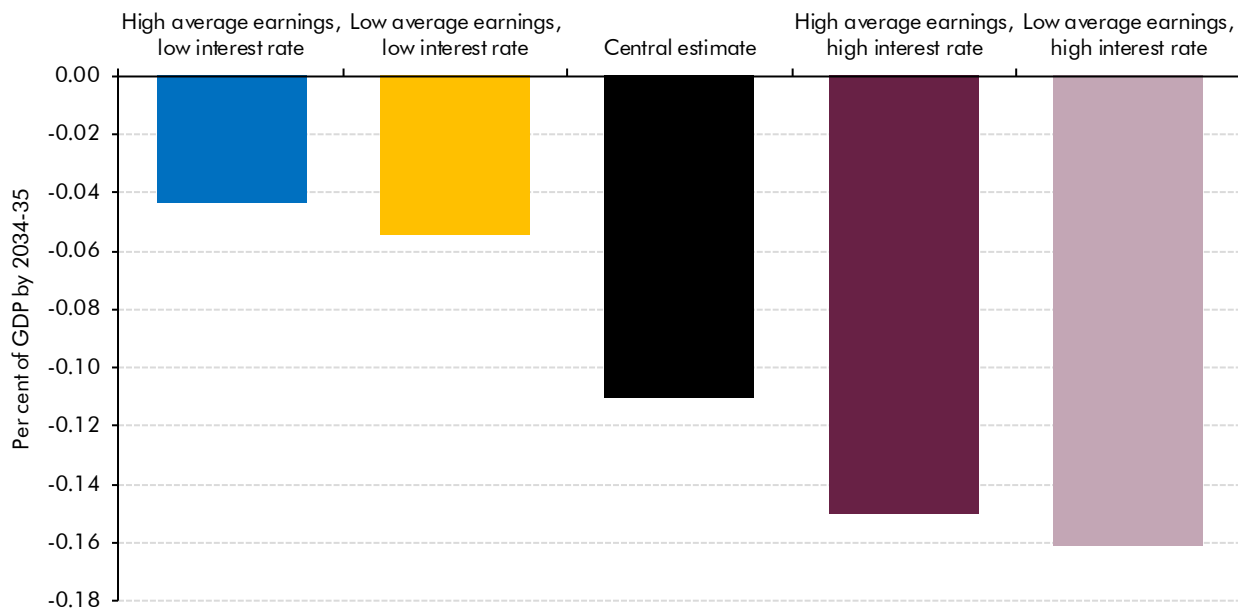
4.14 Charts 4.3 and 4.4 show that in all the combinations that we have modelled, the net effect across the measures is positive in the medium term but negative in the long term. The estimated long-term effect on the budget balance lies between 0.04 and 0.16 per cent of GDP. The results are more sensitive to changes in the assumptions about interest rates than earnings growth.

Chart 4.3: Alternative scenarios for the net long-term cost



Source: OBR

Chart 4.4: Comparison of long-run effects across alternative scenarios



Source: OBR

Fiscal drag

- 4.15** Fiscal drag is the process by which average tax rates rise as taxpayers move into higher tax bands over time. For example, income tax thresholds are indexed to prices, which have typically risen less quickly than earnings resulting in more taxpayers in the higher rate band and a higher share of all earnings paying tax at that rate. The opposite would be true if prices grew faster than earnings, as has been the case in a number of recent years.
- 4.16** For the pensions restriction measures, we would expect fiscal drag to increase the yield over time. For example, the July 2015 measure to taper the annual allowance for those earning over £150,000 would be affected by fiscal drag across two thresholds. First, the £150,000 threshold is not indexed, so as earnings grow more people would be affected over time. Second, the annual allowance is not indexed either, which would reinforce the effect of fiscal drag, further increasing the number of people affected over time. There would be similar effects for the lifetime allowance, where the threshold is indexed to the CPI inflation, which we would expect to increase at a slower rate than earnings in the long term due to the effects of productivity growth.
- 4.17** For the savings measures, the effect of fiscal drag would be to increase the cost over time. Each of the measures results in a more generous tax treatment for savings, so the total cost increases with the number of higher rate taxpayers, for whom the tax that would otherwise be collected would have been at 40 per cent. Working in the opposite direction, the savings allowance is only £500 for higher rate taxpayers compared to £1,000 for basic rate payers, so a greater proportion of higher-rate taxpayers would mean less interest income being shielded from tax by the allowance.

Indirect effects on the wider economy

- 4.18 A number of policies announced at Budgets or Autumn Statements have indirect effects on the wider economy. These indirect effects may include the effect of policy changes on whole economy output, employment, investment, consumer spending or inflation. Indirect effects differ from the direct behavioural effects that are included in individual policy costings because they affect economy-wide variables. We factor them into our economy forecast so that their knock-on implications for other areas of tax and spending can be captured in our fiscal forecast.
- 4.19 For the measures we consider in this paper, we have generally taken the view that the principal effect is on the composition of household assets rather than the aggregate flow of saving or spending. They are very likely to prompt individuals to shift their financial wealth between asset types. At an individual level, they will also affect the net propensity to save. But in aggregate, we have typically assumed that these effects will be offsetting – for example, while pensions flexibility is likely to reduce saving and increase consumption among those drawing their pensions early, it will also encourage some to save more now so that they can benefit from the tax-free lump sum when they draw down those pension savings in the future.

Effect on housing market

- 4.20 Measures that change the relative incentive to save, whether in savings or pensions, will also affect the attractiveness of other investments such as housing. A number of the measures we cover in this paper could affect the housing market, mostly by increasing demand for housing and putting upward pressure on house prices.
- 4.21 Separating the effect of this set of measures from other factors, including other measures, that impact savings and investment decisions is difficult. In our March 2014 *EFO* and again in our 2014 *FSR* we looked at the possibility that the pensions flexibility measure might release funds that would flow into housing. At the time we judged any effect to be highly uncertain and did not adjust our house price forecast. If significant volumes of money were diverted from pensions to housing, then given the relatively fixed supply of housing it would be expected to feed through to higher prices. It is possible that the restrictions in the annual allowance and lifetime allowance might also have diverted funds into housing, with the same potential effects.
- 4.22 In our March 2015 *EFO* we discussed the effect of the help to buy ISA. At the time we noted that this measure might increase the demand for housing, but we felt it was probably too small to have a significant impact on house prices. For the lifetime ISA, which we discussed in our March 2016 *EFO* we judged that the effect would be sufficient to warrant factoring it into our economy forecast, adding 0.3 per cent to the level of house prices by 2020-21. While still highly uncertain, we felt that this measure would have a more significant effect than the help to buy ISA, not least because it is more generous. That said, 0.3 per cent represents an increase of less than £1,000 for the average priced house, which is small relative to the 20 per cent (around £50,000) rise in house prices in our March 2016 forecast.

- 4.23 The effect of higher house prices on the public finances is likely to be relatively neutral. We set out some illustrative ready reckoners in our March 2015 *EFO*. For house prices, these suggest that a 1 per cent rise would boost capital tax receipts (stamp duty, capital gains tax and inheritance tax) by between £180 million to £360 million. Since then, the introduction of a stamp duty surcharge on additional properties mean that revenue effect is likely to be larger. Working in the opposite direction, any house price increase is likely to feed through to higher rents too, which in turn could lead to higher spending on housing benefit. Also, spending on rent and mortgage repayments is not subject to VAT, so as that increases it might divert spending away from items where VAT is applied, lowering overall receipts.
- 4.24 There are also a number of factors that could put downward pressure on house prices. First, measures like the savings allowance and increase in ISA limits would be expected to divert funds towards those products and away from other investments, including housing. Second, there have been a number of other policy measures that are likely to dampen interest in housing investment, including the reduction in the amounts landlords can offset against taxable income and the surcharge on the purchase of additional homes. Third, if interest rates rise, borrowing to fund housing investment would become more costly and less attractive.

5 Conclusions

- 5.1 In recent years, the Government has made a number of significant changes to the tax treatment of private pensions and savings and introduced a variety of government top-ups on specific savings products. In doing so, it has generally shifted incentives in a way that makes pensions saving less attractive – particularly for higher earners – and non-pension savings more attractive – often in ways that can most readily be taken up by the same higher earners.
- 5.2 Over the five-year periods covered in Budgets and Autumn Statements, the estimated yield from reducing generosity on private pensions slightly exceeds the estimated cost of increasing it for other savings. But some of the private pensions measures – notably the March 2014 pensions flexibility measure – only brings forward receipts from the future, whereas the cost of some of the savings giveaways – in particular the savings allowance and higher ISA limits – will continue to rise over the long term.
- 5.3 The central estimates that we present in Chapter 4 suggest that the small net gain to the public finances from these measures over the medium-term forecast horizon becomes a small net cost in the long term. While the 0.11 per cent of GDP steady-state cost is small relative to some of the demographic pressures on the public finances that we discuss in our *Fiscal sustainability reports*, cumulated over a period of 50 years that small cost would add 3.7 per cent of GDP to public sector net debt.
- 5.4 We have highlighted the uncertainty around the medium-term costings of these measures, often assigning our highest uncertainty ranking to them. Over the longer term, the uncertainties will be even greater. We test the sensitivity of our results to alternative assumptions about long-term earnings growth and the path of interest rates. To the extent that the historically positive correlation between these drivers of the cost or yield from the different measures continues to hold, our conclusions would be little changed by different assumptions. If they were to diverge – and particularly if interest rates were to rise in the absence of a pick-up in earnings growth – the long-term cost from these measures could be greater.
- 5.5 As with any of our analysis of long-term pressures on the public finances, the relatively slow pace at which they would affect the public finances would allow future governments to adjust policy if they felt that was necessary. But the conclusions presented in this paper do show how the effect of decisions on the public finances over the medium term may be different over longer horizons.

