

NO LIMIT

Attitude to saving

Tax concessions which encourage saving have not been planned as part of a systematic and rational approach. They have been added, withdrawn or changed over the years, depending to a large extent on the attitude of different governments and various Chancellors. The result has been a marked lack of coherence, and a complexity which defeats the intention of the exercise.

In an ideal economy, government would decide if it wished to encourage saving, the extent to which it wished to do so, and the measures most likely to bring positive results. Bearing in mind the lack of accounting training on the part of most of its taxpayers, it would keep the system simple, easy to explain and understand, and attractive to those it was aimed at. This plainly bears little relation to the system which has evolved over the years in Britain.

The only consistency which tax-encouraged savings exhibit in Britain derives from two consistent attitudes rather than from rational plans. The first is the general presumption on the part of the Conservative governments from 1979-1997 that private savings were a good thing which enabled people to achieve a measure of independence from government and a degree of self-reliance. To this extend those governments introduced and supported various measures which made saving more attractive and encouraged more people to do it.

Previous governments had encouraged people to save with them, rather than with private alternatives. Thus National Savings Certificates had been tax advantaged, not necessarily to increase the savings ratio, but to divert savings to government which might otherwise have gone elsewhere. The 1979-97 Conservative governments gave tax concessions in addition to savings which were not made with government, but with a variety of competing private alternatives.

They introduced Personal Equity Plans (PEPs) in 1987, which allowed people to save in protected funds. Savers were allowed up to £6,000 in a general PEP, and an additional £3,000 in a single company PEP. The key fact here was that the savings themselves came out of *taxed* income; only the growth and dividends achieved by the funds were exempt from further taxation. PEPs proved highly popular with large numbers, with the Treasury estimating 3m PEP savers by late 1997, although it was argued by some that the rules made them more suitable for higher earners than for ordinary wage-earning, basic rate taxpayers.

The addition by John Major, as Chancellor in Lady Thatcher's last government, of Tax Exempt Special Savings Accounts (TESSAs) went some way to tax tax-encouraged saving down the income scale. They came into effect at the beginning of 1991. With a TESSA, a saver was allowed an additional £9,000, paid for over 5 years into the chosen bank or building society offering the special account. Once again, the principal was that the savings came from taxed income, but the earnings of the account would be tax-free. TESSAs covered a wider group of savers, estimated by the Treasury to number 4.5m by late 1997.

The Treasury attitude

If the 1979-97 governments were consistent in their desire to encourage people to save privately, an even more consistent attitude came from the Treasury. They have always treated any tax exemption or concession as a "tax cost," and have fought against all of them. They not only see themselves as guardians of the public revenue; they treat it largely as their own. Any revenue foregone is not regarded by them as money left in the hands of those to whom it belongs, but as money *spent* by the Treasury.

It is significant that in their Pre-Budget Report of December 1997, they say that tax relief on PEPs "is estimated to *cost* over £800m in 1997/98" (our italics). Similarly, they said that the tax relief on TESSAs "is estimated to *cost* £450m in 1997/98" (our italics). The assumption behind the use of this term is that, had there been no tax relief, people would still have saved it, and the capital growth and dividends would then have yielded these sums to the Treasury. It is, to say the least, a curious assumption, in that the tax relief was offered in order to encourage people to make savings they would *not* have made otherwise. Without the tax relief, perhaps people would not have saved the money at all; or if they had, they might have made use of off-shore funds, like the Minister who introduced the report.

Completely missing from the Treasury calculation of what it calls the "cost" of this relief is any inclusion of revenue saved or generated by the savings so encouraged. For example, there will undoubtedly be some people whose savings take them out of the need for subsequent state help. To some the savings will provide an adequate pension which obviates the need for income support. To others they will be available for nursing home care which might otherwise have fallen as a charge upon the state. Yet another group will use their savings to fund private education for children or grandchildren, lowering the state education budget accordingly. A further group still will undoubtedly use them to pay for private medical treatment which might otherwise have had to be provided on the NHS at cost to public funds.

Not only do the Treasury estimates of "cost" fail to take account of the uses to which such savings might be put; they fail to allow for additional tax revenues which might be generated. The point is that saving not only benefits the saver by providing for future needs and security. It also benefits society by providing investment for the economy. Business and economic activity expands because of the additional investment, and growth is higher than it would have been without it. The additional growth brings more money into the Treasury as the yield is increased from income tax, value added tax, corporation tax and others.

The additional growth brought about by the investment effect of extra savings can be considerable. Prof Martin Feldstein, former head of the President's Council of Economic Advisers in the US, calculates that if the US state pension system (called Social Security) were switched over to private savings, the US economy would grow by an additional 3-5%. In Britain Peter Lilley has estimated that if the changeover of basic pensions to funded savings accounts generated only one twentieth of one percent of extra growth, it would fund the entire transition over a generation.

Individual Savings Accounts

The new system is designed to encourage saving by a wider group than has taken advantage of PEPs and TESSAs. It does this by being more accessible; in addition to banks and investment houses, it will feature building societies, supermarkets and swipe cards among the options. Each Individual Savings Account (ISA) will have a manager chosen by the holder, and the manager will handle the various elements, including cash, stocks and shares, life insurance and national savings.

On accessibility the new system scores heavily. By making it generally available in settings and circumstances familiar to most people, it removes it from the realm of financial expertise and puts it into the High Street. If it is kept very simple and easily promoted, it could greatly increase the numbers who make long term savings.

It scores, too, on flexibility. The mix of assets (cash, shares, life insurance and national savings) will enable ordinary people to opt for the vehicles with which they feel most comfortable. The maximum of £1000 each in cash and life insurance seems unnecessary, but will hardly deter people from saving. It could be argued that the asset mix will prove complicated for ordinary savers to get to grips with, but most people are familiar with at least three of the asset classes included. In practice the fund managers will package their ISAs in ways most readily understood by their clients. Their statements will feature totals and sub-headings which tell savers the bottom line information they need.

Like PEPs and TESSAs (which ISAs will replace), the savings come out of taxed income, but any gains and dividends within the fund will be tax free. In addition, for the first five years of the scheme there will be a 10% tax credit paid on dividends from UK shares. Unlike TESSAs, which have to be held for 5 years, people will be able to take money out of ISAs without losing benefits already gained.

The prize draw among ISA holders, which picks 50 winners each month to have a £1000 prize added to their account, could be dismissed as a gimmick, but it is part of the drive to make these funds accessible to groups which have not been traditional savers. It might just provide an added incentive and a vehicle for attractive promotion of the new scheme.

The investment limit

The annual limit of £5,000 of saving per person per year is very much less than that allowed by the schemes which ISAs replace. The full PEP allowance of £9,000 per year plus the £5,000 over 5 years allowed by TESSAs gave an upper limit which averaged out at approximately £10,800 per year. The proposed £5,000 limit is less than half that. The Government's case is presumably that although each saver is allowed half as much, there will be at least twice as many of them as the non-traditional savers come on board.

It could also be argued that many PEP and TESSA savers do not use the maximum annual allowance anyway. The problem with the proposed new scheme is not the £5,000 annual limit; it is the £50,000 lifetime limit. This is sufficient to negate all of the other advantages of the scheme. Any increased accessibility, flexibility and simplicity are wasted on so limited a scheme.

A lifetime limit on £50,000 for ISAs, given an annual limit of £5,000 per saver per year, sends a completely wrong message. It tells people they may

save for 10 years, whereas it should be encouraging them to save for a lifetime. £50,000 might look like a large sum to Treasury officials anxious not to lose a penny of the tax they might gain from the growth achieved within savings funds (they have already taken tax on the money put in). It does not look large, however, for a saver looking 40 years ahead to a fund which can provide security and comfort when they are older.

The proposal to allow existing PEPs and TESSAs to be rolled into ISAs (within the £50,000 limit) becomes meaningless to those already above or near that figure already. This is another raid on the savings accumulated under a different set of promises and assumptions. People took out PEPs and TESSAs expecting them to continue, and made long term plans accordingly. Now they are told of an arbitrary limit which makes nonsense of their plans.

Those who took out private pension plans were similarly confounded when their funds were raided by the Chancellor in his first budget. Again, their long term plans were confounded by an ex post facto change in the rules which has made them all worse off. The Chancellor is sending a message loud and clear: he does not care about the middle classes or their habits of thrift, and is not prepared to encourage them.

The smallness of the overall size of each ISA will increase costs as a proportion of the fund, and reduce competitiveness by keeping out many potential fund managers. The total size of each account is just too small to interest many who might otherwise provide a very competitive product. Several potential managers have already expressed the view that ISAs will not be worth while with such a low lifetime limit. Richard Branson of the Virgin group reacted with immediate opposition to the proposed limit. The government should take notice that the success of the whole scheme is threatened by this arbitrary restraint on savings.

There will, in addition, be considerable policing costs incurred by the Treasury in checking the size of ISAs and trying to ensure that people do not go above the lifetime limit. It will involve a whole new database, and an expensive one to assemble and to operate. With several different types of saving permitted, and a different fund manager each year, it will be a nightmare to keep track of them all to ensure their total remains less than £50,000.

If policing is simplified by forcing savers to stick with one lifetime manager, there will be lack of competitive choices, and lack of diversification for savers. It is difficult to see how the Treasury will keep abreast of the various different holdings which savers have with different managers, to ensure compliance with the upper limit.

No limit

For the new savers attracted to ISAs, if there were an annual limit of £5,000 per saver, but no lifetime cap, the effective upper limit would be in the region of £225,000, representing a saving of £5,000 over a working life of perhaps 45 years. This would really be an upper limit, because few savers could begin their working life by putting aside £5,000 from their annual earnings. The likelihood is that they would save little in their early working years, and gradually build up to the annual limit.

The Treasury should recognize that with no upper limit, the £5,000 per annum will provide an effective cap, and that, although they will forego

some revenue they might have levied on the growth of the ISAs, there will also be gains to the Treasury. Savers will make less claim on public funds in the future, and the investment boost which their savings give to the economy will increase the revenue from other taxes.

If existing PEPs and TESSAs are allowed to roll into the new ISAs without tax liability, the Treasury should recognize that only a few people have large amounts, given the relatively recent introduction of both instruments. Such people will tend to be older, and have a limited working life in which to add £5,000 per year under the new limit. There will not be many who will exceed the de facto limit of about £225,000.

Given the extra cost of policing a limit, the proportional increase in costs which so low a ceiling will bring about, the disincentive to potential fund managers to enter the field for such paltry fund sizes, and the deterrent to lifetime savings, government would be well advised to delete the £50,000 limit from its proposals, and to introduce the scheme with no upper cap on lifetime savings. If they do so, the new scheme will rightly earn praise as imaginative, flexible, accessible, simple and low cost. If they retain the limit, the scheme will be worthless until such time as a more sensible subsequent government removes it.