Taxing Household Saving:

What Role for the New Individual Savings Account?

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Executive summary

The government has announced that it intends to introduce a new Individual Savings Account (ISA). This is intended to build on the experience of TESSAs and PEPs and, through the use of tax incentives, to encourage saving, particularly among those on low incomes. In this Commentary, we consider the background to this reform and some of the options the government will be considering in designing the new ISA. In particular, we focus on current household saving behaviour, the tax treatment of savings in the UK, the experience of PEPs and TESSAs, and issues in the design and implementation of an ISA that will fulfil the government's stated objectives.

The main arguments of the Commentary are as follows.

One-third of households do not have either a savings account or stocks and shares. Saving rates vary considerably across different types of households. But this does not necessarily mean that the government should be encouraging people to save more. Many of those who have little or no savings (such as single parents and young married couples with children) have low incomes and high consumption needs.

The most convincing case for the introduction of a new ISA is that the current tax system distorts savings choices. Bank and building society accounts are heavily taxed relative to all other forms of savings and relative to consumption. This penalises those with low levels of saving for whom bank and building society accounts are the main form of saving.

Past tax incentives for saving have attracted substantial flows of savings. As of April 1996, £35 billion was held in PEPs, and over £26 billion was held in TESSAs at the end of 1996. But TESSAs and PEPs have not penetrated to the bottom of the savings distribution. Low-income savers have not taken advantage of the tax incentives in the schemes — TESSA and PEP holders are, on average, older and richer than non-holders.

One problem currently facing the Chancellor is how to design the new ISA to encourage saving among those with low incomes, where TESSAs and PEPs have failed to do so. Another is how to give incentives to low-income savers without giving large lump-sum gains to those who already have a lot of savings who will be able to transfer money immediately (thus increasing the cost of the scheme).

Among the particular design features of the new ISA that will help the Chancellor achieve these goals,

- no minimum holding period for the new ISA would make it more attractive to savers with low incomes and variable consumption needs;

- annual and lifetime contribution limits would reduce the size of the lump-sum gains to high-wealth savers and reduce the cost to the exchequer;

- keeping a broad range of assets that can be held as part of the new ISA would make it flexible for meeting changing household needs over time and attractive to the financial services industry which will seek to market the new ISA at both high- and low-income savers;

- TESSA- and PEP-type treatment for funds in the ISA — in which interest income is exempt from tax, and capital gains and dividend payments in the fund attract no tax — would be simplest to implement and would remove the distortion between consumption and saving for low savers.

With moderate annual and lifetime contribution limits, the cost of the ISA may not be very high. The target groups do not have high stocks of wealth, and hence little interest income tax revenue will be lost by granting a tax exemption. On the other hand, wealthy households will not be able to move all their assets into an ISA (and are likely already to hold part of their wealth in TESSAs and PEPs). Anticipated increases in tax revenue from changes elsewhere in the tax treatment of savings will not fully materialise if funds are channelled into other tax-favoured assets (pensions, housing etc.).

The design of the new ISA is being considered along with other possible policy reforms to PEPs, pensions and long-term health care. The relationship between the tax treatment of all these savings vehicles will be crucial in determining households' savings behaviour. The decision of whether or not to pay the 10 per cent dividend tax credit on funds in an ISA, and whether to reinstate the tax credit on funds in pensions and PEPs, if they were to continue after 1999, will affect the relative attractiveness of the three assets.

The stock of savings in the UK is highly concentrated, and highly mobile. An ISA reform, whilst desirable, should recognise the interactions between different forms of saving. Unless the interactions are taken into account in the design of the ISA, there is a danger of creating large incentive effects for the wealthy, without helping those with little or no savings.

1. Introduction

In July 1997, in the first Budget of the new government, the Chancellor announced that the government would be developing plans for a new Individual Savings Account. This will build on the experience of TESSAs and PEPs, encouraging people to save through the use of tax incentives. Particular emphasis is being placed on encouraging those on low incomes to save.

There is evidence to show that many households in the UK currently have little or no savings in financial assets such as savings accounts or equity holdings. A higher proportion of households hold wealth in the form of housing and/or a private pension, but the fact that many have no wealth in a relatively liquid form may be a cause for concern. Ideally, households should hold some precautionary balances as a safeguard against unexpected changes in their circumstances, such as unemployment — although the extent to which the state provides support will affect the extent to which individuals require their own savings. Of greater concern, perhaps, is that under the current tax treatment of savings, small liquid balances held in bank and building society accounts (and direct holdings of equity, apart from those held in PEPs) are treated far less favourably than other less liquid forms of savings such as pensions and housing. Not only may this distort people's choice between different types of assets and mean that individuals do not hold sufficient precautionary balances in their portfolios compared with their holdings of other assets, but it also means that low-income households and those with only low levels of savings who typically hold their savings in bank and building society accounts face higher effective tax rates on their savings than those with larger and more diversified portfolios. The new Individual Savings Account provides an opportunity for the Chancellor to move further towards neutrality in the tax treatment of savings and remove the vertical inequity between high and low savings. However, in considering the design of the new Individual Savings Account, the dilemma facing the Chancellor is how to make it attractive to those on low incomes and those with low levels of savings, but also to keep the whole scheme relatively inexpensive and not provide lump-sum gains to those with high levels of savings who will be quick to take advantage of another tax-free savings opportunity.

In this Commentary, we concentrate on the current taxation of savings (excluding the recently announced reforms to corporate taxes which, in a fully comprehensive analysis, should be included) and background issues relating to the introduction of the Individual Savings Account (ISA). In reality, the scheme will be introduced in the context of other important policy reforms currently being designed. In particular, links with stakeholder pensions, long-term care, the introduction of individual learning accounts and reforms to social insurance mechanisms will all be important in the operation, and effectiveness, of ISAs. These cannot be addressed, partly for reasons of brevity and partly because insufficient information is as yet available as to the direction these reforms might take. The links should be borne in mind, however, when considering the arguments presented in what follows.

This Commentary is in two parts. First, we deal with the reasons why a government might want or need to reform the taxation of savings. We present evidence on the current level of savings and the distribution of different types of assets across households

and discuss the current tax treatment of savings in different forms. In the second part, we look in detail at some of the general issues surrounding the design and implementation of the new ISA.[1] Two important factors will be the relationship between the new ISA and private pensions (particularly in the light of the removal of the dividend tax credit in the last Budget) and the extent to which PEPs are allowed to continue after the introduction of ISAs in 1999. We discuss these briefly along with other implementation issues in Section 5.2.

[1]From the financial services industry or tax practitioner's perspective, there will be many additional detailed implementation issues which we do not cover in this Commentary.

2. UK household saving

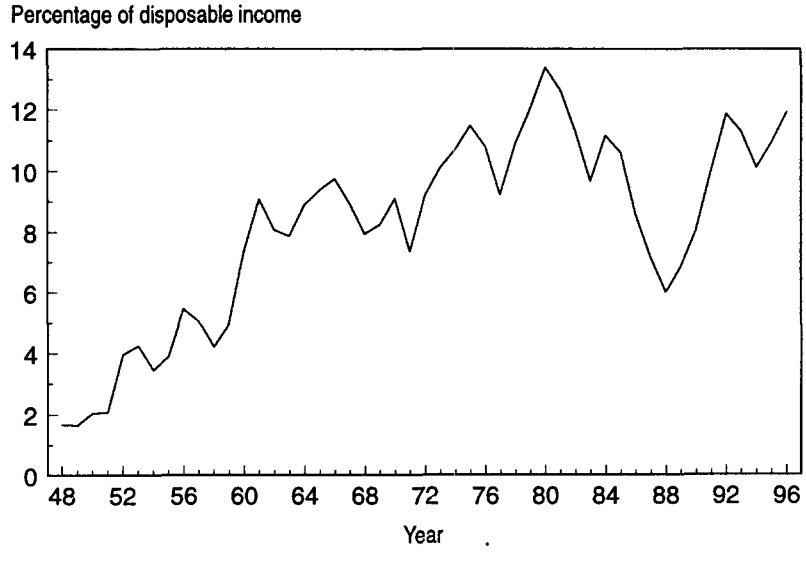
In this section, we provide some background figures relating to trends in household saving and households' holdings of financial assets. Clearly, if one of the motivations for reform of the taxation of household saving is that households, or certain groups of households, should be saving more, it is important to know which households have what types of assets and how we might want this to change as a result of any reforms undertaken.

2.1 Aggregate saving and household asset holding

During the mid- to late 1980s, there was a dramatic fall in the personal sector saving rate in the UK and widespread concern that the level of savings was too low. However, by the mid-1990s, the fall had been almost entirely reversed. There is little evidence from aggregate data that the current personal sector saving rate is low compared with its historical average.

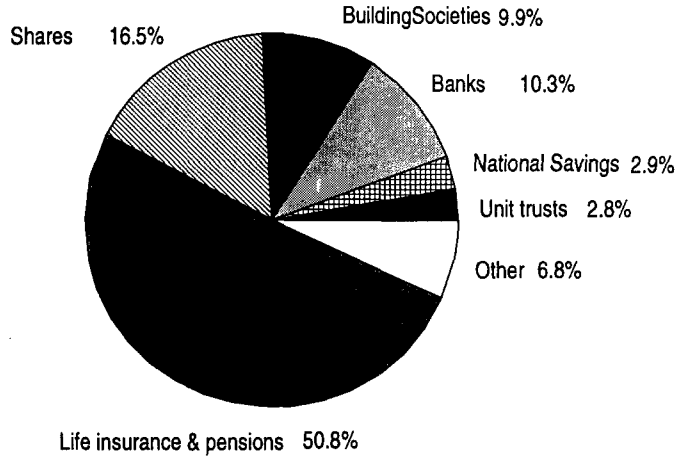
In fact, the personal sector is currently saving more out of its disposable income than at almost any point during the post-war period, apart from during the early 1980s (see Figure 2.1), although definitional issues surrounding large changes in the market for housing and private pensions since the mid-1980s may obscure the picture partially. At the end of 1996, personal sector financial assets totalled over £2,126 billion (GDP in 1996 was £742 billion). Half of this is held in life assurance and pension funds, one-fifth as deposits in banks and building societies and one-sixth in direct holdings of equities (see Figure 2.2).

Figure 2.1. Personal sector saving rates



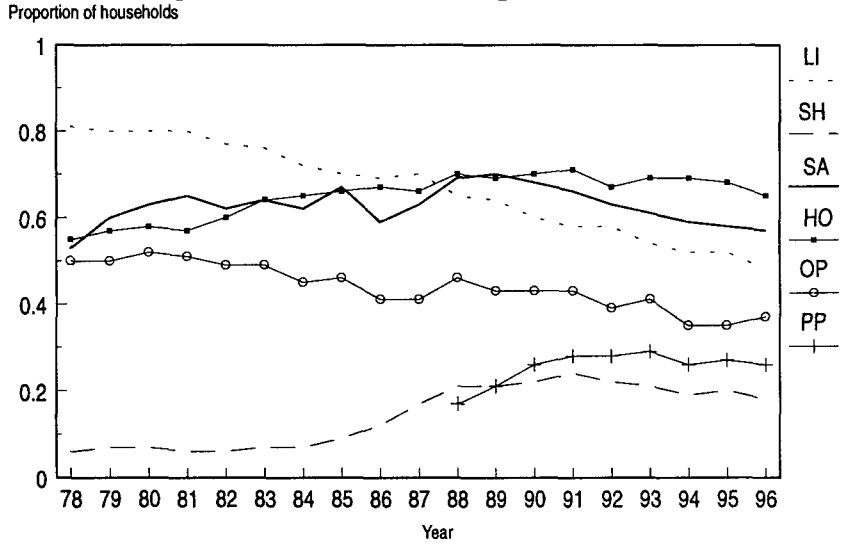
Notes:
The saving rate is measured as saving out of disposable income from National Accounts figures for personal sector disposable income and consumers' spending. The personal sector includes unincorporated businesses.
Source: Office for National Statistics, 1997.

Figure 2.2. Personal sector financial assets



Source: UK National Accounts, 1997.

Figure 2.3. Asset ownership rates, 1978–96



Notes:

LI: Life insurance, defined on the basis of current contributions.

SH: Stocks and shares, including unit trusts, PEPs and government gilts, defined on the basis of receipt of interest and dividend income over the previous 12 months.

SA: Savings accounts, including interest-bearing bank or building society accounts (including TESSAs), National Savings investment accounts and National Savings ordinary accounts, defined on the basis of receipt of interest income over the previous 12 months.

HO: Housing wealth, defined as ownership with mortgage as well as outright ownership.

OP: Occupational pension, defined on the basis of current employee contributions only.

PP: Personal pension, defined on the basis of current employee contributions only.

Figures for 1996 are based on data from the first quarter of the year only.

Source: Family Expenditure Survey.

Using data from the Family Expenditure Survey (FES), we can identify ownership rates for different assets since 1978 from receipt of interest and dividend income and from contributions to life insurance and private pensions.[2] These are shown in Figure 2.3 for working-age households only.

The proportion of working-age households holding money in a savings account has been broadly constant across the period 1978–96, fluctuating around 60 per cent (although there is some evidence of a decline since 1990). The level of share ownership changed dramatically over the period — nearly trebling from 7 per cent of households to over 20 per cent of households during a concentrated period between 1985 and 1988, coinciding with the start of the Conservative government's privatisation programme.[3]

The proportion of working-age households making contributions to an occupational pension plan has fallen over the period, although this could have been partially offset by increasing employer contributions which would not show up in household survey data. There has been a rapid increase in the coverage of personal pensions among working-aged households — from 17 per cent in 1988, the year they were introduced, to nearly 30 per cent in 1996. There has been a significant fall in the proportion of households with a life insurance policy — from over 80 per cent in 1978 to less than 50 per cent in 1996. Home-ownership increased fairly steadily during the period.

These aggregate figures conceal wide disparities in both saving rates and stocks of assets across different households. Table 2.1 summarises the average income and spending of different types of households using 1995–96 FES data and gives a residual savings measure for each group. Most groups are net savers, although young single-parent households have a large negative saving rate as well as the lowest levels of income. Married childless couples are the biggest savers. This group is likely to include both those who have never had children and those whose children have left home. Note that, on average, retired households continue to save out of their current income and accumulate assets when we might expect them to be running down assets accumulated during their working lives.[4]

Table 2.2 shows ownership rates of savings accounts and stocks and shares for each of the different household types.[5] More than one-third of all households have neither a savings account nor any stocks and shares, while one-fifth of households hold both types of assets. Single-parent households are by far the most likely not to have any of these assets. Older married couples without children and retired households are the most likely to hold both types of assets. Within each household type, there is a strong correlation

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[2]For a detailed analysis of trends in household savings using the FES asset data, see Banks and Tanner (1996).

[3]Note that at the same time as there was an increase in the proportion of households owning shares, the proportion of total equity owned directly by individuals actually decreased as institutional ownership (particularly by pension companies and insurance companies) increased.

[4]This phenomenon is analysed in detail in Banks, Blundell and Tanner (1998).

[5]Further tabulations of ownership rates are presented in the Appendix. For details of amounts held in each asset as a proportion of total wealth, there is little household information in the UK. The most comprehensive survey is carried out by NOP and the 1991–92 wave is analysed in detail in Banks, Dilnot and Low (1995).

Table 2.1. Income, expenditure and saving rates, by household type

Demographic groups			% of sample	Mean weekly income (£)	Mean weekly spending (£)	Saving rate (s/Y)
Head's age	Marital status	Children				
20–34	Single	No	4.4	215	208	0.03
35–49	Single	No	3.9	219	211	0.04
50–64	Single	No	4.2	164	154	0.06
20–34	Married	No	5.0	411	389	0.05
35–49	Married	No	3.9	480	396	0.18
50–64	Married	No	7.5	351	316	0.10
20–34	Single	Yes	3.4	116	140	–0.21
35–49	Single	Yes	2.7	200	231	–0.16
20–34	Married	Yes	8.5	330	331	0.00
35–49	Married	Yes	13.7	432	414	0.04
50–64	Married	Yes	1.2	384	404	–0.05
Retired	Single		12.3	120	110	0.08
Retired	Married		11.6	237	229	0.03
Multiple tax unit household			17.8	410	374	0.09
All			100.0	307	290	0.06

Note:
Income is net household income not accounting for household size. Saving rates for the group are defined at the mean and as a proportion of income. Because of this, and since they are computed from weekly spending and income figures, they should be interpreted as a guide to the saving of a group rather than an accurate measure. Housing costs are included in both income and expenditure and hence not counted as saving. Employer pension contributions are not included anywhere and hence not counted as saving. Employee pension contributions are included in income but not in spending and are therefore treated as saving.
Source: Family Expenditure Survey, 1995–96.

between ownership of one or more of the types and household income: households with both a savings account and stocks and shares have higher-than-average incomes.

2.2 Is there a case for increasing saving?

One argument for increasing saving might be that higher savings are desirable from a macroeconomic perspective. Evidence on this, however, is mixed, and, even if true, would not suggest a rationale for encouraging low income savers, since these households provide only a very small fraction of the stock of wealth. A more important issue for ISAs is whether individuals, or particular groups of individuals, are saving enough for their own needs. The key economic motivation for saving out of current income (and hence forgoing current consumption) is individuals' desire to smooth the level of their consumption coupled with a belief that their future levels of earned income will not be sufficient to meet future consumption needs. People save to finance future consumption during periods of anticipated falls in earned income (particularly retirement) and anticipated increases in consumption needs (such as children), as well as unpredictable reductions in income (such as unemployment) and unpredictable increases in needs (such as illness). This implies that, as well as a stock of assets to draw on during retirement — which can be relatively illiquid — individuals want to hold liquid 'precautionary balances' as security against unforeseen fluctuations in income and/or consumption needs. The need for liquidity may lead them to hold some savings in vehicles (such as bank and building society accounts) that attract lower rates of return and (in the UK) that have less

Table 2.2. Asset ownership, by household type

Demographic characteristics			*No assets*		*Savings account only*		*Stocks and shares only*		*Both assets*	
Head's age	Marital status	Children	% of group	Mean income (£)	% of group	Mean income (£)	% of group	Mean income (£)	% of group	Mean income (£)
25–34	Single	No	40.6	171	46.3	232	2.0	273	11.1	294
35–49	Single	No	44.7	155	37.2	248	3.4	265	14.7	327
50–64	Single	No	45.9	125	37.8	179	2.8	256	13.4	233
25–34	Married	No	31.5	312	52.5	416	1.5	429	14.5	604
35–49	Married	No	27.0	324	46.1	464	3.0	440	24.0	691
50–64	Married	No	24.8	236	37.3	331	4.3	328	33.6	458
25–34	Single	Yes	81.6	107	17.6	150	0.4	286	0.4	418
35–49	Single	Yes	60.9	173	30.4	229	1.1	187	7.6	300
25–34	Married	Yes	46.5	267	41.0	377	2.8	398	9.7	411
35–49	Married	Yes	34.1	327	42.4	453	3.6	489	19.9	556
50–64	Married	Yes	39.0	240	36.6	413	4.9	384	19.5	615
Retired	Single		28.7	90	47.8	112	2.6	117	20.9	178
Retired	Married		18.2	165	44.9	207	1.8	287	35.2	309
Multiple tax unit household			16.4	333	41.6	406	3.1	396	23.4	524
All			34.8	228	41.9	313	2.8	347	20.6	420

Note:
Savings accounts include interest-bearing bank or building society account (including TESSAs), National Savings investment accounts and National Savings ordinary accounts. Ownership variables are defined on the basis of receipt of interest income over the previous 12 months.
Stocks and shares include unit trusts, PEPs and government gilts. Ownership variables are defined on the basis of receipt of interest and dividend income over the previous 12 months.
Income is net weekly household income not accounting for household size.
Source: Family Expenditure Survey, 1995–96.

preferential tax treatment. A further implication of individuals' desire to smooth consumption is that, when young, they may seek to borrow against expected future increases in income to raise their current level of spending. Low (or even negative) saving rates among younger households are not necessarily an indication that these households should be saving more.

So, can we judge whether individuals are currently saving enough without making simple paternalistic statements such as that people should save more for their own good or that saving is somehow a 'good thing'? A key issue is whether there are any existing market distortions that would make us believe that individuals' current levels of saving are not likely to be optimal. Clearly, the savings market is not perfect. However, many of the restrictions in the savings market are more likely to prevent people borrowing as much as they want against their future income (liquidity constraints) rather than saving as much as they want. From this point of view, the process of financial liberalisation that occurred in the 1980s, by extending consumer credit, encouraging greater competition between financial institutions and greater flexibility in financial practices, may have made it easier for people to achieve their optimal levels of saving and borrowing. Two further possible distortions — the tax treatment of saving and imperfect information — seem likely to affect the level and form of individuals' savings. The tax system is discussed in detail in the next section. Information failures are discussed briefly below.

Several studies have shown that information plays a key role in determining individuals' choices about which assets to hold. In the US, for example, Haliassos and Bertaut (1995) find that low levels of information are the most plausible explanation for low levels of share ownership, and Bernheim and Garrett (1996) show that workplace education can increase participation in, and contribution into, retirement savings schemes. In the UK, it seems likely that the heavy promotion of share ownership at the time of privatisation played a role in the rapid growth in share ownership in the mid-1980s. Also, the publicity surrounding the launch of new products such as personal pensions, TESSAs and PEPs — and the new ISA — is likely to affect their take-up (however, there is less evidence that low levels of information are responsible for a level of saving that is too low).

One argument might be that the decision about the 'optimal' level of assets to hold is a complex problem that most people do not solve explicitly in deciding how much to save.[6] More realistically, individuals may plan how much to save for their retirement or how much to hold in precautionary balances by following simple rules of thumb. If these simple rules of thumb are backward-looking (following the example set by their parents, for example), changes in individuals' current or future circumstances (such as increasing life expectancy and/or possible future reductions in welfare state provision) might leave them with an inadequate level of saving. If people are not fully informed about changes in their future circumstances and, particularly, the implications of such changes for their current savings behaviour, there may be a case for government intervention — although the most direct response from the government would be to increase the supply of information.

In conclusion, there is little evidence either way that savings are too low, either from an aggregate or from an individual perspective, and to the extent that there are market failures, it is not clear which, if any, are constraining household choices. Imperfect information may result in suboptimal savings decisions — limited information about certain types of assets may distort individuals' portfolio choices, or unanticipated future changes in individuals' circumstances may imply a current level of saving that is too low (or too high) relative to future needs. But in none of these cases is it clear that changing the tax treatment of savings (which affects the price of saving compared with the price of current consumption) is the most direct response.

We argue, in the next section, that the tax treatment of savings needs reforming, not because savings are too low, but because the tax system itself currently distorts individual saving choices, even in the absence of clear market failures. In our view, this is the most convincing reason for introducing some form of Individual Savings Account.

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[6]Another possibility is that individuals are 'non-rational' in the sense that they are either myopic with regard to the future or unable to implement strategies for self-control reasons. Recent research has considered both of these possibilities. Two examples are mental accounting, whereby individuals stop themselves touching certain types of assets (see Thaler (1992)), and commitment mechanisms, where individuals force themselves into plans with regular contributions (Laibson, 1994).

3. Does the taxation of saving need reforming?

Any form of saving will typically have three components — initial payments, income accrual and withdrawal — and each of these is a possible target for taxation.[7] Table 3.1 gives simple numerical examples of the impact of imposing tax at different points. Thus the EET regime is 'exempt-exempt-taxed', implying no tax on initial savings and no tax on fund income but taxation on withdrawal. We assume that there is a single income tax rate of 25 per cent, that the rate of return on savings is 10 per cent, and that a single contribution, derived from earned income of 100, is saved for one year and then withdrawn. Regimes A and B correspond to what has traditionally been called an expenditure tax, while regimes C and D correspond to a comprehensive income tax. Note that the examples given in the table ignore inflation. This is not a problem for regimes A and B, which do not tax investment income. In regimes C and D, where investment income is taxed, difficulties arise — if investment income is taxed ignoring inflation, the post-tax real return will fall still further below the pre-tax real return.

Table 3.2 places the current tax treatment of saving in the UK in the context of the above discussion. Private pensions are arguably the most tax-favoured form of saving,

Table 3.1. Alternative tax regimes

	Regime A (EET)[a]	Regime B (TEE)[b]	Regime C (TTE)[c]	Regime D (ETT)[d]
Earnings	100	100	100	100
Tax paid	—	25	25	—
Savings	100	75	75	100
Net income earned	10	7.50	5.63	7.50
Savings on withdrawal	110	82.50	80.63	107.50
Tax on withdrawal	27.50	—	—	26.87
Benefit withdrawn	82.50	82.50	80.63	80.63

Notes:

[a]Savings from taxable income are deductible, allowing the whole of the 100 of earnings into the fund. No tax is charged on the investment income of the fund, but tax is charged in full on withdrawal. This type of tax treatment confers a post-tax rate of return on saving equal to the pre-tax rate of return and is commonly seen in the case of private pensions across the world. Faced with this regime, an individual earning 100 can either choose to spend now, paying 25 of tax and consuming goods worth 75, or save now and consume goods one year later worth 82.50. The figure 82.50 is simply 75%1.1.

[b]This regime does not allow deductibility of saving, thus reducing the initial size of the fund from 100 to 75. As with regime A, investment income is free of tax but now withdrawal of funds attracts no tax. This type of tax treatment also preserves the equality of pre- and post-tax rates of return. In the case of regime B, it is easy to see the non-taxation of investment income which ensures this. This is the treatment of PEPs and TESSAs. This regime is equivalent to A apart from in the presence of a progressive income tax. In this case, individuals can engage in tax rate smoothing (getting relief when working at 40 per cent and only paying tax when retired at 25 per cent, for example) under A but not under B

[c]This regime is basically that applied to interest-bearing short-term saving in most OECD countries. There is no tax deductibility of contributions, investment income is taxed in full, and there is no tax on withdrawal of benefits, since there is no untaxed investment income. Unlike regimes A and B, this tax treatment brings the post-tax rate of return below the pre-tax return. Here, the post-tax rate of return is 7.5 per cent (80.63 = 75%1.075).

[d]This regime produces the same outcome as C, and therefore the same post-tax rate of return.

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[7]For a more detailed discussion of these issues, see Capital Taxes Group (1989).

Table 3.2. Current tax treatment of savings

Asset	Summary of treatment	Tax paid
Pensions	Tax relief on contributions No tax on fund income Taxed withdrawal and tax-free lump sum	< EET
PEPs	Saving out of taxed income No tax on fund income No tax on withdrawal	TEE
TESSAs	As for PEPs	TEE
Owner-occupied housing	Saving mainly out of taxed income (MIRAS being withdrawn) No tax on imputed income from owner-occupation No capital gains tax	< TEE
Interest-bearing accounts	Saving out of taxed income All interest income taxed No tax on withdrawal	> TTE
Life assurance	Saving out of taxed income (post-1984) Some tax on fund income No tax on withdrawal	< TTE
Stocks and shares	Saving out of taxed income Income tax on all dividends Capital gains tax on real gains over £6,500 p.a.	< TTE

with a regime of the form EET except for the exemption from tax of a lump-sum benefit broadly up to a maximum of one-quarter of the accumulated fund. PEPs and TESSAs are taxed under a TEE regime. The changes to the tax treatment of dividends announced in the July 1997 Budget complicate matters somewhat, and highlight the difficulties caused by treating the personal and corporate tax systems separately, as we do here.[8]

Housing is subsidised to the extent that mortgage interest tax relief (MIRAS) provides a tax subsidy on the acquisition of a capital asset. None of the returns to owner-occupied housing, whether in the form of imputed income from occupation or capital gains, is taxed by central government, although the council tax might be seen as a tax on housing consumption.[9]

Interest-bearing accounts, unless held as TESSAs, stand out as being heavily taxed. If inflation were zero, the tax regime would be precisely TTE. As soon as inflation is

[8]Under the new system (which may well be changed), pension funds will have no capital gains tax liability on gains, or tax liability on dividends received. In the past, they have been able to reclaim the tax credits on dividends, as have tax-exempt individuals holding shares directly. But the 1997 Budget announced the abolition of the right to claim this tax credit. As a consequence, pension funds will be worse off, but still have no tax liability directly on their income and gains. The same would be true of PEPs were they to continue.

[9]The imputed income from owner-occupation was taxed under Schedule A income tax until 1963.

positive, the tax regime is more harsh than TTE, bringing the post-tax rate of return below that implied even by a comprehensive income tax.

Life assurance taxation is especially complex. Prior to 1984, premiums attracted tax relief, but for policies taken out since then there has been no such relief. Some tax is charged on fund income, at an effective rate a little below the basic rate of income tax, and no tax is charged on withdrawal. The regime is relatively attractive to higher-rate taxpayers since the tax on fund income is not related to the individual policyholder's marginal income tax rate.

Direct investment in stocks and shares is less favourably taxed than pensions, PEPs, TESSAs or housing, but does not suffer a full TTE regime since there is a relatively large (£6,500 per person per year) tax exemption on real capital gains.

The tax treatment of different forms of saving is clearly diverse. Individuals with diversified portfolios (containing a number of different types of assets) will be holding a set of assets with different effective tax rates. One thing to note is that higher effective tax rates are typically associated with more liquid assets. Hence the need for liquidity in precautionary balances may mean that people are prepared to hold these assets in spite of higher effective tax rates. The majority of personal sector wealth, however, is held in relatively tax-favoured forms of saving, i.e. housing, pensions and life insurance (see Figure 2.2).

In an ideal world, the tax treatment of savings should not distort choices regarding the form in which to save. In the UK over the last two decades, we have moved to a more uniform system of taxation (predominantly of the EET/TEE type) across most assets. The introduction of personal pensions has made EET pensions available to many who did not have access to employer-based schemes; the introduction of PEPs and TESSAs has made more liquid savings vehicles available without the tax penalty associated with other interest-bearing accounts. The erosion of MIRAS has reduced the extent to which house purchase has received a special tax subsidy. The abolition of life assurance premium relief (LAPR) in 1984 was the one large step in the other direction, motivated in part by a particular vision of the right goals for tax reform, but also no doubt by the desire to raise revenue. Two years after abolishing LAPR, the same Chancellor — Nigel Lawson — introduced PEPs and announced personal pensions, which, with TESSAs, have made tax-relieved savings available in new ways to many households. However, the continued taxation of full nominal interest income is a distortion only partially offset by the existence of TESSAs, since the five-year lock-in on TESSAs makes them unattractive for those on low incomes or with variable consumption needs.

Ideally, the tax treatment of savings should also not distort choices between consumption and saving. This is more problematic. There are two ways of interpreting fiscal neutrality in relation to the decision to save. We might seek to be neutral between consumption and savings, or we might seek to be neutral between present and future consumption. Neutrality between consumption and savings is achieved by a comprehensive income tax on real income of all types (TTE in our earlier discussion). Whatever the source of income, whether it be from work or from savings, and whether it is consumed or saved, it is taxed in the same way and at the same rate. But under a

comprehensive income tax, savings are treated as if they are simply another commodity, akin to consumption. Since people do not generally save for saving's sake, but instead as a means to future consumption, there is an argument for believing that the relevant concept of neutrality is not between consumption and savings but between consumption now and consumption in the future.

It is precisely this neutrality in the impact of the tax system on the decision between current and future consumption that is achieved by tax systems of the EET or TEE type. Such systems offer the alternative of consuming now or deferring tax by means of saving and paying tax when the funds are withdrawn (EET) or paying tax now but paying no tax on the return to saving or its withdrawal (TEE). Thus both present and future consumption are taxed on the same basis. And, as noted above, the EET/TEE regime corresponding to the expenditure tax maintains equality of pre- and post-tax returns, another reflection of the lack of distortion imposed on the decision as to whether to consume now or in the future.

The tax treatment of saving in the UK is far from perfect, but has moved towards a more neutral regime in recent years. Moves to make tax-free savings income available to those currently excluded by TESSAs and PEPs would tackle a clear vertical inequity. But if funding for such a change were needed from elsewhere in the savings tax regime, it would seem far more sensible to look to those areas where the system is already more generous than EET/TEE, such as the tax-free pension lump sum or the remaining elements of MIRAS, than to restriction of the availability of PEPs/TESSAs and their successor, the ISA.

4. Past experience with tax incentives

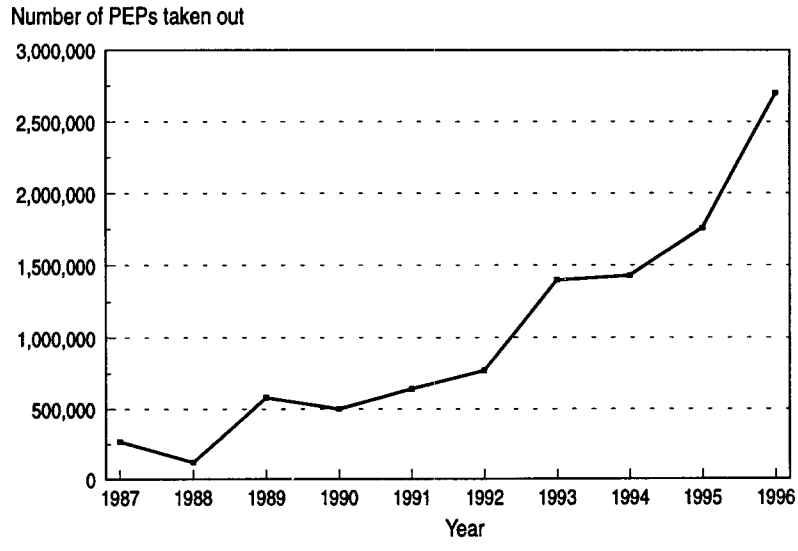
The Chancellor has announced that the new Individual Savings Account will 'build on the experience of TESSAs and PEPs'. In this section, we present evidence, using both aggregate and micro-level data, showing what the experience with TESSAs and PEPs has been and whether there are any lessons to be learnt for the new ISA.

4.1 Personal Equity Plans

First introduced in 1987, the original design of PEPs provided expenditure tax treatment principally for direct holdings of UK equity (although some other assets were allowed). Contributions to PEPs are not tax-deductible, but any income or capital gain accrued within a PEP is tax-free, and there is no tax on withdrawals. Official statistics, shown in Figure 4.1, show that take-up of PEPs was initially fairly slow, with only around 200,000 plans being taken out in each of the first couple of years following their introduction. In subsequent Budgets, the rules applying to PEPs were relaxed — most importantly, the minimum holding period requirement was removed in 1989 and the proportion that could be held in a designated unit trust or investment trust was increased from 50 per cent to 100 per cent in 1992–93). Following these changes, the take-up of PEPs increased. Take-up in 1996–97 was far higher than in previous years — possibly a result of increased competition in the PEP market, increasing affluence, windfalls or advertising.

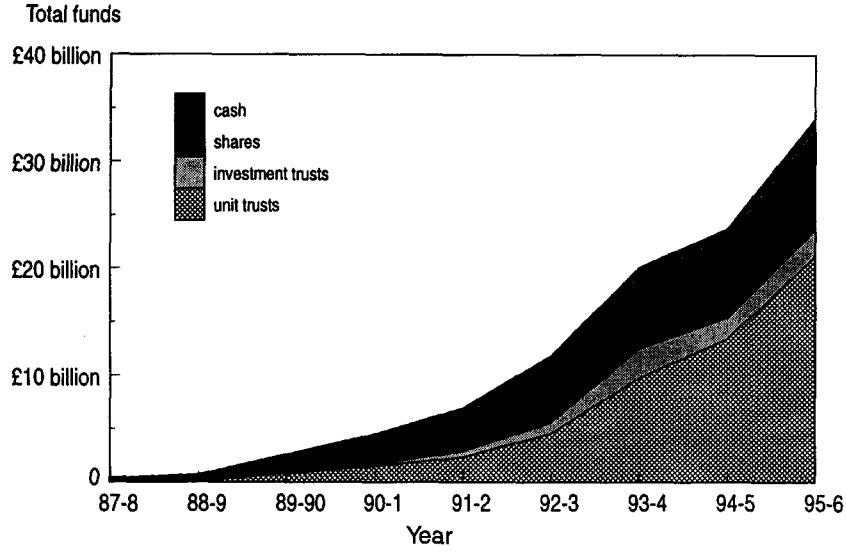
When they were introduced, the maximum amount that could be invested in a PEP in any one year was £2,400. The annual limit for a general PEP was increased to £6,000 in 1990–91, but there has been no further increase since then. The most recent estimate of the total amount held in PEPs is just under £35 billion by the end of April 1996 (see

Figure 4.1. Number of PEPs taken out



Note:
The number for 1989 includes the first quarter of 1990. From 1990, the annual figures are for the fiscal year rather than the calendar year. Since one individual may take out a number of PEPs, this figure does *not* give the number of PEP holders.
Source: Inland Revenue, 1997.

Figure 4.2. Total amount of funds in PEPs



Source: Inland Revenue, 1997.

Figure 4.2). Around two-thirds of this was held in investment and unit trusts. The average amount invested in each plan was around £4,000, although the average amount held by each PEP investor is likely to be higher than this since many PEP holders hold more than one account.

Household-level information on PEP ownership is available from the fifth wave (1995) of the British Household Panel Survey (BHPS).[10] Just over 10 per cent of all households in the BHPS have a PEP (see Table 4.1). The BHPS questionnaire separates assets into 'savings' (accounts at the bank, building society or post office) and 'investments' (other financial assets except pensions). More than half of those with PEPs have some other form of 'investments' as well.

In Table 4.2, we summarise PEP ownership by income and age. Within each income decile, there will be differing numbers of households of different ages and one might

Table 4.1. PEPs and other 'investments'

% of households with:	
No 'investments'	49.65
Some 'investments', no PEP	40.27
No 'investments' other than a PEP	4.62
A PEP and other 'investments'	5.46

Note: Investments are defined as all financial assets excluding pensions, housing and accounts at the bank, building society and post office (i.e. National Savings bonds, shares, PEPs, unit trusts, etc.).
Source: British Household Panel Survey, 1995.

[10]The 1995 BHPS is a useful source of information on PEPs, particularly since there is no information on PEPs in the Family Expenditure Survey. However, it should be noted that, as the fifth wave of a panel survey, the 1995 BHPS sample is likely to be affected by non-random attrition bias. In particular, the 1995 BHPS sample is known to be richer, on average, than the whole of the population (and than the corresponding year of FES data that we use in this section). We choose to use the data (unadjusted) as they are the only source of data on household holdings of PEPs available to us for recent years.

Table 4.2. Percentage of households with at least one PEP, by income and age

Income decile	*Age of head of household*					All
	20–29	30–39	40–49	50–59	60+	
Poorest	0.0	0.0	2.2	3.0	0.1	0.8
2	0.0	0.0	0.0	8.3	1.8	1.9
3	0.0	1.5	0.0	4.9	6.9	4.4
4	0.0	2.6	5.3	5.5	7.9	5.4
5	3.5	4.6	9.1	10.4	12.5	8.3
6	0.0	10.0	8.3	19.1	24.2	12.3
7	3.8	9.6	7.8	18.7	29.2	12.5
8	4.0	10.3	16.4	21.6	27.3	14.6
9	6.9	14.1	14.0	14.7	35.0	15.0
Richest	11.9	28.3	19.6	30.7	42.6	25.6
All	2.9	10.4	11.3	15.9	10.0	10.1
Number in cells:						
Poorest	63	42	46	33	256	440
2	40	42	30	36	325	473
3	61	66	40	41	262	470
4	52	77	57	73	216	475
5	78	108	88	77	128	479
6	71	140	96	68	99	474
7	79	135	115	75	72	476
8	75	145	128	88	44	480
9	58	142	136	102	40	478
Richest	42	127	168	101	42	480
All	619	1,024	904	694	1,484	4,725

Note:
Income is net weekly household income not accounting for household size. Deciles are defined with 480 households in each, but households with head aged under 20 are excluded from this table.
Source: British Household Panel Survey, 1995.

think that, for example, a young poor household will have different savings behaviour from that of an older household in the same income group. In the table, we divide the households in each decile into five age-groups to examine differences between groups. PEP ownership increases systematically with household income, from less than 1 per cent of the poorest tenth of households, to more than one-quarter of the richest 10 per cent of households. Looking at the distribution by age, ownership is highest among the group of households with head aged 50–59 (16 per cent of those in their fifties compared with less than 3 per cent of those in their twenties). In part, this observed pattern of PEP ownership by age is likely to reflect the typically 'hump-shaped' profile of income by age. Within each income decile, there is some evidence of increasing ownership by age, although the small cell sizes amongst those aged 60+ in the top income deciles (who have very high ownership rates) make it difficult to treat this as evidence of systematic patterns.

Table 4.3 confirms the link between PEP ownership and household income by comparing the average income within age-groups for those with and without PEPs. The average income of those with PEPs is considerably higher than the average income of those without — and in some cases it is over twice as high.

Table 4.3. Percentage of PEP holders and their income, by age

Age of household head	% without PEP	Average income (£)	% with PEP	Average income (£)
20–29	97.1	366.68	2.9	836.92
30–39	89.7	446.93	10.4	721.36
40–49	88.7	508.25	11.3	682.27
50–59	84.2	447.87	15.9	692.92
60+	90.0	201.83	10.0	453.69
All households	89.9	366.07	10.1	629.11

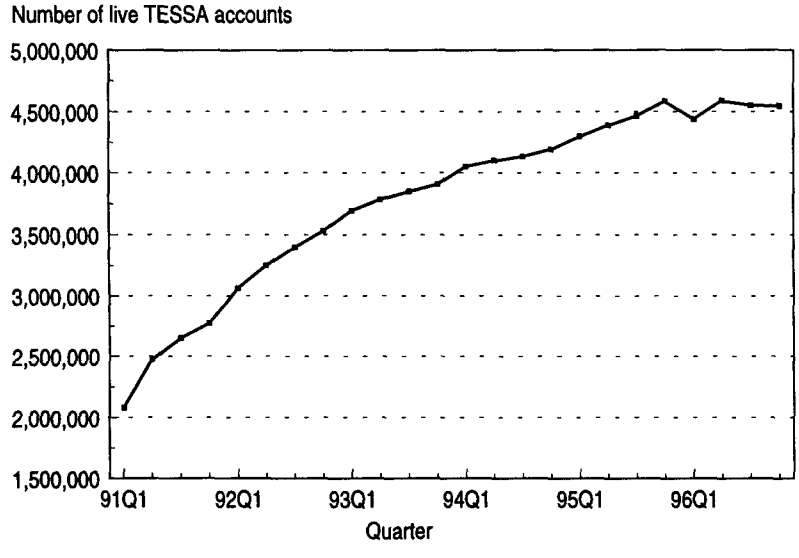
Note:
Income is net weekly household income, not accounting for household size.
Source: British Household Panel Survey, 1995.

4.2 Tax-exempt special savings accounts

Introduced in 1991, TESSAs provide tax exemption for the interest income from deposits held in specially designated bank and building society accounts, provided that the capital remains untouched for five years. Savers are allowed to invest up to £9,000 over the five years — £3,000 during the first year and £1,800 in each of the four subsequent years, up to the maximum. After five years, the full amount of capital deposited (but not the accumulated interest) can be rolled over into a new TESSA. The usual limits of £1,800 each year up to a maximum of £9,000 apply to the follow-up accounts. The take-up rate for TESSAs was much smoother than that for PEPs (see Figure 4.3.)

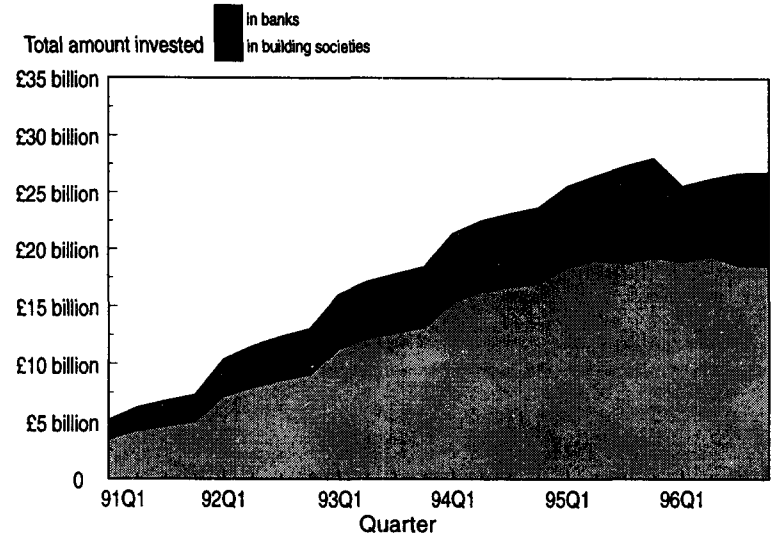
Approximately 2 million TESSAs were opened during the first quarter that they were available. Over the next six years, the total number of live TESSAs grew to just over 4.5 million. Around two-thirds of these are held in building societies. The dip in the first quarter of 1996 corresponds to the end of the five-year period for the first schemes.

Figure 4.3. Number of TESSA holders



Source: Inland Revenue, 1997.

Figure 4.4. Total amount invested in TESSAs



Source: Inland Revenue, 1997.

Assuming all TESSAs were kept open for five years, two-thirds of the TESSAs opened in the first year were rolled over into new accounts (Inland Revenue, 1997). Interestingly, most of the money withdrawn came from banks as opposed to building societies (see Figure 4.4).

The total amount invested in TESSAs (in banks and building societies) by the end of 1996 was just over £26 billion. Aggregate figures on the total amount of funds held in TESSAs are illuminating (see Figure 4.4). Although the number of live accounts increased smoothly over time, the total amount of funds held in TESSAs jumped upwards during the first quarter of each year, coinciding with the annual increase in the amount of funds that could be invested. This suggests that individuals were investing in their TESSA close to the maximum amount allowable in each year. Knowing the total number of TESSAs each year (and hence when the TESSAs were opened),[11] we can calculate the maximum amount of money that could be held in TESSAs, given the annual limits imposed by the rules of the scheme. Comparing this with the actual total amount held in TESSAs gives us an indication of the extent to which savers were investing up to the maximum. The actual amount invested as a proportion of the maximum possible has been very high — 88 per cent in the first year, 73 per cent in 1992, 80 per cent in 1993, 77 per cent in 1994, 74 per cent in 1995 and 84 per cent in 1996.

Household-level information on ownership of TESSAs is available from the Family Expenditure Survey (FES). In the latest available year of FES data (1995–96), just over 10 per cent of households had at least one member owning a TESSA.[12] Table 4.4 shows

[11]We assume that no TESSAs are closed once they are opened. Hence the number of TESSAs opened in any particular year is simply the total for that year minus the previous year's total.

[12]Given that the total number of live accounts during this period was 4.5 million, this suggests that, unless the average ownership rate is more than two accounts per household, the FES tends to under-record total TESSA ownership. This is consistent with the FES tending to under-sample richer households.

Table 4.4. TESSAs and other savings

Percentage of households with TESSA	10.3
Of the group of TESSA holders ...	
Percentage with only a TESSA	6.3
Percentage with a TESSA & other savings account	37.6
Percentage with a TESSA & stocks/shares	2.6
Percentage with a TESSA & other savings account & stocks/shares	53.6

Note:
Ownership of TESSAs is defined according to receipt of interest during the previous 12 months. Other savings accounts include interest-bearing accounts at a bank or building society and National Savings investment or ordinary accounts. Stocks and shares include PEPs, unit trusts and government gilts.
Source: Family Expenditure Survey, 1995–96.

how many of these households had other assets. The fact that most TESSA holders invested at least very close to the maximum amount allowable at any time suggests that they had funds available in other accounts which were moved to take advantage of the tax exemption. The evidence from the FES supports this by showing that the overwhelming majority of TESSA holders do hold other financial assets.

During the first year of the scheme, no household in the bottom fifth of the income distribution owned TESSAs and 36 per cent of all TESSAs were owned by the richest 10 per cent of households, although there were not very many TESSA owners in household surveys on which to base this inference. Take-up among households in the bottom fifth of the income distribution is still fairly low: in 1995–96, only 6 per cent of TESSAs are owned by the poorest 20 per cent of households. The proportion owned by the top 10 per cent has now fallen to 18 per cent (see Table 4.5).

TESSA ownership is still concentrated among older and richer households. As with PEPs, the highest rate of ownership by income is among the richest 10 per cent of households, whilst, by age, the highest ownership rate is among those aged 50–59. There are clear differences between the distributions of TESSAs and PEPs across households. Ownership of TESSAs is more heavily concentrated among older households than ownership of PEPs. Households with head aged over 50 are nearly three times as likely to own a TESSA as those aged under 50. Households aged over 50 are also more likely

Table 4.5. Distribution of TESSAs by income decile

Income decile	*Percentage of all TESSAs held by:* 1991	1992	1993–94	1994–95	1995–96
Poorest	0	3	1	1	2
2	0	4	3	4	4
3	10	5	5	5	5
4	14	7	6	8	10
5	7	8	9	8	9
6	12	12	12	12	12
7	7	12	12	13	10
8	5	12	13	13	14
9	9	14	15	15	15
Richest	36	23	24	21	18
	100	100	100	100	100

Note: Ownership of TESSAs is defined according to receipt of interest during the previous 12 months.
Source: Family Expenditure Survey, 1991–96.

Table 4.6. Percentage of households with at least one TESSA, by income and age

Income decile	*Age of head of household* 20–29	30–39	40–49	50–59	60+	All
Poorest	0.0	4.8	0.0	4.8	1.6	1.9
2	2.1	0.0	6.0	6.3	5.1	4.1
3	1.6	1.1	1.3	7.5	7.4	5.3
4	2.5	3.7	6.0	13.3	15.4	10.6
5	0.0	5.0	2.9	11.7	18.6	9.7
6	3.0	4.3	7.4	16.7	26.1	11.9
7	3.1	4.2	4.3	16.7	23.1	10.0
8	3.8	5.3	8.6	21.9	42.3	14.4
9	12.9	9.1	10.6	25.6	36.5	16.3
Richest	7.3	10.8	16.4	29.4	34.7	19.1
All	3.3	5.3	8.3	17.3	14.3	10.4
Number in cells:						
Poorest	92	63	68	83	364	670
2	92	107	50	63	366	678
3	64	91	79	53	390	677
4	81	108	84	83	324	680
5	83	161	105	94	237	680
6	99	185	121	108	165	678
7	98	190	141	108	143	680
8	79	188	187	128	97	679
9	70	187	217	121	85	680
Richest	41	157	274	136	72	680
All	799	1,437	1,326	977	2,243	6,782

Note:
Ownership of TESSAs is defined according to receipt of interest during the previous 12 months. Income is net weekly household income not accounting for household size. Deciles are defined with 680 households in each, but households with head aged under 20 are excluded from this table.
Source: Family Expenditure Survey, 1995–96.

to own a PEP than those younger than 50, but the difference is not nearly as striking: 9 per cent of those aged under 50 compared with 12 per cent of those older than 50. The ownership rates for TESSAs among households in their twenties, thirties and forties in the top income deciles are low (see Table 4.6). One possibility is that the minimum holding period acts as a disincentive to younger households, particularly those with children, who may have less predictable consumption needs.

4.3 Lessons from PEPs and TESSAs

It is worth drawing together some tentative conclusions from the evidence on PEPs and TESSAs which may be relevant for the new ISA.

- Ownership of financial assets (savings accounts and shares) is concentrated amongst older and richer households (see Table 2.2). However, this is particularly true of PEPs and TESSAs. In the case of PEPs, there is an issue about the extent to which low-income households are able to take the risk associated with equity investment (as well as the administration charges). In the case of TESSAs, one possible explanation for the low rates of take-up (strikingly low among young rich households) is that the

minimum holding period acts as a disincentive to those with varying consumption needs.

- Where new tax-favoured savings vehicles are very close substitutes for existing ones, immediate take-up is likely to be fairly high (given the amount of available funds) and the amount of money invested will be very close to the maximum allowable. It is likely in the case of TESSAs that many of the funds that were invested in TESSAs were simply transferred out of bank and building society accounts and hence the total invested in each year was very close to the maximum allowable.

- Clearly, the degree of flexibility affects take-up to a large extent. In the case of PEPs, increases in take-up have followed removal of minimum holding periods and increased flexibility in the type of assets people could hold. However, by no means all savers have taken up either TESSAs or PEPs — there is a very substantial group of the population (even those with positive savings) for whom the five-year lock-in period makes TESSAs unattractive but who also do not want to hold PEPs.

5. The Individual Savings Account

The announcement of the intention to introduce Individual Savings Accounts, to be in place by 1999, was accompanied by a number of supplementary statements. Inland Revenue Budget Press Release 4 (1997) provides some further details as to the goals of the reform. Specifically, these were:

- to give individuals, including PEP investors, the opportunity to invest in a new ISA providing a tax-favoured environment for savings;
- to build on TESSAs and PEPs, refocusing and simplifying existing rules and possibly bringing together a range of savings vehicles up to an overall limit;
- to encourage people to leave their savings in the account on a long-term basis, building on the five-year holding period in the TESSA scheme;
- to give particular encouragement to those who do not save at the moment, especially those on low incomes.

The main question relating to these intentions is a simple one: is it possible to design an ISA that will get the poorest households to save more without the tax advantage simply providing lump-sum gains to many of those who are already saving? If not, the scheme would simultaneously generate adverse distributional effects and cost the exchequer large amounts in terms of lost tax revenue. To the extent that it is possible, however, a number of broad design features will be important. In Section 5.1, we discuss some of these. In Section 5.2, we move to more specific issues relating to the implementation of the ISA, given the savings behaviour of UK households, the current taxation of savings in the UK and the general issues governing tax reforms to savings vehicles.

5.1 Designing the ISA

There are number of features of any potential ISA design that would appear, to us, to be crucial. The extent to which various characteristics would impinge on any of the above goals is outlined below.

Minimum holding periods

Given that one of the statements in the Budget Press Release relates directly to this issue, it seems that a scheme in which funds had to be left for some minimum holding period (such as five years) to qualify for the tax advantage is a possibility. But such a scheme would need large incentives to get poorer households to save. Households towards the bottom of the income (or, more particularly, the savings) distribution do not, and quite possibly should not, hold medium-term non-liquid accounts. Consequently, the incentives required to induce low-saving households to hold an account in the scheme would probably be quite large. In turn, this would generate large gains for households that are already high savers and also make the scheme expensive.

So is there a powerful rationale for an ISA with a substantial minimum holding requirement, such as the five-year period for TESSAs, that would justify the effects it

would have? In our view, probably not. It is hard to argue that tying small savers into medium-term accounts would reduce so-called 'short-termism' in investment horizons. Aggregate balances of small savers are only a very small proportion of total saving, and there is not necessarily a connection between the time horizons of individual savers within an institution and the time horizons of the institution lending or investing the funds. Another argument for encouraging longer-term holdings might be that households are not saving enough for their retirement or for the possibility of having to finance long-term care. This may or may not be the case, but even if it were, we would argue that the appropriate (and most efficient) approach to tackling the problem would be through reforming either the pension system or the financing of long-term care.

Contribution limits

The size and type of any limits placed on the scheme may have some effect on the attractiveness for low savers but will have a much greater effect on the lump-sum gains to existing savers. The first point to note is that limits on the *value* of funds within the scheme would be very difficult to administer since valuing the funds of individual investors would be problematic and the values will also be fluctuating as (non-cash) asset prices change. More practical, although still potentially problematic, would be limits on *contributions* into the scheme.

There are two areas in which contribution limits will be important, the first being in determining the 'cost' of the scheme to the exchequer,[13] the second being issues associated with transition effects. It is likely that most of the 'target' groups would not be able to save enough for reasonable total contribution limits to bind. But a scheme that did not have a total limit could ultimately cost the exchequer its entire revenue from taxes on interest income and dividends and, whilst providing a totally neutral taxation of many financial assets, would be worth much more to richer households. As far as transition effects are concerned, the use of annual limits would limit the degree to which rich households could transfer all their balances immediately, thus enjoying bigger gains than those who could only build up their balances gradually, and causing cash-flow problems for the exchequer.

Hence, there is some argument for both an annual and a total contribution limit. A scheme with just a total contribution limit would yield much greater gains to those who had assets to move in immediately, whereas a scheme with just annual contribution limits would discriminate against those with irregular incomes (such as the self-employed) or those with fewer years of their working lives remaining. Both would leave some vertical inequity — those who could fill their ISA immediately would benefit the most — but this is inevitable, given the distribution of wealth and the impracticality of targeting the scheme explicitly. It is worth noting that both types of limit have potential administrative problems, but these are potentially greater in the case of cumulative limits.

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[13]A good example of this is the US Individual Retirement Account. In 1981, eligibility was increased to all households and limits were increased. In one year, contributions rose from $5 billion to $28 billion and, by 1986, IRA saving represented about one-fifth of personal saving. In the Tax Reform Act of 1986, high income tax payers with employer-provided pensions were excluded from the scheme and contributions immediately fell by 62 per cent.

One final limit should be discussed and this is a limit on the amount of cash to be contributed to (or held in) the scheme, both annually and in total. The degree to which this might be required depends to a certain extent on where, and from whom, money going into the scheme would come (see Section 5.2 for more detail on this). Once again, administration may be a problem, in particular with the definition of which assets within the scheme qualify as 'cash' and which do not.

The nature and size of the incentive

Given that the scheme is expected to use tax incentives as a basis for encouraging saving, the precise size and nature of the tax incentive will be a factor. As we discussed in Section 3, there are three places at which savings can be exempt from tax — on the way into, whilst in, or on the way out of the fund. This subsection deals with each in turn. It is worth remembering, however, that tax incentives will not affect the rate of return on savings for non-taxpayers, i.e. those on very low current incomes.

If upfront relief is a possibility, a tax credit would be more practical than a US-style tax deduction (and would not result in some individuals' marginal rates of earned income tax changing). The rate at which the tax credit is applied could be 10, 20 or 23 per cent, or even the individual's marginal rate. However, in a country in which the vast majority of people still do not file tax returns, upfront tax reliefs of this form are very difficult to administer apart from through employers, and this would exclude large proportions of those individuals at whom the scheme is supposedly aimed (the self-employed, unemployed or inactive, those on short-term contracts and the retired, for example). In addition, upfront tax relief of any form would result in greater gains to those who can afford to transfer large balances into the scheme from the start and hence increase the 'costs' of the scheme further, having more severe cash-flow implications for government and generating more vertical inequity.

If the tax relief is to be on the accumulation within the account (i.e. a PEP- or TESSA-style TEE treatment), then the important concept is whether interest income and capital gains are fully or partially exempted from tax. Whilst this distinction will be important in many respects, it is worth remembering that, even for the full exemption, the effects for the lowest savers will be small. If the nominal interest rate were 5 per cent and there were no inflation, the change in the rate of return on saving for a basic-rate (23 per cent) taxpayer would be from 1.0385 (1 + 0.05×(1–0.23)) to the full 1.05 — a change that is small compared with historical cyclical fluctuations in the pre-tax interest rate even for safe assets such as deposit accounts. Although there is no convincing recent estimate of the elasticity (i.e. responsiveness) of saving with respect to the interest rate in the UK, the substitution effect (from current consumption to future consumption) for a change of this magnitude is likely to be quite small, although there will be no significant income effect to counteract it for low-saving households since they do not have and are not likely to have large stocks of wealth.[14] A further possibility would be to pay the 10p tax credit on dividend income to individuals within the scheme.

[14]See Boadway and Wildasin (1994) for a summary of the economic theory relating to tax incentive effects on saving and a brief survey of empirical evidence.

Given that we have argued that tax relief on the way in is impractical, it is extremely unlikely that a scheme would be required to tax funds on the way out. This is just as well, since taxing funds on withdrawal would be equally hard, effectively being impossible to administer at individuals' marginal rates apart from through employers, with the taxable income for non-employees being either low (for the retired) or extremely difficult to measure.

Qualifying assets

There are good arguments for making the scheme as broad as possible with respect to the assets that individuals or households are permitted to hold to gain the tax advantage. Partly, this would reduce the set-up and transactions costs faced by the financial services industry and hence yield more attractive returns. In addition, allowing a flexible portfolio of assets within an umbrella scheme would probably be the most effective way to encourage households that were previously saving little or nothing whilst allowing a wide range of financial institutions to compete for funds from all households within the scheme. Given that it is higher savers who will prove the most attractive customers for a financial institution, it is important that institutions can set up schemes designed to meet the needs of individuals with diverse portfolios as well as those who may want simply to hold a single relatively safe asset.

Income tapers or cut-offs

Since the scheme is designed to encourage those on low incomes to save, a natural approach might be to target the scheme explicitly on that group by the use of tapered tax reliefs (where the tax incentive declines as a function of income) or cut-off points (whereby individuals or households only qualify for the scheme if their income falls below some level). The current UK tax system makes such an approach difficult. It would require a coherent notion of income on which to base the qualification criteria. This is fine for regularly employed individuals but less easy for those with fluctuating incomes (such as those on short-term contracts or the self-employed) or indeed the retired. 'Asset-rich' retired households with a high lifetime income but low contemporaneous income could easily qualify for the scheme and transfer balances up to the full limit immediately, for example. But even with a coherent notion of income, there are two problems. First, most people do not file tax returns so measurement of this income would involve a large administrative burden. Second, in the absence of joint taxation, assets could be transferred in name within households to household members with incomes below the qualifying limit in order to gain the tax advantage. As well as introducing an extra kink into the budget constraint for all workers, such transfers will particularly distort work incentives for those household members who are not the principal earner. These effects get more severe as the contribution limits increase and, since one of the reasons to target the scheme explicitly would presumably be to allow higher contribution limits than would be the case if the scheme were to be universal, they could be substantial.

5.2 Implementing the ISA

It is clear that there are two broad considerations in designing the ISA reform. On the one hand, the plan must redress the balance in the taxation of financial assets in the UK and aim to encourage saving amongst low savers. On the other, it must not prove prohibitively expensive or distributionally unpalatable by subsidising the existing savings of the well-off. It is in this second respect that accompanying changes to the taxation of other financial assets could prove important. Whilst revenue to finance the new tax relief presumably has to be raised from somewhere, the concentration of the stocks of saving in the hands of a small part of the population is such that small changes in the taxation of other assets to finance the ISA could have large distortionary effects. The taxation of savings is also such that abolishing tax reliefs in one part of the distribution may not necessarily lead to significantly more revenue (savings may just move to other tax-sheltered or tax-privileged forms) with which to finance the reform.

Extending TESSA- and PEP-type tax treatment (TEE in the terminology of Section 3) to all interest-bearing accounts would remove what is currently one of the biggest distortions in the taxation of savings. The introduction of the new ISA presents an opportunity for the government to move further towards more uniform tax treatment of savings by exempting interest income from taxation. However, it is extremely unlikely that this will happen in full. Total government receipts from income tax on interest from bank and building society accounts were £2.2 billion in 1996–97 (and are estimated to be £2.8 billion in 1997–98). The government will not want to give up this source of tax revenue — at least, not all in one go. Furthermore, if the government were serious about applying expenditure tax treatment to all forms of saving, it would also lose revenue from capital gains tax and income tax on dividend income.

The crux of the problem facing the government in deciding how to implement the new ISA is how to keep it relatively inexpensive — in terms of lost revenue from taxation of interest income from bank and building society accounts — whilst making it attractive to those with low levels of savings. As will be clear from our previous arguments, in our opinion the obvious response is a flexible account, with no minimum holding requirements but annual and, possibly, lifetime contribution limits.

The first thing to note is that the current heavily skewed distribution of wealth in bank and building society accounts works in the government's favour in helping it to achieve its twin goals of low 'cost' to the government and attractiveness to small savers. With annual and lifetime limits of, say, £10,000 and £50,000 respectively, the current distribution of bank and building society deposits (shown in Table 5.1) is such that most of the tax revenue might well still accrue to the government. More than half of all interest income is received by only 770,000 individuals who hold very large balances which are likely to exceed the annual (and even lifetime) limits.

A large proportion of individuals with high levels of interest income are likely already to have a TESSA or a PEP. If the ISA is introduced alongside TESSAs and PEPs, the effect will be to reduce the amount of tax paid at the top as those with large bank and building society deposits or direct holdings of equity take advantage of the additional tax-free savings opportunity and transfer money from existing stocks of wealth into the new ISA. But if TESSAs and PEPs are brought into the scheme, then — with sensible limits

Table 5.1. Distribution of interest income and number of taxpayers, by range of interest income

	Range of bank and building society interest in 1997–98 (£ per year)						
	0–100	100–500	500–1,000	1,000–2,000	2,000–4,000	4,000+	All
Amount (£m)	423	694	798	1,245	2,440	6,639	12,239
Number (thous.)	19,510	2,710	1,110	880	875	770	25,860

Source: Inland Revenue estimates using the Survey of Personal Incomes (1995–96 data projected to 1997–98).

— a relatively high proportion of the tax revenue from those with a lot of interest income will be kept, since these individuals will already have invested up to their limits in TESSAs and PEPs.

The experience of TESSAs and PEPs has shown that they have not penetrated all the way down the savings distribution. Not all current savers have taken out a TESSA or a PEP (and they have not appeared to encourage many new savers) — their tax-free status has not been sufficient compensation for other features that are unattractive to these households (the minimum holding period in the case of TESSAs and riskiness, transactions costs or information costs in the case of PEPs). There is a case for a new savings scheme with greater flexibility (no minimum holding period, choice over which type of assets to hold etc.) which will appeal to households that have not taken out a TESSA or a PEP (typically households with low savings). This will open up tax-free savings to those at the bottom as well as those at the top of the savings distribution.

To conclude, it is not clear that the cost of the ISA in terms of tax revenue from interest on bank and building society accounts will be high with moderate annual and lifetime limits. Those at the top of the distribution of interest income generate a disproportionately high proportion of total tax revenue, and it is likely that many of them will not benefit from an ISA that incorporates TESSAs and PEPs since they are likely to have invested up to the limit in TESSAs and PEPs anyway.

The interactions between ISAs and other savings vehicles will be important in determining the allocation of savings, particularly for high savers. Two savings vehicles that may be particularly important are private pensions and PEPs. Our comments here are, of course, speculative because the taxation of pensions way well change in the future, as, presumably, will PEP rules in the light of the ISA reform. But they demonstrate the issues that are likely to be important as tax reforms are designed.

The first issue is the tax treatment of ISAs versus private pensions. In the last Budget, the government ended payment of the dividend tax credit to funds in pension schemes (and PEPs from April 1999), and announced a reduction in the dividend tax credit to 10 per cent. If the ISA were to allow payment of the 10 per cent dividend tax credit, boosting the rate of return on equities held within the fund, the tax advantages of pension saving would be less relative to an ISA than they were relative to PEPs in recent years. The continued existence of the tax-free pension lump sum and the possibility of

tax-rate smoothing[15] mean that the relative attractiveness of an ISA compared with a private pension will depend on a number of factors including investors' preferences for liquidity, the profile of investors' marginal tax rates, portfolios within the ISA and, more particularly, the importance of dividend payments within the portfolio and contribution limits into both forms of saving. Removal of, or reduction in, the tax-free lump sum in future reforms to private pensions, without restoration of the tax credit, could make an ISA more attractive than a pension for many households.

The second issue relates to the treatment of funds currently in PEPs that are not carried over into ISAs. The government has announced that the dividend tax credit for PEP investors will cease to be paid from 1999 but that these investors will have the opportunity to switch to the new ISA (Inland Revenue Budget Press Release 2, 1997). With moderate annual and lifetime limits, it is likely that not all current PEP holders will be able to bring in all the funds they currently hold (or the combined total of a TESSA or PEP). One possibility is to 'grandfather' PEPs, i.e. allow old schemes to continue but not allow new schemes to be taken out. PEPs would then have no tax advantage relative to holding equities directly except in the few cases where investors had used up their capital gains exemption. These are exactly the investors who are likely to have the biggest PEP balances after contributing into their ISA up to the lifetime limit. For these (super-rich) investors, keeping the capital gains tax exemption in PEPs may mean that they would rather transfer funds other than their PEP balances into their ISA.

A second possibility is the abolition of PEPs post-1999. This would remove the possibility of further exemptions for households with very large wealth holdings discussed above. There are two important points here. First, although this may seem to be distributionally more palatable, and more in keeping with the stated aims of the ISA in focusing attention on the bottom end of the savings distribution, it may not necessarily prove to be so. To the extent that any of the funds currently held in PEPs were to move into other tax-favoured assets (for example, pensions, owner-occupied housing or offshore funds), these effects would be mitigated. Second, by exactly the same argument, policymakers could not rely on abolishing PEPs as a potential source of tax revenue — to the extent that funds did not go into taxed assets, any revenue gain would be reduced, potentially quite dramatically.

Therefore we wish to sound a note of caution about trying to make the introduction of the scheme revenue-neutral by amending other areas of the taxation of saving. The taxation of saving is a good example of a field where policymakers may be readily tempted by the appearance of juicy, revenue-laden bits of the tax system, ripe for reform, only to find that in the act of grasping the revenue, it slips between their fingers.

[15]That is, paying tax when retired at a lower rate than that at which tax relief was enjoyed while working.

6. Conclusions

The most convincing economic rationale for introducing an Individual Savings Account is the presence of distortions in the current tax treatment of different forms of saving. Savings held in bank and building society accounts and direct investments in equities are treated less favourably by the tax system than pensions and housing. This penalises people holding liquid assets as precautionary balances against unforeseen changes in their circumstances. In addition, it means that those with low levels of savings who typically hold only interest-bearing accounts face higher effective tax rates than those with fully diversified portfolios.

The new ISA presents an opportunity to move further towards neutrality in the tax treatment of savings by exempting interest income from bank and building society accounts. There is a danger that the case for removing existing distortions (for which there is a clear economic rationale) is confused with an argument that people should be saving more (which is simple paternalism). There are many households with little or no savings, but unless there is any obvious market failure that is preventing people from saving as much as they otherwise would, it is not clear that the current level of saving is too low. Many of those who have little or no savings are on very low incomes and/or have high consumption needs (such as children).

The introduction of TESSAs and PEPs was a move towards a more uniform tax treatment of savings. Take-up of both TESSAs and PEPs has been heavily concentrated among older and richer households. The ISA presents an opportunity to extend tax-free savings to those who are currently excluded by TESSAs and PEPs — either because of the lock-in period or because of the risk associated with equity investments. To make the ISA more attractive to low savers, it is clear that there should be no minimum holding requirement since this will exclude those with low incomes and/or variable consumption needs. Also, the new ISA should be simple and flexible, allowing for a variety of different savings vehicles within the account, for example.

Most things that the Chancellor could do to make the new ISA more attractive to those with low savings, in terms of removing any minimum holding period and making it flexible, would also make it more attractive to those with high savings. The current distribution of wealth in the UK is skewed and there are potentially large amounts of wealth that could be transferred into ISAs to take advantage of additional tax-free savings opportunities. As well as encouraging those on low incomes to save, the Chancellor may find himself giving lump sums to those who already have high levels of saving. An obvious response is annual and, perhaps, lifetime contribution limits. Furthermore, if TESSAs and PEPs are included in the new ISA, many individuals who have high savings will already have a TESSA and/or a PEP and, hence, will find themselves already at, or over, the new limits.

This may provide a case for capping current values of PEP holdings. However, this capping should not be seen as a way that the government can necessarily raise tax revenue to cover the cost of the new ISA. Some of the money that current PEP holders cannot carry over to the new ISA may go into taxed unit trusts or direct holdings of equity. Equally, however, the money may go into forms of saving that are more tax-

favoured than PEPs, such as additional voluntary contributions to private pensions, housing or venture capital. In this case, the government could actually see a decrease in net tax revenues from saving as a result of capping PEPs. This applies to current PEP holders as well as, in the future, to those who would have invested in PEPs. There is no obvious economic rationale for any loss in tax revenue from introducing the ISA to be met from changes elsewhere in the tax treatment of savings. If it has to come from taxes on savings, however, changes to forms of saving that are more tax-favoured than PEPs (such as reductions in MIRAS or the tax-free lump sum attached to private pensions) would be the obvious place to raise money and reduce distortions in the UK savings market even further.

Appendix

A.1. Savings accounts — bank or building society (including TESSAs) and National Savings accounts

Source: Family Expenditure Survey, 1995–96.

Percentage of households with a savings account, by income decile

Income decile	% with savings account
Poorest	38.0
2	46.3
3	55.6
4	58.6
5	62.2
6	64.8
7	66.7
8	71.7
9	78.3
Richest	82.2
All households	62.5

Percentage of households with a savings account, by age of head of household

Age of head of household	% with savings account
20–29	47.3
30–39	55.3
40–49	61.6
50–59	63.3
60+	72.9
All households	62.5

Percentage of households with a savings account, by income and age

Income decile	*Age of head of household*				
	20–29	30–39	40–49	50–59	60+
Poorest	18.5	22.2	13.2	30.1	52.7
2	13.0	18.7	32.0	46.0	65.0
3	28.1	28.6	41.8	49.1	70.5
4	40.7	38.9	51.2	50.6	73.8
5	55.4	47.8	46.7	57.4	83.1
6	56.6	55.1	58.7	65.7	84.8
7	58.2	59.5	53.9	77.8	86.7
8	68.4	67.0	70.6	68.8	89.7
9	80.0	77.0	76.5	76.9	87.1
Richest	70.7	83.4	81.0	78.7	97.2

Percentage of households with a savings account, by income and education (working-age households only)

Income decile	Compulsory schooling only	A levels	Degree
Poorest	20.4	23.2	46.9
2	25.6	44.2	38.2
3	40.9	51.3	65.2
4	44.6	56.2	60.0
5	57.0	66.4	66.7
6	53.7	66.9	76.2
7	59.4	76.5	80.0
8	69.6	67.2	74.2
9	77.9	82.6	83.6
Richest	69.0	83.2	85.4

A.2. **Stocks & shares** (including PEPs, unit trusts and government gilts)

Source: Family Expenditure Survey, 1995–96.

Percentage of households with stocks & shares, by income decile

Income decile	% with stocks & shares
Poorest	7.6
2	11.6
3	14.2
4	20.8
5	22.5
6	24.1
7	27.7
8	29.7
9	32.3
Richest	45.4
All households	23.6

Percentage of households with stocks & shares, by age of head of household

Age of head of household	% with stocks & shares
20–29	8.6
30–39	16.0
40–49	23.3
50–59	32.4
60+	30.3
All households	23.6

Percentage of households with stocks & shares, by income and age

Income decile	*Age of head of household*				
	20–29	30–39	40–49	50–59	60+
Poorest	1.1	6.3	8.8	7.2	9.6
2	0.0	1.9	10.0	12.7	17.5
3	0.0	2.2	5.1	15.1	21.0
4	4.9	9.3	13.1	24.1	29.9
5	8.4	9.3	11.4	30.9	37.8
6	9.1	11.9	18.2	29.6	47.9
7	14.3	16.8	22.7	38.9	48.3
8	13.9	17.6	25.7	37.5	63.9
9	22.9	27.3	25.8	38.8	58.8
Richest	17.1	38.2	41.2	56.6	72.2

Percentage of households with stocks & shares, by income and education (working-age households only)

Income decile	Compulsory schooling only	A levels	Degree
Poorest	3.3	7.0	18.8
2	3.2	12.5	0.0
3	8.1	23.5	18.8
4	13.0	15.4	30.0
5	12.2	17.2	19.3
6	19.3	31.6	22.2
7	14.6	29.6	33.3
8	21.4	35.1	34.0
9	28.4	30.5	31.0
Richest	34.5	52.7	43.9

A.3. Tax-exempt special savings accounts

Source: Family Expenditure Survey, 1995–96.

Percentage of households with a TESSA, by income decile

Income decile	% with TESSA
Poorest	1.9
2	4.1
3	5.3
4	10.6
5	9.7
6	11.9
7	10.0
8	14.4
9	16.3
Richest	19.1
All households	10.4

Percentage of households with a TESSA, by age of head of household

Age of head of household	% with TESSA
20–29	3.3
30–39	5.3
40–49	8.3
50–59	17.3
60+	14.3
All households	10.4

Percentage of households with a TESSA, by income and age

Income decile	*Age of head of household*				
	20–29	30–39	40–49	50–59	60+
Poorest	0.0	4.8	0.0	4.8	1.6
2	2.1	0.0	6.0	6.3	5.1
3	1.6	1.1	1.3	7.5	7.4
4	2.5	3.7	6.0	13.3	15.4
5	0.0	5.0	2.9	11.7	18.6
6	3.0	4.3	7.4	16.7	26.1
7	3.1	4.2	4.3	16.7	23.1
8	3.8	5.3	8.6	21.9	42.3
9	12.9	9.1	10.6	25.6	36.5
Richest	7.3	10.8	16.4	29.4	34.7

Percentage of households with a TESSA, by income and education (working-age households only)

Income decile	Compulsory schooling only	A levels	Degree
Poorest	1.2	4.7	6.3
2	2.2	5.8	0.0
3	3.3	9.6	8.7
4	3.3	10.0	4.0
5	4.4	8.6	17.5
6	5.4	6.0	7.9
7	6.8	11.7	16.0
8	10.3	14.2	6.2
9	12.8	16.2	23.3
Richest	7.1	18.6	20.5

A.4. Personal equity plans

Source: British Household Panel Survey, 1995.

All questions relate to current holdings in the interview week (September–December 1995).

Percentage of households with a PEP, by income decile

Income decile	% with PEP
Poorest	0.8
2	1.9
3	4.4
4	5.4
5	8.3
6	12.3
7	12.5
8	14.6
9	15.0
Richest	25.6
All households	10.1

Percentage of households with a PEP, by age of head of household

Age of head of household	% with PEP
20–29	2.9
30–39	10.4
40–49	11.3
50–59	15.9
60+	10.0
All households	10.1

Percentage of households with a PEP, by income and age

Income decile	*Age of head of household*				
	20–29	30–39	40–49	50–59	60+
Poorest	0.0	0.0	2.2	3.0	0.1
2	0.0	0.0	0.0	8.3	1.8
3	0.0	1.5	0.0	4.9	6.9
4	0.0	2.6	5.3	5.5	7.9
5	3.5	4.6	9.1	10.4	12.5
6	0.0	10.0	8.3	19.1	24.2
7	3.8	9.6	7.8	18.7	29.2
8	4.0	10.3	16.4	21.6	27.3
9	6.9	14.1	14.0	14.7	35.0
Richest	11.9	28.3	19.6	30.7	42.6

Percentage of households with a PEP, by income and education (working-age households only)

Income decile	None	O levels	A levels	Degree
Poorest	0.7	3.3	0.0	0.0
2	0.6	2.6	2.6	8.0
3	1.9	5.8	10.0	7.4
4	3.8	5.7	13.0	15.2
5	9.9	10.1	8.3	10.9
6	8.1	10.2	10.1	12.0
7	11.8	5.9	12.7	28.6
8	12.1	15.5	6.8	12.1
9	14.9	14.6	8.1	13.1
Richest	17.9	30.4	37.7	29.9

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