Saving for Retirement
How taxes and charges affect choice

Malcolm Cook
and Paul Johnson

May 2000
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SAVING FOR RETIREMENT
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FSA Occasional Paper

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Abstract

The government is keen to promote saving, especially in pensions. Traditionally pension saving has received relatively privileged tax treatment, providing an incentive to save in that form. This paper examines the size of that incentive and puts it into the context of other features of the savings choice, in particular the charges associated with different financial products. We find that differences in charges between products of a particular type can be more important in determining final outcomes than is the difference in tax treatment between different types of product. We find that, despite the slightly more generous tax treatment available to pensions, a basic rate taxpayer can expect a greater return from investing in a CAT-standard Individual Savings Account than in a median charge personal pension if the underlying investment return is the same. Once one takes account of the high probability that contributions to a pension will not be sustained for the full period of the policy then the choice becomes marginal even for higher rate taxpayers. We conclude that the imposition of charging limits in stakeholder pensions could potentially be an important step in persuading people to make greater provision for their own retirement.
Introduction

The state will not provide an income in retirement on which many people would be content to live. It is an explicit part of the policy of this government – as it was of the previous government – to encourage people to save to provide an income for their own retirement.

An important part of this encouragement is – and always has been – a relatively generous tax treatment of pension savings. Broadly speaking, contributions to pensions are free of tax, the build up in the scheme is free of tax (although pension funds can no longer reclaim the tax credit on dividends), but the income stream after retirement is taxed at the individual’s marginal rate, with part of the accumulated fund available to be taken as a tax free lump sum.

This tax treatment can be, and has been, justified in two ways. First, its effect is broadly similar to that of an expenditure tax. An expenditure tax is neutral between spending now and spending in the future and is generally considered by economists to be the appropriate way of taxing savings.

The second type of justification for this type of tax treatment for pensions is a more paternalistic one. Pension savings need to be encouraged because, in the absence of some financial stimulus, for example through tax breaks, people will be too myopic to save adequately for their own retirement. And if people do not give themselves an adequate income in retirement then they may claim extra state benefits at the expense of taxpayers in general. (So the paternalistic argument coincides with the self-interest of the government.) Thus far the paternalistic argument is not inconsistent with the expenditure tax justification. But there is one very important difference. Arguments for an expenditure tax tend to be taken to apply to all types of savings equally. Arguments based on paternalism tend to imply that the tax treatment of pension saving should be more advantageous than the tax treatment of other forms of saving. After all, why tie your money up until retirement unless you are going to achieve a better return than is available in savings vehicles where your money is accessible whenever you want it?

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1 See, for example, Kaldor (1955), Meade (1978), Pechman (1980).

2 See Dilnot and Johnson (1993) for a demonstration of this.
Our paper concentrates on this latter argument, and particularly on the choice between saving in a pension and in the other major tax relieved savings product, the Individual Savings Account (ISA). What we ask is ‘Given a marginal pound to be saved, would an individual be better off putting that pound in an ISA or a personal pension/stakeholder pension?’.

In itself this is not an especially novel question. However, we go beyond the simple tax comparison and also take account of consumers' differential costs from saving in different ways. The current government is attempting to tackle costs directly, by proposing the introduction of ‘stakeholder pensions’ with very stringent controls on the level and structure of their costs. If the reduction in costs is achieved not just by removing services for which the investor is willing to pay the price, stakeholder pensions should benefit the investor. So we consider the impact of stakeholder pensions on the savings choice. We also consider the price that individuals would need to be willing to pay to trade off the greater tax advantages associated with pensions for the greater flexibility implicit in ISAs.

We consider the effect on consumers who maintain their contributions for the full period until retirement. But, in a world where a large proportion of people make their personal pension paid-up after a short period and where personal pensions normally have front loaded charges, we also compare the costs for consumers who stop their contributions early.

In what follows we concentrate on these specific issues. We do not discuss the pros and cons of different forms of tax treatment. Nor do we engage with proposals to bring about a radical change in the shape of tax based incentives for pensions. We start by briefly setting out the policy context, the tax treatment of pensions and ISAs and the

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3 The ISA is a tax privileged savings account that, in 1999, replaced Personal Equity Plans (PEPs) and Tax Exempt Special Savings Accounts (TESSAs).

4 Stakeholder pensions do not yet exist, but the government has proposed that they should be introduced in April 2001. The framework for them has been set out by the Department of Social Security, particularly in a series of consultation papers during the summer of 1999 (including DSS 1999a, 1999b & 1999c) and announcements this year on the outcome of those consultations (DSS 2000a & 2000b).

5 The interested reader is referred to Dilnot and Johnson (1993) or Hills (1984).

6 For example the radical ideas of Agulnik and Le Grand (1998).
charging structures associated with pensions.7 We go on to look at the returns implied by the different tax systems, we add in information on costs to compare returns again, and we then examine the expected duration of contributions to a personal pension and compare the returns to the investor if contributions are stopped early. Finally, we consider the options open to members of occupational pension schemes who are looking to save more. We are able to draw some strong conclusions on the importance of charging levels and especially the charging limits that the government has proposed for stakeholder pensions.

1 Taxes and charges

Context

The Labour government elected in 1997 has been active in reforming the pensions and savings system. It has replaced the previous tax advantaged savings accounts with a single account, the ISA, while at the same time introducing CAT standards. These are voluntary standards relating to the charges, access and terms to which providers can choose to adhere in the design of their products. The CAT standards differ for each of the three types of ISA, namely cash ISAs, stocks and shares ISAs and life assurance ISAs. The government has also announced the introduction of stakeholder pensions, a new form of collective money purchase pension arrangement which must meet compulsory minimum standards with regard to price and flexibility. The government intends that the compulsory features of these schemes should address some of the problems that have dogged personal pensions over the past decade, but as competitors to personal pensions rather than replacements for them.

7 Here we use ‘pensions’ to mean personal or stakeholder pensions rather than state or occupational pensions.
At the same time, the tax advantages associated with saving in private pensions of any sort were materially reduced by the removal of the dividend tax credit in the Budget of July 1997.

In this climate of change the choices facing financial consumers remain complex but, given the increasing extent to which they will have to provide for themselves in retirement and in other circumstances, the choices are increasingly important. This paper deals with just a few aspects of these choices taking account of the different tax and charging structures that affect the choice between pensions and ISAs.

**Taxes**

The tax treatment of pensions is, of course, a subject complex enough to have provided lucrative employment to numerous lawyers and accountants. We, however, are only interested in the broad structure of the system.

Contributions to a personal pension are made out of pre-tax earnings. So tax relief is effectively available at the contributor’s marginal rate. The returns to the fund then roll up tax free (though they no longer attract dividend tax credits). At retirement one quarter of the accumulated fund may be taken as a tax free lump sum. The remainder, though, has to be used to purchase an annuity, the income from which is subject to tax at the individual’s marginal rate.\(^8\) The government’s proposals on stakeholder pensions are that, at this broad level of detail, they will be subject to a similar tax regime. (DSS, 1999c & 2000b) This tax treatment – ignoring the tax free lump sum – is often referred to as EET (contributions are tax Exempt, investment income is tax Exempt, money on withdrawal is Taxed).

ISAs, like PEPs and TESSAs before them, receive the tax relief at the other end – they are taxed according to the TEE regime (Taxed Exempt Exempt). So saving is out of taxed income, the return within the fund is exempt and no tax is payable on withdrawal.

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8 Since 1995, holders of personal pensions have been allowed not to buy an annuity at retirement. Instead they can, within certain limits, invest their personal pension fund and draw down income and capital from it when needed. This is termed ‘income drawdown’. The whole of the remaining fund must, however, be used to buy an annuity no later than the pensioner’s 75th birthday. Because of the continuing decisions that need to be made if this route is chosen and the consequent need for continuing advice, it is sometimes recommended that income drawdown should not be used unless the personal pension fund at retirement is at least £250,000.
For stocks and shares ISAs, though, a 10% dividend tax credit will be available until April 2004.

It is worth noting that the ability to take a tax free lump sum is probably inconsistent with the paternalistic argument for giving tax advantages to pensions saving. The paternalistic approach aims to ensure that people have sufficient income in retirement. On this basis, income should be given more favourable treatment than lump sums – whereas the present tax regime puts them the other way around.

If three things are ignored – the tax free lump sum, the dividend tax credit and the fact that people’s marginal tax rates change over time – these two tax regimes (EET and TEE) are exactly equivalent in their effect. This is demonstrated in Table 1. For simplicity we look at someone saving the proceeds of 100 of pre-tax earnings. We assume that this is invested for five years with a 10% per annum gross rate of return. The marginal tax rate is taken as 22%, the current basic rate. The equivalence, obviously, is not sensitive in any way to these assumptions.

\begin{table}[h]
\centering
\begin{tabular}{l|ll}
\hline
 & EET & TEE \\
\hline
Earnings & 100 & 100 \\
Tax paid before investing & – & 22 \\
Amount invested & 100 & 78 \\
Accumulated growth from 10% gross per annum for 5 years & 61.05 & 47.62 \\
Fund after 5 years, but before tax & 161.05 & 125.62 \\
Tax paid before investor takes lump sum & 35.43 & – \\
Post-tax fund & 125.62 & 125.62 \\
\hline
\end{tabular}
\caption{Equivalence of EET and TEE tax regimes: The ultimate return to investor who saves 100 out of pre-tax earnings}
\end{table}
Table 1, though, is very much just the base case. The biggest divergence from it is for those whose marginal tax rate when they are saving differs from their rate in retirement when they are drawing on their savings. Almost always that means paying a lower rate of tax during retirement than whilst working. In that situation the EET regime is of course to be preferred.

The impact of this and of the tax free lump sum is considered in Section 2. One issue that might seem important is the effect of the pensioner’s tax free personal allowance against income tax. In retirement one is likely, roughly speaking, to have the state basic pension plus whatever one gets from one’s own private savings and occupational scheme pension. For a single person aged from 65 to 74 the basic pension is currently £2,280 lower than the tax free allowance. Thus the first £2,280 of income from non-state pensions and from other taxable savings is effectively received free of tax. This, one might have thought, would significantly increase the incentive to save in a pension by comparison with an instrument such as an ISA that offers tax relief at the end. In fact this is not so. This is because it is compulsory to belong to the State Earnings Related Pension Scheme (SERPS) or its contracted out equivalent. For most people this will plug the gap between the basic state pension and the personal allowance. Thus the decision over how to save any extra income – in a pension or in an ISA – is essentially unaffected by the existence of the tax free allowance.

SERPS is soon to be replaced by the state second pension (S2P), which will, for low earners, be considerably more generous and hence more effective than SERPS in plugging the gap between the basic pension and the tax free allowance. S2P’s introduction will therefore reduce the incentive for low earners to save extra money through a pension relative to an ISA – and indeed will reduce their incentive to save at all. Therefore low earners will have less opportunity to take advantage of the potential tax free treatment of additional pension savings. This problem is accentuated by the minimum income guarantee for pensioners.

For the purposes of this paper we need add only one more thing about the details of the tax treatment of pensions and ISAs, namely that saving in each is subject to limits on contributions. For ISAs, no more than £5,000 may be invested in any one year.\(^9\) The

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\(^9\) When ISAs were introduced, the limit was set as £7,000 for the first year (1999/2000) and £5,000 thereafter. In his March 2000 Budget the Chancellor extended the £7,000 limit to the 2000/01 tax year but said nothing about later years.
rather more generous limits available to ISAs’ predecessor schemes, PEPs and TESSAs, are likely to have constrained the amounts invested since a large proportion of investors contributed the allowable maximum amounts.\(^{10}\) The personal pension contribution limits increase with age but, for example, someone aged 51 to 55 can contribute up to 30% of pre-tax earnings. Few people contribute the maximum allowable to their personal pension – mainly, no doubt, because for many investors the maximum is much larger than the limits for ISAs, PEPs or TESSAs. The proposed limits for stakeholder pensions are broadly the same as for personal pensions. However, someone will be allowed to contribute up to £3,600 to a stakeholder pension without providing any evidence of earnings. A consequence of this is that someone who is not earning – and who is therefore currently banned from contributing to any form of pension – will be able to use stakeholder pensions as a means of saving. The government has pointed out that this will help mature students, carers and people taking career breaks (DSS, 2000b). The differences in limits could be a very important factor in people’s actual savings decisions.

**Charges**

In choosing where to save one’s money, the tax system is not the only thing that counts, even if the expected rates of return on the underlying assets are the same. Investing in a pension introduces a number of elements of inflexibility for the investor: the money is tied up until retirement; three-quarters of the fund at retirement has to be used to buy an annuity, unless income drawdown is used (and income drawdown can involve costly advice and is only suitable for relatively large funds); even if income drawdown is used, the fund has to be converted into an annuity before the pensioner reaches 75; and on death the pensioner’s estate gets nothing from the money used to buy the annuity. The state has imposed these inflexibilities because the purpose of a pension is to provide an income throughout the pensioner’s retirement. This inflexibility generally reduces the attractiveness of a pension – although some investors may welcome, and be willing to pay for, the extra discipline imposed by this method of saving. Another important aspect of the investor’s decision, though, is the

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\(^{10}\) Although no firm figures are available, the Inland Revenue has estimated that around 40% of PEP investors and something over half of TESSA investors contributed the maximum amounts. (Source: Oral communication)
cost - in other words, the charges levied by the provider. Some of the cost may be caused by product features that the investor regards as useful - such as advice, convenience and quality of service. Thus the investor has to decide whether the extra services are worth the extra charges.

To give some impression of the size of charges, Table 2 shows some descriptive statistics for personal pensions. The figures are based on PIA's most recently published disclosure survey (PIA, 2000) and show the value of the fund at maturity for a 25 year unit-linked personal pension with contributions of £60 per month. Also included is the equivalent reduction in yield (RIY). The only thing that varies between the figures is the charges that companies levy. A 7% rate of return before charges is assumed in each case. Using a single rate of return, regardless of the level of charges, is appropriate because there is no evidence that high charging investments tend, on average, to produce better underlying returns than lower charging investments – see, for example, James (2000). For comparison, Table 2 also includes the eventual fund in a (clearly mythical) zero cost scheme, as well as the eventual fund in a stakeholder scheme meeting the proposed charge limit of 1% of fund annually.

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11 Here and in what follows we use 'charges' to mean explicit charges as disclosed in, for example, the 'key features' documents given to potential investors and as published by PIA in the report on its annual disclosure survey. We do not - indeed cannot - include the implicit or hidden charges to which James (2000) attributes a large portion of the costs of investing. James concludes that most of the implicit charges are caused by the dealing costs when the fund buys or sells. Since funds with low charges are often trackers - which will also tend to have a relatively low turnover within the fund and hence low dealing costs - then if we took account of implicit charges the difference between high charging and low charging funds might be even greater than is shown by the results in this paper.

12 In most of the offices that sell both unit-linked and with-profit personal pensions, the projected fund is the same for both types of policy.

13 Reduction in yield is the assumed annual investment return before charges less the average annual return to the investor after all charges, taken over the whole term of the investment.

14 7% is the central rate of return required to be used in projections of pensions policy proceeds. It is also the assumed rate of return used in PIA's disclosure survey (which was carried out as at 1 September 1999).

15 The proposed maximum charge is actually 1/365% per day. This gives a true annual charge of 1.06% per annum because of the effect of compounding.
The proposed maximum charge for the stakeholder pension would produce a projected fund greater even than that for the 90th percentile personal pension. The difference between the 10th and 90th percentile personal pensions comes to some 12% of the projected fund.\textsuperscript{16}

\textbf{Table 2}

<table>
<thead>
<tr>
<th>Projected funds after 25 years of £60 a month contributions\textsuperscript{17}</th>
<th>Fund</th>
<th>Equivalent RIY</th>
</tr>
</thead>
<tbody>
<tr>
<td>10th percentile personal pension</td>
<td>£35,900</td>
<td>1.88%</td>
</tr>
<tr>
<td>Median charge personal pension</td>
<td>£37,200</td>
<td>1.63%</td>
</tr>
<tr>
<td>90th percentile personal pension</td>
<td>£40,300</td>
<td>1.08%</td>
</tr>
<tr>
<td>‘No charge’ personal pension</td>
<td>£47,248</td>
<td>0.00%</td>
</tr>
<tr>
<td>Stakeholder pension</td>
<td>£40,392</td>
<td>1.06%</td>
</tr>
</tbody>
</table>

\textsuperscript{16} Note, though, that a major element of the charges for most personal pensions is the commission or other remuneration paid to the adviser who sells the policy. Stakeholder pensions, on the other hand, have been designed so that they will be sold with a minimum of personalised advice, in order that their charges will be much lower. Indeed, the government proposes that product providers and advisers should be able to charge an investor a separate up-front fee on top of the 1% per annum maximum charge if the investor wants personalised advice (DSS, 1999b & 2000a). Thus the comparison in Table 2 is, in effect, between a personal pension \textit{with} advice and a stakeholder pension \textit{without} advice.

\textsuperscript{17} We define the median charge personal pension in a way that weights the projected funds by new business. In other words, the median fund is such that funds with charges greater than it attract 50% of total new business. Similarly, 90% of new business goes to more expensive funds than the ‘90th percentile’ personal pension. (The new business is for all unit-linked regular premium personal pensions in the first half of 1999, taken from unpublished data collected by PIA as part of its disclosure survey.)
There is one more important issue that needs to be discussed under the general heading of charges. That is the impact of stopping contributions before the end of the contract. It is a vitally important issue for purchasers of personal pensions, as rates of persistency are low. The latest PIA Persistency Report (PIA, 1999c) shows that, of regular premium personal pension policies bought through independent financial advisers (IFAs), 10% had stopped paying premiums to that policy by the end of the first year and that 33% had stopped paying within the first four years. Persistency is even worse for purchases through company representatives, where over 40% of investors had stopped paying in the first four years. Longer runs of data are not available, but we estimate that the average contribution period on a 25 year regular premium personal pension is probably in the region of 10 years. The proportion of investors who continue paying for the full 25 years is more sensitive to the assumptions made about lapse rates after year 4 but, even for purchases through IFAs, it seems unlikely that the proportion paying for the full 25 years is greater than one in three and it could be as low as 15%.18

This poor persistency matters because historically most personal pensions have had substantial ‘up front’ charges, generally as a result of commission payable to the salesman or adviser. This means that net returns after a few years are lower than if the policy is held for long enough that the up front charges can be spread over many years. The effect, and general pervasiveness, of these charges was one of the main driving forces behind the government’s proposals for stakeholder pensions. One of the most important features of stakeholder pensions is that up front charges will not be permitted.

The impact of the up front charges is illustrated in Table 3. The contributions are still £60 a month gross, but this time we are looking at the fund at the end of 25 years if contributions cease after 5 years. (Most of those who stop paying make their pension paid-up rather than take a transfer value to another pension arrangement.19)

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18 The reported persistency figures may be distorted to some extent by group personal pension (GPP) policies (i.e. personal pension policies for employees of a single employer and to which the employer would usually contribute). Lapse rates tend to be higher on GPPs than on personal pensions arranged individually. This is mainly because employees who have GPPs and who then move to an employer with an occupational scheme must stop contributing to their GPP if they join the occupational scheme. PIA’s persistency statistics for personal pensions include GPPs. The published persistency figures may also tend to overstate the extent of lapsing because early retirements are, in effect, counted as lapses, as are policies where the policyholder is in the middle of a contribution holiday at the time of the persistency survey but later resumes payment.

19 According to Money Marketing (14 January 1999), research carried out for AXA Sun Life by a firm of consulting actuaries indicated that only 15% of holders of personal pension policies who stop contributing take a transfer value whereas 85% leave the policy paid-up.
The greater potential impact of charges in this case is demonstrated by the fact that the median charge personal pension provides only 62% of the fund that one would have received from a mythical no charge personal pension, compared with 79% if one were to pay premiums for the whole 25 years. The divergence between the 10th and 90th percentile funds is very much more striking than for the full period. The data collected in PIA’s disclosure survey do not enable us to judge whether this greater divergence is due purely to the effect of up-front charges or whether there are also penalties imposed when premiums stop early – but from the investor’s point of view it makes no difference.

### Table 3

**Projected fund after 25 years if policy with (gross) premium of £60 a month is made paid-up after five years.**

<table>
<thead>
<tr>
<th>Fund</th>
<th>Equivalent RIY</th>
</tr>
</thead>
<tbody>
<tr>
<td>10th percentile personal pension</td>
<td>£9,194</td>
</tr>
<tr>
<td>Median charge personal pension</td>
<td>£10,300</td>
</tr>
<tr>
<td>90th percentile personal pension</td>
<td>£13,008</td>
</tr>
<tr>
<td>‘No charge’ personal pension</td>
<td>£16,624</td>
</tr>
<tr>
<td>Stakeholder pension</td>
<td>£13,252</td>
</tr>
</tbody>
</table>
The changing market

The pensions market is already changing in anticipation of stakeholder pensions, even though they are not due to arrive until 2001. The change is partly because of guidance issued by PIA early last year (PIA, 1999b). Charges on stakeholder pensions will be substantially lower than the current charges on most personal pensions - and this will be especially marked if premiums are stopped early. Thus, when recommending new personal pension policies or increases to existing policies, advisers must take into account any penalties which could arise on early discontinuance. In its guidance PIA noted that 'any such problems will be avoided if customers are recommended contracts which, on the introduction of stakeholder pensions, can be converted to stakeholder contracts without material disadvantage'.

Some providers have already reacted to this by improving the discontinuance terms on their personal pension contracts. The extent of the reaction can be seen by comparing the results of PIA's 1999 disclosure survey with those of the previous survey, which was carried out as at 1 September 1998 (PIA, 1999a). The 1999 survey was based on an assumed growth rate of 7% per annum whereas the 1998 survey was based on 9% per annum. To enable the two sets of results to be compared, we have re-expressed them in terms of the equivalent RIYs.

Looking at how RIYs have changed from 1998 to 1999, only a few companies have significantly changed their charges on policies where contributions are paid for the full term, but many companies – especially the more expensive ones – have substantially reduced their charges for policies that become paid up. This is illustrated by Charts 1 and 2. Chart 1 shows what happens if premiums are paid for the full 25 years. Chart 2 shows the corresponding results if the policy is made paid up after five years (using the same scale as Chart 1). Each point on the chart represents a life office that was included in both the 1998 and 1999 surveys. Each office's 1998 RIY is plotted along the horizontal axis and the change in RIY from 1998 to 1999 is plotted along the vertical axis. Points above the horizontal axis represent increases in charges and points below the axis represent reductions.

20 When a company has different charging structures for different distribution channels we have used the RIYs for the channel through which the company sells most business..
Chart 1: Change in RIYs from 1998 to 1999
Personal pension policy for £60 a month paid for 25 years

Chart 2: Change in RIYs from 1998 to 1999
25 year personal pension policy for £60 a month, made paid up after 5 years
2 The savings choice

Having laid out the framework for thinking about the impact of taxes and charges we turn to the relative attractiveness of investing through the different saving vehicles.

We take account of a number of scenarios, varying the tax treatment, the tax position of the individual, the charges, the level of contribution and whether or not the policy is made paid-up. Since our data on charges are taken from the PIA disclosure survey we have been unable to investigate the effect of varying the rate of return. The tax comparisons are in fact invariant both to the rate of return and also to the level of contribution. However, the impact of charges is not invariant either to the assumed rate of return or to the size of contributions. Charges are, in general, proportionally more important in the face of low contributions and low rate of return.

It is unusual in doing work of this kind for the results of tax comparisons to be invariant to rates of return. The reason for that result here is that we are at no stage looking at different tax treatment of fund earnings, and we are not looking at an ‘income tax’ where nominal earnings are taxed. We are also ignoring the 10% tax credit on dividends that stocks and shares ISAs attract for the first five years after the introduction of ISAs. However, averaged over a 25 year term, 5 years of this tax credit would increase an investment return of 7% per annum only to 7.02% per annum. (Additional analysis of the impact of the dividend tax credit is provided by Emmerson and Tanner (2000).)

Note that we are considering only the choice facing an individual. Emmerson and Tanner make the point quite forcefully that, because of the treatment of National Insurance contributions, the most tax efficient form of saving is when the employer puts money into a pension scheme.
Our initial set of results is relatively well known – qualitatively at least. We simply compare the tax treatment of pensions and ISAs, ignoring charges and assuming that both the pension money and the ISA earn the same rate of return – 7% per annum. (The greater flexibility resulting from not tying one’s money up in a pension is given some consideration later.) We show the situation for three types of people:

- those who start off as basic rate taxpayers and continue to be basic rate taxpayers when they draw down their pensions/savings;
- those who start as higher rate taxpayers and still pay at the higher rate after retirement; and
- those who contribute as higher rate taxpayers but are basic rate payers after retirement.  

Note that higher rate tax is paid by 8% of taxpayers whose largest source of income is from employment or self-employment but by just 3% of those whose largest income source is a private pension (Inland Revenue, 1999).

For each of the three types of taxpayer we index the results by taking the lump sum they would have received if investing through an ISA as 100. For pensions, since three quarters of the fund at retirement must be used to buy an annuity whose payments are subject to tax at the investor’s post-retirement marginal rate and the rest can be taken as a tax free lump sum, we reduce three quarters of the fund by the appropriate tax rate. There is no need to get into the complexities associated with transforming these pots of money into annuities – from our point of view the results do not depend on this. We also examine what would happen if the tax regime for pensions were to change either to get rid of the tax free lump sum or to restrict relief on contributions to the basic rate only.

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21 We have chosen to ignore a fourth – less significant – category. This arises when contributions are made by a basic rate taxpayer whose earnings later increase to such an extent that he pays higher rate tax in retirement.

22 Thus 100 represents a different amount of money for each of the three different types of taxpayer.
Table 4

Comparing tax regimes by product and by type of taxpayer, ignoring effect of charges: Post-tax fund at retirement (relative to ISA)

<table>
<thead>
<tr>
<th>Tax rate pre-retirement:</th>
<th>Basic</th>
<th>Higher</th>
<th>Higher</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax rate post-retirement:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>ISA</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Baseline pension (lump sum taken)</td>
<td>107</td>
<td>117</td>
<td>139</td>
</tr>
<tr>
<td>Pension - no lump sum</td>
<td>100</td>
<td>100</td>
<td>130</td>
</tr>
<tr>
<td>Pension - basic rate relief only (lump sum taken)</td>
<td>107</td>
<td>90</td>
<td>107</td>
</tr>
<tr>
<td>Pension - no lump sum, basic relief only</td>
<td>100</td>
<td>77</td>
<td>100</td>
</tr>
</tbody>
</table>

Table 4 shows that, ignoring charges, a basic rate taxpayer who invests in a pension under the current tax regime will end up with a sum of money 7% greater than by investing in an ISA. (An alternative way of expressing this is that saving through a personal pension rather than through an ISA is equivalent to earning a return over the 25 years of 7.46% per annum rather than 7.00% per annum.) As the third row of the table indicates, the difference is entirely down to the existence of the tax free lump sum. Without the tax advantage of the lump sum, the eventual amount of money accumulated by a basic rate taxpayer would be the same in an ISA as in a pension. This is merely confirming the EET/TEE identity shown in Table 1.

The results for the taxpayer who is higher rate throughout are similar except that the tax free lump sum is relatively more valuable because the tax rate that would have been applied to it is higher. Looking further down the column though, one can see that any proposal to restrict tax relief for pensions to the basic rate would leave this type of investor better off putting their money in an ISA. In this case the tax free lump sum is not adequate to counteract the effect of getting a lower rate of tax relief than in an ISA.
Under the current tax regime those who have a really big incentive to save in a pension as opposed to an ISA are those who can take advantage of the tax rate smoothing that the existence of up front tax relief affords (and those who can invest more than £5,000 a year). As the final column shows, those who are higher rate taxpayers while contributing but pay only basic rate tax in retirement will end up with almost 40% more cash by investing in a pension than in an ISA. The choice only becomes neutral if both the tax free lump sum and higher rate relief are removed.

But of course the choice between a pension and an ISA is not genuinely neutral. Any money one puts in an ISA can be accessed as and when required, with no restrictions on how it is then used or invested. By contrast, pension monies can be accessed only after age 50 and then three quarters of them have to be converted into an annuity. So faced with a choice between an ISA and a pension each of which promised a return of 100, one would have a clear incentive to choose an ISA. How much more than 100 one would need from a pension investment to make it preferable to an ISA is a moot point. To put it another way, one could ask – ‘how much would one be willing to pay for the extra flexibility that an ISA offers?’ If the charges on ISAs and pensions were identical, a basic rate taxpayer would need to be willing to pay 7% more for that flexibility to make an ISA the right choice.

Finally, it is interesting to compare the projected funds in Table 4 with those for a savings vehicle which has no tax advantages at all. Consider, for example, a deposit account into which monthly contributions are paid out of taxed income and where the interest on the account is taxed and then reinvested – TTE in our notation. Then if the gross return on both deposit account and ISA is an assumed 7% per annum and if contributions are paid for 25 years, the deposit account fund at retirement (relative to 100 in an ISA) is only 80 for a basic rate taxpayer and 67 for a higher rate taxpayer.
Charges

Having looked at the effect of taxation, we now incorporate the impact of charges.\textsuperscript{23} We have already seen how large charges can be and how much they vary.

Table 5 is constructed in a similar fashion to Table 4, but compares the proceeds over a 25 year term for:

- a CAT-standard stocks and shares ISA (with the maximum permissible CAT charges);
- the median charge non-CAT unit trust ISA;\textsuperscript{24}
- the 10th percentile, median and 90th percentile personal pensions; and
- a stakeholder pension (with maximum permissible charges).

The data come from the PIA disclosure report. The CAT ISA forms the base product.

For a basic rate taxpayer the table shows results for contributions of both £60 a month and £200 a month, the two sizes of contribution for which PIA obtained data in its disclosure survey. Results for a higher rate taxpayer are shown only at the £200 a month level. To put this in perspective, in 1999 the average monthly premium for personal pension new business was £79\textsuperscript{25}. National average earnings for full-time employees are now over £20,000 a year\textsuperscript{26}, so £79 a month represents less than 5\% of an average employee’s earnings. This is much less than would normally be recommended for someone who wants to secure a comfortable retirement and who has no other savings.

\textsuperscript{23} We ignore any charges associated with buying an annuity at retirement. In effect, we treat such charges as being just part of the reduced flexibility that is a consequence of saving via a pension.

\textsuperscript{24} PIA’s disclosure survey collected data on charges for each company’s best selling unit trust (measured in terms of gross retail sales in the first half of 1999) in each of three categories: UK equity non-tracker funds; UK equity tracker funds; and UK bond funds. We have based our results on the data for funds in the first two categories, since a bond fund would normally be regarded as a less appropriate investment than an equity fund over a 25 year term. When calculating the median charge unit trust ISA, we have weighted each trust’s projected fund by the combined gross retail sales of PEPs and ISAs based on that trust in the first half of 1999.

\textsuperscript{25} Calculated from ABI (2000). It excludes any SERPS rebates.

\textsuperscript{26} Source: Incomes Data Services, press release dated 5 July 1999.
Table 5

Projected post-tax fund after 25 years:
Combining tax, charges and an assumed investment return of 7% per annum
(relative to CAT-standard ISA = 100)

<table>
<thead>
<tr>
<th>Tax rate pre-retirement:</th>
<th>Basic</th>
<th>Higher</th>
<th>Higher</th>
<th>Higher</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax rate post-retirement:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Basic</td>
<td>Higher</td>
<td>Higher</td>
<td>Basic</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>CAT stocks and shares ISA</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Median charge non-CAT unit trust ISA</td>
<td>90</td>
<td>90</td>
<td>90</td>
<td>90</td>
</tr>
<tr>
<td>Personal pension* - 10th percentile</td>
<td>95</td>
<td>100</td>
<td>109</td>
<td>130</td>
</tr>
<tr>
<td>Personal pension* - median charge</td>
<td>99</td>
<td>104</td>
<td>114</td>
<td>136</td>
</tr>
<tr>
<td>Personal pension* - 90th percentile</td>
<td>107</td>
<td>109</td>
<td>119</td>
<td>142</td>
</tr>
<tr>
<td>Stakeholder pension*</td>
<td>107</td>
<td>107</td>
<td>117</td>
<td>139</td>
</tr>
</tbody>
</table>

* Assuming the maximum lump sum is taken at retirement

For low levels of savings the impact of charges is actually to turn around the relative attractiveness of personal pensions and CAT ISAs for basic rate taxpayers. Even with its more advantageous tax treatment, the median charge personal pension provides a lower return than a CAT-standard stocks and shares ISA, as well as being less flexible.

The table also shows the really substantial differences between CAT ISAs and the median non-CAT ISA and lesser differences between stakeholder pensions and the median personal pension. It also shows the substantial differences between different providers of personal pensions. At the £200 a month level, stakeholder pensions outperform everything except the cheapest 12% of personal pensions. At the £60 a month level, stakeholder pensions’ outperformance is even greater. These differences are all due to charges. For a basic rate taxpayer at least, differences in charges
between cheaper and more expensive providers of a particular type of product are at least as important as tax differences between different types of products. Indeed, if we look at the cheapest and dearest providers rather than just the 90th and 10th percentiles, the projected fund for the cheapest provider is over 40% greater than that for the dearest. Thus even for higher rate taxpayers the differences in charges between providers of a particular type of product can be more important than differences in the tax regime. This is a clear demonstration of the advantage that investors can gain by shopping around or by using an IFA to shop around on their behalf – or indeed by opting for a stakeholder pension, which may not be the best product but which should provide good value.

As an aside, for a basic rate taxpayer with a median charge personal pension the effect of the charges is almost exactly equal and opposite to the effect of the tax relief on the contributions. In other words, from the investor’s point of view the whole of the tax relief on the contributions (as opposed to the tax relief on the lump sum or on the underlying fund) goes to pay the charges.

Only the personal pension results in Table 5 vary with the size of contribution. This is because most life offices use a charging structure that includes a fixed element per policy. Almost all unit trust ISAs, on the other hand, charge a percentage of each contribution plus a regular percentage of the fund. Hence, in percentage terms, their charges are the same for £60 a month as for £200 a month.

The RIY for the median charge non-CAT unit trust ISA is 1.82%, whereas the maximum charge for a CAT ISA is only 1.06% - an enormous difference. However, much of the difference is due to the cost of providing advice. The charges for most non-CAT ISAs and for personal pensions allow for the cost of providing advice; the charges for CAT ISAs and for stakeholder pensions allow for no more than minimal advice. An investor has therefore, in theory, to decide whether the advice is likely to be worth the cost of that advice. The problem, of course, is that most investors have insufficient financial knowledge to be able to make that decision.

Traditionally government has used tax incentives as its main tool in promoting saving for retirement and in promoting saving in general. The advent of CAT benchmarks for ISAs and of stakeholder pensions with tight charging criteria represents a new approach for government intervention in this field. The figures in Table 5 suggest that, in terms of the returns offered, this type of intervention could be a very important extra weapon in the government armoury.
Nevertheless, the success of such measures depends on how product providers react.
Out of all the many stocks and shares ISAs on the market, very few meet the CAT
standards.\(^\text{27}\) Most of those that do meet the CAT standards are based either on tracker
funds or bond funds, which are of course cheaper to manage than active equity funds.

Finally, we return to the impact of stopping contributions in the early years of the
policy. As we have seen, many pension contributors discontinue their contributions in
the first few years. Figures reported in PIA (2000) enable us to demonstrate the
combined impact of taxes and charges on eventual benefits if contributions are
stopped after the first five years.

<table>
<thead>
<tr>
<th>Table 6</th>
</tr>
</thead>
</table>

**Projected post-tax fund after 25 years if contributions are paid only for first five years: Combining tax, charges and an assumed investment return of 7% per annum (relative to CAT-standard ISA = 100)**

<table>
<thead>
<tr>
<th>Tax rate pre-retirement:</th>
<th>Basic</th>
<th>Higher</th>
<th>Higher</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax rate post-retirement:</td>
<td>£60 a month</td>
<td>£200 a month</td>
<td>£200 a month</td>
</tr>
<tr>
<td>CAT stocks and shares ISA</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Median charge non-CAT unit trust ISA</td>
<td>87</td>
<td>87</td>
<td>87</td>
</tr>
<tr>
<td>Personal pension(^*) - 10th percentile</td>
<td>74</td>
<td>92</td>
<td>101</td>
</tr>
<tr>
<td>Personal pension(^*) - median charge</td>
<td>83</td>
<td>99</td>
<td>107</td>
</tr>
<tr>
<td>Personal pension(^*) - 90th percentile</td>
<td>105</td>
<td>111</td>
<td>121</td>
</tr>
<tr>
<td>Stakeholder pension(^*)</td>
<td>107</td>
<td>107</td>
<td>117</td>
</tr>
</tbody>
</table>

\(^*\) Assuming the maximum lump sum is taken at retirement

\(^{27}\) For example, a survey by Fitzrovia for Norwich Union in May 1999 claimed that out of more than 1,000 funds available for investment through a stocks and shares ISA only 29 met the CAT standards. (See Norwich Union press release of 24 May 1999.)
Compared with Table 5, in Table 6 the relative position of personal pensions has worsened substantially, and the worsening is greater for a £60 premium than a £200 premium. The most significant change of all is probably the widening of the gap between the best value personal pensions and the worst value ones. Relative to the CAT ISA, the 90th percentile personal pension is little changed from its position in Table 5, but for a basic rate taxpayer contributing £60 a month the projected proceeds of the median pension have fallen from 99 to 83 and the 10th percentile projected proceeds have fallen from 95 to 74. Thus if contributions stop after five years, the CAT ISA provides substantially better value for the basic rate taxpayer than does the median personal pension. For the higher rate taxpayer paying £200 a month the median personal pension still provides better value than the CAT ISA but the advantage is wiped out if the investor has chosen the 10th percentile provider.

As noted earlier, available data on persistency are, unfortunately, not adequate for us to be able to estimate an expected period of contributions to a pension with any degree of confidence. It is possible – in theory at least – that the distribution of contribution periods could be bimodal with, we know, a large group ending contributions very early and, perhaps, another substantial group staying the course in full. It seems likely that most people will not, when they take out a new product, know into which group they fall. Given this, and given our earlier tentative estimate that the expected period of contributions is around 10 years, the expected returns from saving in the various products are likely to lie between the figures shown in Tables 5 and 6.

Members of occupational schemes

In all our analysis so far we have ignored one very important group of savers – those with an occupational pension. They are relevant to the current debate because, while Inland Revenue rules prevent members of occupational schemes from contributing to a personal pension, members can augment their occupational pension by contributing to an ISA, by making additional voluntary contributions linked to the occupational scheme (AVCs) or by making free standing additional voluntary contributions (FSAVCs). Additionally, the government is proposing that members of defined contribution occupational schemes should be allowed to pay into stakeholder pensions. The current proposals would not allow any members of defined benefit occupational schemes to contribute to stakeholder pensions but the government has invited suggestions for a cost-effective and workable way in which low- and middle-earning members of final salary schemes could make use of stakeholder pensions. (DSS, 2000b) Thus
stakeholder pensions will provide a further method of augmenting some occupational pensions.

The tax position of AVCs and FSAVCs is broadly the same as for other forms of pension. In theory, a major difference is that none of the fund from an AVC or FSAVC can be taken as a lump sum: it must all be converted into an annuity. However, the Inland Revenue’s limits on the amount that someone can take as a tax-free lump sum at retirement are expressed as percentages of the person’s total pension entitlements – i.e. including any pensions arising from AVC/FSAVCs. In effect, subject to the rules of the particular occupational scheme, the existence of the AVC/FSAVC fund increases the employee’s total tax-free lump sum by an amount equal to 25% of the AVC/FSAVC fund. Thus in practice the AVC/FSAVC fund can often be treated as if 25% of it can be taken as a tax free lump sum.

It is often not until the later years of their working lives that members of occupational schemes start to make extra provision for retirement. Hence the average term of AVCs and FSAVCs tends to be shorter than for personal pensions. Consequently, in its disclosure survey PIA investigates charges on AVCs and FSAVCs with a 10 year term rather than the 25 year term used for personal pensions.

Table 7 shows the projected proceeds after 10 years for CAT ISAs, median charge non-CAT unit trust ISAs, median charge unit-linked AVCs, median charge unit-linked FSAVCs, and stakeholder pensions. (On the government’s current proposals, stakeholder pensions will, as noted earlier, be an alternative only for members of certain types of scheme.) As before, the results are expressed relative to CAT ISAs. The table is based on contributions of £60 a month, since that is the only size of contribution that PIA investigated.

The table has two separate lines for AVCs. The figures in PIA’s disclosure report allow for full charges on both AVCs and FSAVCs. From the point of view of the employee, such figures give a possibly misleading comparison between AVCs and FSAVCs. Occupational schemes often arrange that AVCs are provided to employees on a ‘nil commission’ basis – i.e. the intermediary who advises the scheme does not receive a commission on the AVC, the AVC’s standard charges are correspondingly reduced, and the employer may then pay a separate fee to the intermediary. Thus the employee bears less than the full charge. In such circumstances the employee’s outcome under the AVC is much better than is implied by an unadjusted comparison with FSAVCs. The figures shown for the
median ‘nil commission’ AVC are estimates calculated from data in a 1998 survey of FSAVCs and ‘nil commission’ AVCs and from PIA’s data for full charge AVCs.

Table 7 shows that, on our chosen assumptions and taking account only of taxes and charges, the median charge AVC on a nil commission basis is comfortably the best option whatever the tax position of the employee. In practice, the comparison between AVCs and FSAVCs is not as simple as this. FSAVCs are more flexible than AVCs in certain respects, since they can give the employee greater choice, and they can have cost advantages for employees who change jobs frequently. So the employee has to decide whether these advantages of FSAVCs outweigh the greater charges. The table also shows that the CAT ISA is better for a basic rate taxpayer than either the median full charge AVC or the median FSAVC. For higher rate taxpayers – and especially for those who become basic rate after retirement – the tax advantages of AVCs/FSAVCs outweigh

28 In the July 1998 issue of ‘Pensions Management’.
the lower charges of the CAT ISA. The median charge nil commission AVC is always better than the CAT ISA regardless of the employee's tax position. For those members of occupational schemes who will be able to use stakeholder pensions as a method of augmenting their pension, the maximum charge stakeholder pension will produce almost exactly the same outcome as the median ‘nil commission’ AVC.
3 Conclusions

Choosing the most cost efficient and tax efficient way to save is a complex process. Yet the pension policy, and increasingly the welfare policy generally, of successive governments has been built around the assumption that people must make that choice. Governments have been particularly keen that people should choose to save through a pension because only that provides the security (to the government as well as to the individual) of an income in retirement.

Saving through a pension, though, means tying up one’s money for a long period. The government must therefore provide incentives so that people can obtain a better return from pension saving than from competing but more flexible savings products. The present approach of giving more generous tax treatment to the pension lump sum at retirement than to pension income is inconsistent with the aim of trying to encourage people to provide themselves with an adequate income in retirement. Yet it is the existence of the tax free lump sum that gives pensions their tax advantage over other products currently available. However, this advantage is often more than offset by charges, especially for basic rate taxpayers who stop contributing early on. Indeed, for basic rate taxpayers the value of the additional tax relief is not very substantial in itself. If there were no differences in charges, basic rate taxpayers would only need to be willing to pay an extra 7% for the very substantial flexibility of a CAT-standard ISA in order to make that the more worthwhile choice. For an average level of contribution, the difference between the charges on the median personal pension and those on a CAT-standard ISA broadly cancel out the tax advantages of the former, even when contributions are paid until retirement. For higher rate taxpayers, especially those who expect to pay tax at the basic rate during retirement, the pension tax relief is much more valuable.

Given that the tax system itself is probably an inadequate incentive for many people to save in a pension, the steps that the government has taken in introducing stakeholder pensions with tightly defined charging criteria could potentially be an important step in increasing the relative attractiveness of pension saving. The announcement of the stakeholder proposals has already caused many of the more expensive providers to give better value when contributions are stopped early. But whether stakeholder pensions will provide enough incentive for those who do not want to save remains open to question.
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