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3 Taxation and Personal Saving Incentives in the United Kingdom

James Banks and Richard Blundell

3.1 Introduction

In the United Kingdom in 1991 personal sector saving accounted for £42 billion of a total personal sector disposable income of £410 billion. To understand the relationship between taxation and savings it is critical to focus on behavior at the household level, where after-tax returns on particular assets can be precisely defined. It is also useful to separate two stages of decision making—how much to save and how to save it—although these will not usually be independent. In this paper we will look predominantly at the second of these decisions, although the evolution of the level of aggregate savings[1] will be considered when we look at the U.K. experience over the last 20 years in section 3.2 below.

Although many of the anomalies in the United Kingdom's tax treatment of assets and asset income have been ironed out during the past decade, it remains (in common with many other systems that have evolved over a considerable length of time) characterized by a ranking of pretax returns that differs markedly from that of posttax returns. Tax incentives have joined, and in some cases

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1. We will try to use "saving" to indicate flows and "savings" to indicate stocks throughout this paper to reduce ambiguity.

replaced, economic incentives in determining the allocation of saving. In addition, though, the government may want to use the tax system as an instrument to increase the level of aggregate savings or divert saving into a particular vehicle and will therefore introduce a nonneutral tax specifically for that purpose. In the United Kingdom this has usually resulted in new acronyms, with the advent of tax-exempt special savings accounts (TESSAs) or personal equity plans (PEPs), for example, both discussed below. The purpose of this paper is to examine the tax incentives in existence for the different forms of household saving in the United Kingdom and to consider the distribution of personal sector wealth across these assets.

An important distinction to make in this area is that between intermediated household saving and saving through direct investment. A complete treatment of the taxation of saving requires a complete treatment of the taxation of direct investment, in particular for the self-employed. By becoming self-employed or registering as a company, individuals can enjoy tax relief on saving in assets that become treated as investment for tax purposes. For obvious reasons we cannot, in this paper, comprehensively treat the taxation of saving through direct investment, and so we choose simply to ignore such forms of saving and consider only intermediated household saving. We do, however, consider housing and mortgages to be a form of household saving, as is conventional, even though these could be interpreted as saving through investment.

In the subsections below we summarize the existing tax regime and report the important changes instigated in the U.K. tax system in recent years. Section 3.2 looks at the household balance sheet for the U.K. personal sector and briefly considers how this has changed over time along with the distribution of wealth. Sections 3.3–3.6 consider the taxation of specific asset types in more detail and examine more closely the extent to which the personal sector has responded to special tax incentives. Section 3.7 concludes the paper.

3.1.1 The Taxation of Personal Saving in the United Kingdom

The two most important taxes that have implications for saving in the U.K. personal sector are income tax and capital gains tax (CGT), as opposed to National Insurance and VAT, which are equally important from a revenue point of view. In the 1990–91 tax year, 25.7 million people paid a total of £59.6 billion in income tax, and £1.4 billion in CGT revenue was raised from 165,000 individuals. In addition, however, about £1.3 billion was raised from inheritance tax (IHT), but throughout most of this paper we will be more concerned with income tax and CGT. This is in part because very few individuals actually pay IHT (of the order of one-tenth of the estates notified for probate—representing about 30,000 individuals each year), but also because many U.K. commentators (for example, Kay and King 1990; IFS Capital Taxes Group 1988) have shown that IHT is relatively easy to avoid. For completeness, however, we describe IHT briefly in section 3.3 below.

Income tax is payable by any tax unit on income (above their personal tax-free allowance) from many forms of savings and is charged at a basic rate of 25 percent and a higher rate of 40 percent. Currently the single person's allowance stands at £3,445, and the higher rate threshold is £23,700 of *taxable* income. (In his budget of April 1992, the chancellor introduced a reduced rate band of 20 percent to apply to the first £2,000 of taxable income. However, no data exist as yet for the impact of this reform on savings, and it is expected that only 4 million people will pay the reduced rate.[2] Consequently, for the purposes of this paper we will define the "current" tax system to be the pre–April 1992 tax system.)

Capital gains tax operates in a similar way although the distinction between capital gains and income as defined by the tax system is not always clear. Investors receive an exemption of £5,800 per annum, below which any gains are entirely tax-free, and above which any *real* gains are taxed at the investor's marginal rate of income tax.

In reality the tax advantage or disadvantage associated with a particular asset will depend upon a number of other elements. A common measure of tax privilege, the "effective tax rate" (ETR), is computed by taking the ratio of the tax payment to the real pretax return. The three elements in this calculation—tax payments, inflation, and pretax yields—can vary across individual, time, and asset accordingly. First, the pretax yield on intermediated saving will depend on the way that the financial intermediary's portfolio itself is taxed. More important, however, is that some savings tax payments are calculated on nominal returns, and consequently the tax penalty of such assets is made significantly more severe in times of high inflation. Finally, tax exemptions offer significantly higher advantage to high-rate taxpayers than basic-rate taxpayers, and despite the fact that only 1.6 million people paid the higher rate in 1989, the effective tax rates can often be significantly lower for such individuals and as such the total effects could be quite large.

A final issue that clouds the analysis of savings taxation is the well-known process of capitalization of tax privileges into asset prices or pretax yields. In the United Kingdom this effect has been strong in the market for owner-occupied housing, but a less well known example exists in the case of low-yield National Savings Certificates (see Saunders and Webb 1988). The effect of capitalization is to shift the benefit of the tax privilege from the investors who own the asset to the people who invested in the asset before it became privileged. The actual (risk-adjusted) returns realized by investors are significantly equalized by this process.

2. It is worth noting, however, that a significant portion of these 4 million reduced-rate taxpayers will be pensioners, and so much of the taxable income will be unearned and the reduced rate band could prove to be quite an important issue in the taxation of savings.

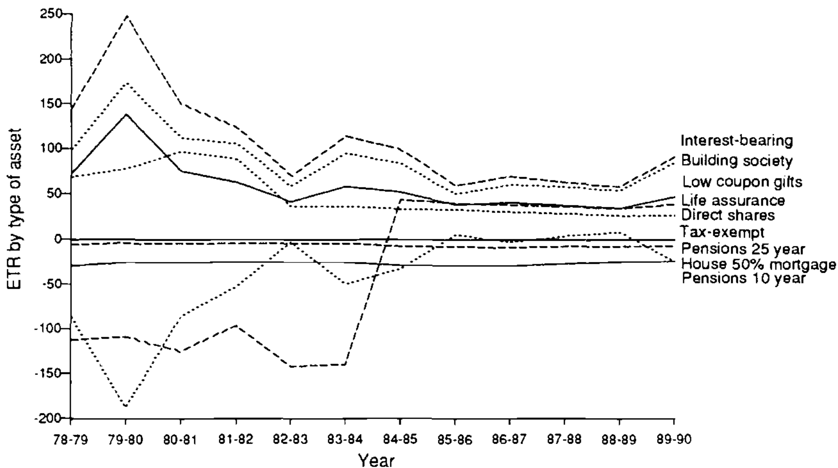

Fig. 3.1 Effective tax rates by asset type, 1978/79–1989/90 (basic rate taxpayers, actual inflation)
Source: Reproduced from IFS Capital Taxes Group (1989).

3.1.2 Major Changes in Tax Regimes

Although this paper seeks primarily to address the current U.K. tax system, any investigation of personal saving that has a time-series element would need to account for some important changes in the tax regime in recent years, in particular in the past decade. The majority of major changes and trends in the taxation of savings occurred in the 1980s, and their net result has been to equalize effective tax rates across assets over the time period concerned. This process is shown in figure 3.1, which is reproduced from the report of the Institute for Fiscal Studies Capital Taxes Working Party (IFS Capital Taxes Group 1989). The equalization has been aided by falling inflation, however, and figure 3.2 presents ETRs by asset calculated at constant inflation—showing distinctly less convergence over the 11 years. Remember that the ETR is the tax paid expressed as a proportion of the pretax return, and those calculated in the figures were calculated on the assumption of constant (real) pretax returns across assets—almost certainly unrealistic since properly functioning capital markets would act so as to equalize *after-tax* returns across assets. The figures do, however, show the direction and scale of the effects induced by fiscal reform in the past 10 years.

The Conservative government, since its election in 1979, has seen fit to reduce and to some extent simplify the direct tax system and has also reduced the rates of most direct taxes (albeit at the expense of the indirect tax burden). Most well known is Nigel Lawson's penchant for abolishing a tax in every budget during his tenure as chancellor of the exchequer in the mid-1980s. In

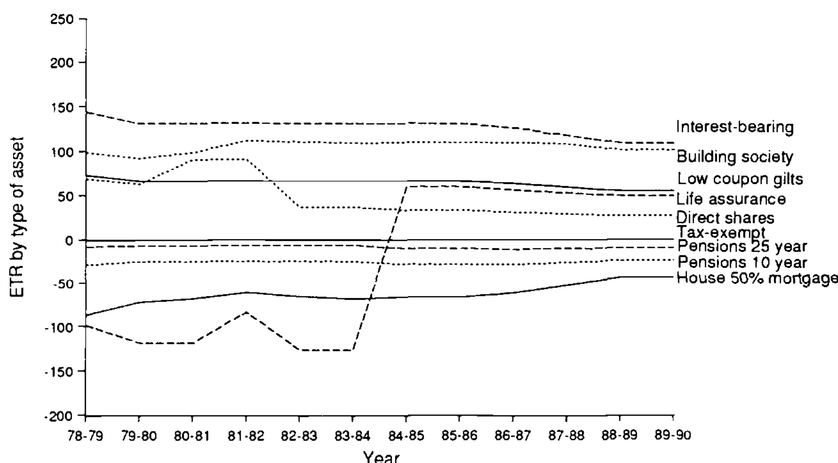

Fig. 3.2 Effective tax rates by asset type, 1978/79–1989/90 (basic rate taxpayers, constant [10.1%] inflation)
Source: Reproduced from IFS Capital Taxes Group (1989).

what follows we will try to describe the major regime changes in the last two decades along with the path of savings—both at the aggregate level and disaggregated by asset. Obviously we cannot describe every tax change, nor do data exist that are powerful enough to fully describe the path of household savings; however, in what follows we try to capture the important factors influencing the ETR profiles illustrated above.

Fewer and Lower Marginal Income Tax Rates

The rates and bands of income tax have important implications due to the tax relief at either the basic or marginal rates for deductible asset purchases and payments. As is well known, after a period of increasing direct taxes during the 1970s, there has been a wide-scale removal of direct tax bands and a reduction in direct tax rates over the last 13 years. This is illustrated in figure 3.3 and has had the effect of equalizing ETRs and therefore fiscal privilege across income ranges. It is worth remembering, however, that the number of higher-rate taxpayers has always been relatively small—as illustrated in the lower part of figure 3.3—rising recently to 6.5 percent of the total number of taxpayers. This has arisen as a result of the broad fixing of the higher rate threshold in real terms in a period of real earnings growth.

Capital Gains Tax

Two major changes in CGT rules have significantly changed the effective tax rates faced by households. First, indexation provisions were introduced into CGT in 1985, considerably reducing the penalties for holding assets in

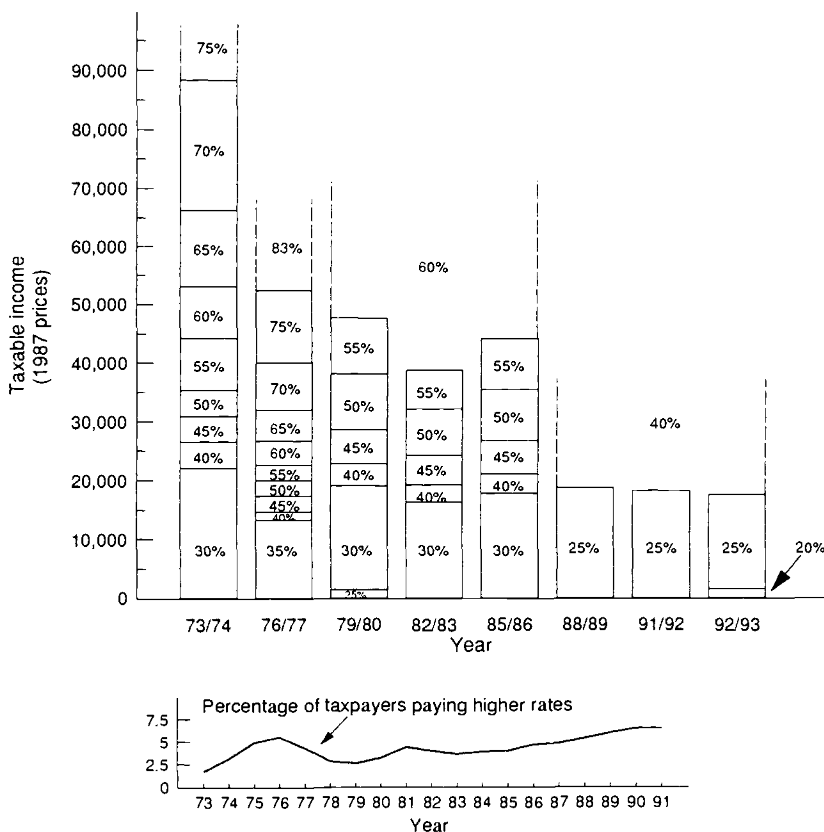

Fig. 3.3 Tax thresholds and tax rates since 1973

times of high inflation. Second, prior to the 1988 budget, CGT was charged at a flat rate of 30 percent thus giving higher-rate taxpayers particularly strong incentives to seek returns via capital gains. The switch to taxing capital gains at the investor's marginal rate of income tax reduced fiscal privilege but did not eliminate it due to the differing bases of the two taxes. Any tax penalties associated with CGT were also reduced by a gradual upward trend in the real value of the tax-free annual exemption until 1988 when the restructuring of CGT rates was combined with a reduction in the real value of the annual exemption.

Abolition of the Investment Income Surcharge and the Extension of the Composite Rate

Prior to 1984 the United Kingdom had an investment income surcharge (IIS) of an extra 15 percent above the investor's marginal income tax rate on invest-

ment income above a threshold. This resulted in a situation in 1976, say, in which income arising from investments was taxed at 98 percent for some individuals. The abolition of the IIS in 1984 and the subsequent reduction in the higher rate of income tax have reduced this to 40 percent, although this may have been less dramatic than it seems because many people believe that the 98 percent rate could only persist because it was easily avoided (e.g., by converting income into capital gains) and the excess burden reduced (Kay and King 1990).

The composite rate was introduced to ease the collection of a large number of relatively small tax payments from building society account income and is a weighted average of the marginal tax rates of zero- and basic-rate account holders that the building society pays on its total deposits. In 1984 this composite rate was extended to bank accounts, thus increasing the number of tax-penalized account holders. Taxation at the composite rate (usually about 21 percent when the basic rate was 25 percent) represented a significant tax penalty for zero-rated taxpayers, who could not reclaim the composite rate payment, and a slight subsidy for basic- and higher-rate taxpayers. Basic-rate tax units were not required to pay the extra (about) 4 percent tax, and higher-rate taxpayers were required to pay additional tax only on the interest grossed up as if the full basic rate had been paid.

Introduced only as an administrative aid and almost universally disapproved of, the composite rate was eventually abolished in the 1990 budget of the then-chancellor, John Major, to wide approval.

Replacement of Capital Transfer Tax

The budget of 1986 saw the replacement of the capital transfer tax with the inheritance tax. The capital transfer tax had attempted to tax transfers of wealth and gifts between the living but had gradually been eroded by base narrowing, high levels of avoidance, and rate reduction (Keen 1991) and was therefore a good candidate for the chancellor's ax. In its place a seven-banded inheritance tax was introduced, and in the following two budgets the number of bands was reduced (from seven to four to one) and the threshold increased to £110,000. The threshold has been increased annually to its current level of £140,000.

Erosion of the "Mortgage Interest Relief Deducted at Source" Ceiling

While there have been no structural changes in the taxation of mortgages, there has been a steady downward trend in the mortgage ceiling resulting in the upward trend in the ETR for housing observed in figure 3.2. The ceiling for "mortgage interest relief deducted at source" (MIRAS) has been fixed in nominal terms at £30,000 since 1983, and 1983–90 has been a period of rapid house price inflation; consequently the real value of the tax relief has fallen to the point at which almost no new mortgages are entirely covered by MIRAS anymore and the attractiveness of saving through owner-occupied housing has

diminished. In addition, the abolition of tax relief for home improvement loans and the switch to MIRAS entitlements being calculated per property rather than per tax unit, both in the 1988 budget, have also contributed to this decline. More recently, an important MIRAS reform was the replacement of tax relief at the investor's marginal rate by tax relief at the basic rate in the 1991 budget, thus reducing the privilege that higher-rate taxpayers gain from saving through housing.

Abolition of Domestic Rates

The only value-based tax on housing—domestic rates—was abolished in 1990 in favor of the community charge (or poll tax). This, unlike most changes outlined above, served to disperse ETRs among asset types and income groups, as it made saving through owner-occupied housing more privileged as the value of the house increased. The public discontent with the poll tax is well known, and the replacement—the council tax—although related to the house price by a nine-banded system, will still not return the taxation of owner-occupied housing to its original status.

3.2 The Household Balance Sheet

It is useful, before we look at asset types in more detail, to consider the way in which personal sector wealth is distributed both across the population and across the different types of assets themselves. While the latter question can be assessed from aggregate data, most of the interesting aspects of the distribution of wealth require some recourse to a microeconomic data set. In the United Kingdom the first preference of most economists is the Family Expenditure Survey, but information on the value of wealth holdings is extremely sparse and unreliable. In general the quality of any one data set is poor, but a study by Saunders and Webb (1988) utilizes a private microeconomic survey of 30,000 households carried out in 1987, and we draw on their results in some of what follows.

3.2.1 The Distribution of Personal Sector Wealth

In table 3.1 we simply report the concentration of wealth in the United Kingdom in three recent years, and this shows, not surprisingly, the large amount of marketable wealth held by the top few percentiles of the population. One noticeable feature is that although the most wealthy 5 percent have retained their share of the total, there has been a slight increase in the share owned by the middle percentiles over the past 13 or so years. This trend is evident under both definitions of wealth (including and excluding pension rights), but the other predominant characteristic of table 3.1 is that the wealth distribution which does not include pension rights (col. [ii]) is significantly more unequal. This emphasizes the importance of state pension rights that accrue to every employed individual in the distribution of personal wealth and also highlights

Table 3.1 **Concentration of Wealth among the Adult Population**

	1976		1982		1989	
% of Wealth Owned by:	(i)	(ii)	(i)	(ii)	(i)	(ii)
Most wealthy 1%	13	21	11	18	11	18
Most wealthy 2%	18	27	15	24	16	25
Most wealthy 5%	26	38	24	36	26	38
Most wealthy 10%	36	50	34	49	38	53
Most wealthy 25%	57	71	56	72	62	75
Most wealthy 50%	80	92	79	91	83	94

Source: Inland Revenue (1990).

Note: For col. (i), wealth is as defined in U.K. *Inland Revenue Statistics* (ser. E), i.e., the current valuation of total marketable wealth including occupational and state pension rights. In col. (ii), wealth is as defined in U.K. *Inland Revenue Statistics* (ser. C), i.e., excluding all rights accruing to individuals under occupational and state pension schemes.

the need for a consistent and relevant definition of wealth itself.

Given this breakdown we might be interested to know the structure of portfolios within different wealth and income categories, and these breakdowns are presented below. It is important to bear in mind that factors influencing the differential choice of assets by differing population groups can often be related to the kinds of variation in ETR described above. For example, there is an association between risk and fiscal privilege because, for tax purposes, gains that arise from the change in value of a tradable asset are treated as capital gains and therefore are taxed more lightly than interest payments. Risk-averse investors will tend to choose less risky, usually nontradable, assets, which also tend to carry a greater tax penalty. In addition, tradable assets tend to have higher holding and transaction costs and require greater information (this is clearly the case for gilts and equity, but also for the Business Expansion Scheme—see below—which has been highly privileged in the past). These fixed costs tend to become more significant when small amounts are invested and can lead to concentration of certain types of financial assets by income or wealth population subgroups. It is probably not feasible for small investors to hold well-balanced portfolios, and they may well simply resort to low-risk, less-privileged forms of saving that cost less to administer and also are more liquid.

Tables 3.2 and 3.3 show exactly these symptoms. When the population is broken down by income or wealth range, there is a clear shift toward equity and away from bank and building society deposits for the richer investors.

Nonfinancial or less-liquid assets such as housing or life assurance have significantly lower information costs but are still tax-privileged and consequently have wider take-up, as can be seen from table 3.4. These assets provide a privileged tax status to a much wider group of the population and will therefore

Table 3.2 Holdings of Financial Assets by Investor's Wealth

	Investor's Level of Wealth				
	Top				Bottom
% of Savings Held in:	1%	2%–5%	6%–25%	26%–75%	25%
Bank and building society accounts	34.2	68.4	76.9	83.8	83.5
Equity	42.0	21.1	13.9	6.4	7.5
Gilts and local authority bonds	16.6	1.2	0.3	0.0	0.0
Tax-free National Savings	3.6	2.7	2.4	1.0	0.8
Other National Savings and savings clubs	3.6	6.7	6.6	8.7	8.2

Source: Saunders and Webb (1988).

Table 3.3 Holdings of Financial Assets by Tax Rate

% of Savings Held in:	Zero Rate	Basic Rate	Higher Rate
Bank and building society accounts	71.0	68.8	51.8
Equity	7.7	20.4	34.3
Gilts and local authority bonds	3.5	3.4	4.5
Tax-free National Savings	1.8	2.1	5.9
Other National Savings and savings clubs	15.9	5.4	3.3

Source: Saunders and Webb (1988).

offset, to a certain extent, the wide disparity in tax status of the portfolios of different population subgroups that is implied by the take-up and ETRs on the liquid assets reported in tables 3.2 and 3.3 and figure 3.1.

Finally in this section we report the distribution of aggregate personal wealth over various asset types in 1989. It can be seen from table 3.5 that over 60 percent of U.K. wealth is held in the form of housing or pension rights and life assurance. Of the £579 billion of wealth held in pensions and insurance funds, £275 billion is held through life assurance companies, and £213 billion of this is life assurance itself (as opposed to pensions)—almost 10 percent of personal sector wealth (Association of British Insurers 1990). Saving through life assurance is addressed in more detail in section 3.5. However, the heavily penalized bank and building society deposits still account for one-eighth of net wealth, between them, and this proportion has remained constant over recent years reflecting, perhaps, the attractiveness of the reduced riskiness of such a portfolio.

3.2.2 Personal Saving over the Past 20 Years

There have been a large number of changes to the savings regime in the United Kingdom in the past few years, both in the structure of existing taxes and tax rates, and in the addition and removal of new taxes themselves. The

path of personal saving has also been variable, with positive saving taking place in the 1970s, despite persisting negative real interest rates, and a recent and well-documented fall in the saving rate throughout the 1980s illustrated in figure 3.4.

Although a consistent series of wealth data is quite difficult to find, it is possible to construct such a series from 1975 from the personal sector balance sheets in the U.K. National Accounts (1987) and *Economic Trends* (August 1991). In figure 3.5 we present a time series of proportions of total net personal sector wealth for six selected asset types. The most striking feature is obviously the doubling of the proportion of wealth held in pensions and life assurance since 1979, and this has occurred with the progressively increasing attractiveness of contracted-out pension schemes and life assurance. In addition, however, there has been a gradual fall in the proportion of wealth held as shares, and this represents a switch from holding equity directly to holding it through some intermediary (e.g., the pension fund). Finally, bank and building society deposits have held their share at around 12 percent, even in the late 1970s when real interest rates were negative and such accounts were being massively penalized by being taxed on nominal gains.

Table 3.4 Proportion of Investors Holding Less-Liquid Assets by Tax Rate

Asset	Zero Rate	Basic Rate	Higher Rate
Savings-based life assurance policy	39.1	46.7	54.1
House owned outright	23.0	22.0	27.6
House with mortgage	8.7	42.7	60.6

Source: Saunders and Webb (1988).

Table 3.5 Distribution of Personal Wealth by Asset Type, 1989

Asset Type	Value (£ billion)	% of Total
Housing (net of mortgages)	842	36.8
Pension and insurance funds	579	25.4
Bank deposits	146	6.4
Building society accounts	141	6.2
U.K. securities and unit trust units	172	7.5
Consumer durables	160	7.0
National Savings	35	1.5
Gilts and other interest-bearing assets	23	1.0
Agricultural and commercial land and buildings	102	4.5
Notes and coins	13	0.6
Other	71	3.1
Total	2,284	100

Source: CSO (1991a).

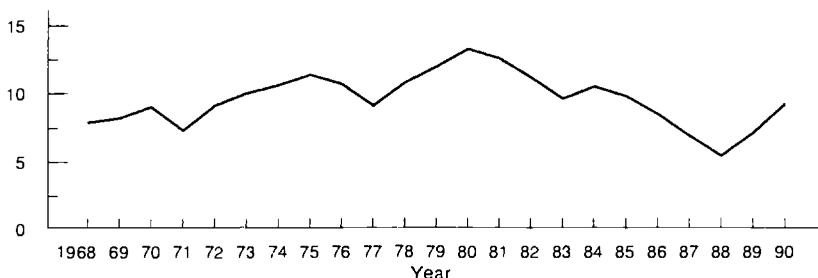

Fig. 3.4 Personal saving as a percentage of disposable income, 1968–90
Source: CSO (1992).

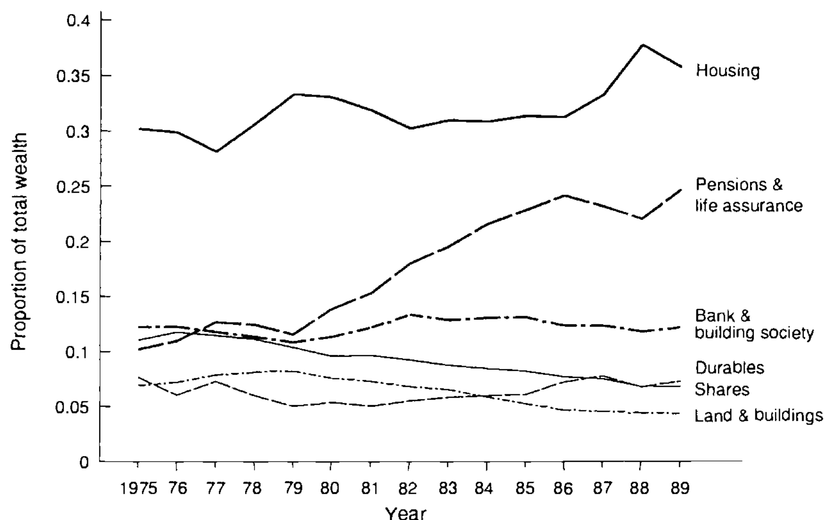

Fig. 3.5 Composition of Wealth, 1975–89

The most recent figures for flows of saving of different assets are for 1990, and these are presented in table 3.6. Unfortunately, the series for dwellings and durables ceased to exist after 1989, so we omit housing and mortgages and consumer durables in what follows.

3.3 The Taxation of Capital Income

As briefly mentioned in section 3.1, the main personal taxes that are relevant to this paper are income tax and CGT, and the taxation of most capital income is related in some way to these rates. This has not always been the case, as is clear from section 3.1.2 above. An individual pays income tax at either the

Table 3.6 Personal Sector Asset Flows, 1990

Asset Type	Financial Surplus or Deficit (£ million)
Pension and insurance funds	37,138
Bank deposits	16,143
Building society accounts	17,964
U.K. securities and unit trust units	−13,536
National Savings	783
Gilts and other interest-bearing assets	−1,209
Notes and coins	−134

Source: CSO (1991b).

basic rate of 25 percent or the higher rate of 40 percent on earned income above their personal allowance, but they also pay National Insurance (NI) contributions of 9 percent on earnings falling between prescribed limits. National Insurance is described in more detail in section 3.4, but the important fact for the taxation of capital income is that such income is not liable for NI. When we talk about the investor's marginal rate in what follows, we refer to the marginal rate of income tax, not the "true" marginal rate of income tax plus NI.[3]

Bearing in mind the caveat in the introduction concerning saving through direct investment, capital income can broadly be split into three categories—interest income, dividends, and capital gains. Income from capital (i.e., rent) is simply taxed as other income.

Interest income and dividends are usually taxed at the same rate—the investor's marginal tax rate—and the only difference between their tax treatment might be the timing of the tax payments in some cases. An imputation system exists for all dividend payments, so basic-rate tax is deducted at source, and higher-rate taxpayers are required to pay the extra 15 percent in tax every six months. Higher-rate taxpayers are required to complete a tax return annually (unlike basic-rate tax units, of which only a few are sent tax returns in any given year), so the interim tax payment is estimated. Most interest income also has income tax deducted at source, again at the basic rate. Such a system usually exists for bank and building society accounts for example, and again a higher-rate taxpayer will pay the tax difference later in the year. On the other hand, some interest income (e.g., that from National Savings) is net of tax, and tax payments are deferred. In both these cases, zero-rate taxpayers require some form of refund. For interest income they can simply provide a certificate of zero-tax status to qualify for removal of income tax deductions at source,

3. In fact, the threshold above which an individual ceases to pay NI lies below that at which they move on to the higher rate of income tax, resulting in the well-known fall in the true marginal direct tax rate—from 34 to 25 percent—as income rises over the NI ceiling (£20,280) but before it reaches the higher rate threshold (at least £27,145).

but for dividend income zero-rate taxpayers are required to claim a tax rebate at the end of the tax year.

Since the 1988 budget, indexed capital gains above the annual £6,000 exemption have also become taxable at the investor's marginal rate of income tax. In addition, any chattels that have a value of £6,000 or less on disposal are automatically exempt from CGT and do not count toward the individual's annual exemption, whereas chattels with a disposal value above this but a capital gain of less than the exemption earn marginal relief. The main exemption from CGT is that of gains realized on disposal of an individual's principal private residence, and this accounts for much of the tax-privileged status of housing, but certain other assets also have exemption from CGT. These include gains arising from occupational pensions, sales of motor vehicles, decorations for valor(!), certain gilt-edged stocks and qualifying corporate bonds or options for these stocks, life assurance policies, betting winnings, gains of approved pension schemes, gains accruing to authorized unit trusts, gains of unit trusts for exempt unit holders, contracts for deferred annuities, and gains within personal equity plans (see below). Retirement relief of £150,000 plus 50 percent of gains up to £600,000 (i.e., a maximum of £375,000) is available for individuals age 55 and over.

Finally, savings can ultimately become liable to inheritance tax under certain circumstances. Under the inheritance tax rules, the first £140,000 of any bequest on death or in the seven years preceding death is tax-free,[4] and above that bequests are taxable at 40 percent on the value over £140,000. This tax is payable immediately by the beneficiary. Inheritance tax exemptions apply to some bequests, including lifetime transfers between spouses (i.e., when the bequestor is still alive), gifts of up to £3,000 per year, gifts to political parties, and trusts for the mentally or physically disabled.

3.4 Retirement Saving and Pensions

Pension rights make up a significant proportion of personal wealth—about 15 percent in 1989—and saving in the form of pensions in particular is quite heavily tax-privileged. Pension regulations have also been an area of rapid change in the United Kingdom in recent years, with much work being done by economists in this area. In this section we look at the treatment of saving through the various types of pension schemes and the extent to which these schemes have been taken up, and then in section 3.5 we turn to the treatment of life assurance policies.

Any U.K. worker has a certain amount of pension rights arising from their NI contributions (NICs). National Insurance is paid by every employee on

4. Transfers within seven years of death are taxed on their value on the date of death but subject to a tapering scale going down to 20 percent of the full charge for transfers between six and seven years of death.

Table 3.7 **Composition of Retirement Income**

Source of Income	% of Gross Normal Weekly Income (retired households only)
Wages and salaries	11.8
Self-employment	0.5
Investments	16.5
Annuities and pensions	20.0
Social security benefits	41.5
Imputed income from owner-occupation	9.2
Other	0.5

Source: CSO (1990).

earnings falling between the lower earnings limit (LEL) and the upper earnings limit (UEL), and by employers on any earnings above the LEL. Once an individual's total NICs rise above a minimum level, he becomes entitled to the basic state pension. In addition, all individuals are, by default, contracted into the State Earnings-Related Pension Scheme (SERPS), which is calculated on the total amount of contributions paid. The individual can, however, choose to contract out of the SERPS into either an occupational pension scheme or a personal pension plan (PPP), and they are then entitled to the "contracted-out rebate" on some of their NICs, which is paid into the approved pension scheme by the government. Rules governing contracting out have been frequently changed in the last five or so years, and the contribution and tax structure of all three forms of pensions is described in more detail below. For the individual, the major savings choice is *whether*, and *how*, to contract out, and therefore we will concentrate mainly on personal and occupational pensions (in particular, personal pensions) in what follows, describing the SERPS only as the alternative against which to base the decision. Broadly, however, the U.K. pension tax system exempts pensions from tax (i) when contributions are made and (ii) when income is derived from investments but levies tax when benefits are withdrawn from the fund.

In 1989, one-fifth of the income of retired households in the U.K. Family Expenditure Survey (FES) was derived from annuities and private pensions, despite the fact that PPPs will have had negligible effects on retirement incomes so close to their inception in 1986. The complete breakdown of income of retired households in the 1990 FES is given in table 3.7. A comprehensive description of the FES as a data source can be found in Kemsley, Redpath, and Holmes (1980).

The replacement rate for retired households (and indeed for all households) falls continuously as a function of household preretirement income, as retirement and social security benefits are not means-tested (although there is a small means-tested SERPS entitlement).

3.4.1 SERPS and the Basic State Pension

National Insurance contributions are paid at a rate of 9 percent by every individual on earnings falling between £54 per week (the LEL) and £405 per week (the UEL) and at 2 percent on the first £54 per week (if earnings exceed the LEL).[5] Employers pay contributions in banded rates varying from 4.6 to 10.4 percent on all earnings over the LEL. The LEL is set annually by regulation and must, by statute, be approximately equal to the value of the basic state pension for a single person. In turn, the UEL must lie between six-and-a-half and seven-and-a-half times the LEL. Individuals who contract into the SERPS receive a pension based on a cumulated fraction of their average annual earnings falling between the LEL and the UEL. In calculating pensions entitlements, annual earnings are revalued in line with an index of earnings, but the earnings limits themselves are linked to the basic state pension, which is only revalued in line with prices. The price indexation of the UEL in particular seems likely to cause a compression of SERPS entitlements relative to those that would arise from a symmetric indexation of earnings and the earnings limits. National Insurance contributions are not income tax–deductible, nor, since the scheme is pay-as-you-go, is there any real fiscal privilege attached to the investment of accumulated contributions.

3.4.2 Occupational Pensions

Occupational pension schemes were originally the only alternative for an individual who wanted to contract out of the SERPS. They typically offer a "defined-benefit scheme," in which pension benefits are based on an earnings formula. In the 1986 Social Security Act, however, the government widened the range of schemes into which an individual could contract out. Occupational schemes must offer a guaranteed minimum pension based on average indexed earnings during years within the scheme, although they are typically more generous than this. A replacement rate (i.e., the pension payments themselves) of up to two-thirds of final salary is permitted, and one-and-a-half times final salary can be converted into a lump sum on retirement.

Employees and employers are entitled to the contracted-out rebate on their NICs. This currently stands at 5.8 percent of earnings between the LEL and the UEL—3.8 percent applicable to employers' contributions and 2 percent applicable to employees' NICs. Employers' contributions can be offset against corporation tax, and employees' contributions can be deducted from their taxable income. Any income or capital gains from occupational funds are exempt from tax, as is the converted lump sum, but pensions in payment are taxable at the normal rate of income tax.

5. The 2 percent introductory NI rate was introduced in the 1989 budget, replacing a 5 percent starting rate on all NICs if the level exceeded the LEL, which in turn replaced an even more extraordinary 9 percent starting rate in 1985.

3.4.3 Personal Pensions and "Money Purchase" Schemes

As mentioned above, the 1986 Social Security Act significantly widened the number of schemes into which an individual could contract out, most importantly allowing "defined-contribution schemes," in which the returns to investment essentially depend on the real rate of return of assets in the fund rather than on the real earnings growth which underpins the SERPS and all defined-benefit schemes. This led to the advent of personal pensions (individual defined-contribution) and also "money purchase" schemes (group defined-contribution). Such pensions can be bought in addition to investments in occupational pension schemes, and these are "free-standing additional voluntary contributions" (FSAVCs).

The benefits of contracting out into personal pensions are even greater than those of occupational pensions because the government simultaneously introduced an extra two-percentage-point rebate to encourage the take-up of personal pensions. This is valid until April 1993, and in addition, for people contracting out before April 1989, the incentive was paid for the previous two tax years as a lump sum into the scheme. These are added to the existing rebate, and the whole contracted-out rebate is then grossed up to account for the income tax relief, resulting in a total rate of contribution to the fund of 8.46 percent of eligible earnings. As with an occupational pension, individuals can then supplement this with contributions from their earnings up to the prescribed maximum, which ranges from 17.5 percent of earnings for a 35-year-old to 35 percent of earnings for someone over age 56, and these contributions are deductible against income tax. A tax-free lump sum can also be withdrawn from a defined-contribution scheme on retirement, and this can be a maximum of one-quarter of the value of the accumulated fund.

3.4.4 The Take-Up and Coverage of Personal Pensions

The incentives to take up personal pensions at the expense of NI revenues have been criticized for being too generous by many groups, including the National Audit Office, and initial take-up has exceeded expectations by a factor of eight—4.6 million individuals have taken them up since 1988, representing 20 percent of the working population. Coverage of defined-benefit schemes in comparison stands at about half the total employed, or 11 million people. Figure 3.6, taken from Disney and Whitehouse (1992), illustrates the striking rates of take-up for groups in the working population differing by age and sex. Indeed, Disney and Whitehouse cite this as evidence contradicting the claim that younger workers often exhibit myopia as to their retirement income 40 years in the future.

As would have happened with a switch from defined-benefit to defined-contribution schemes, though, this take-up of personal pensions has not been coincident with a large reduction in occupational schemes, the coverage of which has stood at around one-half the working population since the mid-

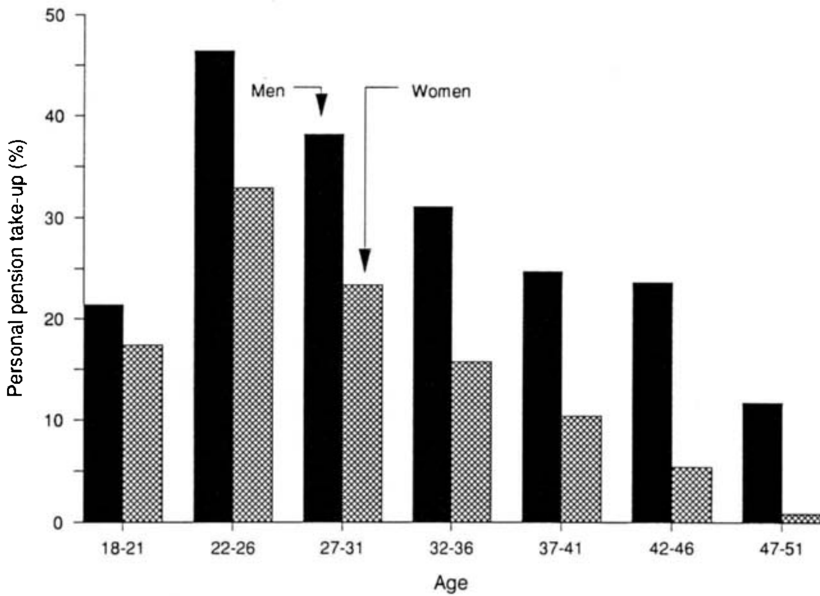

Fig. 3.6 The Take-Up of Personal Pensions by Age
Source: Reproduced from Disney and Whitehouse (1992).

1960s. Employees have either contracted out for the first time into personal pensions or have taken a personal pension in addition to a defined-benefit scheme.

Once again, contracted-out defined-contribution schemes are relatively new in the United Kingdom, and as yet, figures on the distribution of asset holdings within pension funds are difficult to calculate. For occupational pensions, however, some data exist, and these are presented for three recent years in table 3.8.

3.5 Saving through Life Assurance

Although there are rules governing the amount of insurance that life assurance policies must contain, in reality, by far the largest portion of the value of such contracts lies in the sum which is paid out at the end of the contract. Hills (1984) quotes a figure of 1 percent of the premiums paid as the actuarial value of the insurance element alone. For simplicity, in this section we follow the tradition of most analyses of life assurance in the United Kingdom and assume that the pure insurance element in such a scheme is nil.

In 1989 the value of life assurance holdings was £213.4 billion—about 10 percent of personal sector wealth holdings. Yet the tax privilege associated with this form of saving is not that large. Life assurance policies are often described as tax-free, but although on maturity the pay-out is usually free of

Table 3.8 Distribution of Occupational Pension Fund Assets

% of Fund Held in:	1981	1986	1991
U.K. equities	52	55	58
Overseas assets	13	21	28
U.K. fixed interest	23	15	4
U.K. index-linked gilts	1	2	2
Sterling cash	3	3	6
Property assets	8	4	2

Source: Pensions Pocket Book (1992).

tax, this is misleading as the insurance company itself is liable to tax on the returns that it earns on invested funds. The taxation of life assurance companies is, however, complex and also rather cumbersome. Profits have to be allocated between policyholders and shareholders, and companies pay tax at the basic rate on dividends, corporation tax on any interest income, and the basic-rate CGT on capital gains; these taxes combine, in theory, to a tax rate which a basic-rate taxpayer would face (although there are some rules on franked versus unfranked income that mean a life assurance portfolio is actually marginally less attractive than the same portfolio held independently).

Higher-rate taxpayers are required to pay an exit charge equal to the difference between the basic and the higher rates if they withdraw funds before the maturity date. This charge is only levied on the difference between withdrawals and total contributions (unadjusted for inflation) and also depends on the length of time the policy has still to run.

The complexity of issues in the taxation of financial intermediaries, however, means that it is difficult to say whether life assurance policies are on the whole privileged or penalized for the basic-rate taxpayer. This has not always been the case, as life assurance premiums have earned full tax relief in the past. In the budget of 1984, tax relief on life assurance premiums was ended for new contracts. Even nontaxpayers benefited from this relief as it was deductible at source from premiums, and the reform considerably reduced the privilege associated with life assurance. However, premiums on policies taken out before that date still receive tax relief at the investor's marginal rate.[6]

Given the discussion above, it would appear difficult to understand why life assurance is such an important element of personal saving in the United Kingdom. To some extent this can be explained by the large existing stock of policies taken out when privileges were still enormous due to the tax relief on premiums. The other important factor, however, has been the increased incidence of tying life assurance into mortgage borrowing by means of endowment

6. Despite the supposed secrecy of the U.K. budget process, it is well known that the two-week period prior to the announcement (and in particular the night before) saw a monumental escalation in the number of policies being taken out.

mortgages. The housing boom of the late 1980s created a massive increase in personal sector mortgage borrowing, of which most was financed through endowment mortgages (where the household repays only the interest on the loan and takes out a life assurance policy to repay the principal when the mortgage expires). Indeed, 64.9 percent of the premium value of new annual life policies taken out in 1991 was mortgage-related (calculated from Association of British Insurers [1992]).

3.6 Tax-exempt Accounts and Targeted Incentives

Over the last few years a number of initiatives have been implemented with the aim of increasing and directing personal saving. Major schemes usually occasioned acronyms—TESSAs, PEPs, and BES—and have enjoyed varying degrees of success as described below. Personal pension plans were another of these savings initiatives, but have been detailed separately in section 3.4 above.

3.6.1 Tax-exempt Special Savings Accounts

Tax-exempt special savings accounts (TESSAs) were introduced in the Finance Act of 1990 to encourage small savers. From January 1991, investors aged 18 or over were able to open one TESSA with an approved bank or building society. Any interest earned on a TESSA is entirely tax-free provided the savings are left in the account for five years, although it is possible to withdraw some of the interest as it arises (equal to the net-of-tax interest). Withdrawal of capital at an earlier date leads to complete loss of the tax advantage.

There is a limit of £3,000 for savings in TESSAs in the first year and £1,800 for each subsequent year, subject to an upper limit of £9,000 in total over the full five years. These savings can be made in single, regular, or irregular payments, and TESSAs are designed to be as flexible as possible. After five years any further interest on funds becomes liable for tax in the usual way, although the investor can simply open a new TESSA and transfer £3,000 into it in the first year.

Obviously TESSAs have not been in existence long enough for their impact to be analyzed comprehensively, but table 3.9 shows that they have already had a quite substantial impact. As more figures become available it will become clear whether these numbers represent an addition to aggregate saving or simply a diversion of existing (probably bank and building society) funds. At present it appears that there has been a simple transfer of existing building society funds into TESSAs, which would result in a big take-up initially, followed by a much reduced flow.

3.6.2 Personal Equity Plans

In his 1986 budget, the then-chancellor, Nigel Lawson, announced the introduction of personal equity plans (PEPs)—a new measure in the government's policy of encouraging wider share ownership. It is beyond the scope of this

Table 3.9 **The Take-up of TESSAs**

	Building Society Accounts		Bank Accounts		All Accounts	
Quarter Ending:	Number (thousands)	Amount (£ million)	Number (thousands)	Amount (£ million)	Number (thousands)	Amount (£ million)
March 1991	1,351	3,487	731	1,654	2,082	5,142
June 1991	1,613	4,222	858	2,025	2,471	6,247

Source: Inland Revenue (1991).

paper to debate the benefits or otherwise of wider share ownership per se, but the introduction of PEPs in 1986 was an important initiative designed to lure the first-time investor into saving in the form of U.K. equity. Investors in PEPs are exempt from income tax on dividends arising from shares held in a plan, and in addition there is no capital gains tax when shares are sold. This compares favorably with the normal tax treatment of equity or unit trusts. Indirect investment via a unit trust or an investment trust is permitted, and the administration of the plans is carried out by approved plan managers. In 1991 PEPs were extended to cover shares in companies in other EC member states. Individuals can put a lump sum into a plan or a regular amount, and PEPs may be "managed" or "own choice" (where the investor makes the portfolio decisions).

In January 1992, PEPs were split into two subplans—the "single-company PEP" and the "general PEP"—and investors are now allowed to subscribe to one of each of these in any one year. The limit for investing in a single-company PEP is £3,000 and for a general PEP is £6,000, so an investor taking full advantage of the two plans can invest £9,000. Initially, PEPs were set up on a calendar year basis and investments were required to be retained and dividends reinvested for one year to qualify for tax relief. Since April 1989, however, the maximum permitted investment has been calculated on a fiscal year basis, and the minimum holding period has been abolished.

It is clear that the government engaged in a substantial amount of tinkering with the PEP rules, and this represents a response to poor initial take-up, which can be seen in table 3.10. Lee and Saunders (1988) use the same survey as Saunders and Webb (1988) to show that less than 1 percent of their sample were PEP investors and that of these only a low proportion were first-time investors. They give a number of reasons for this initial failure of the scheme. The first factor is the disillusionment with the equity market in general following the crash of October 1987 and the outbreak of insider-dealing scandals. But even before then, investment in PEPs was still very limited compared with, say, unit trusts. In addition the tax advantages may not actually be that substantial to the small investor. Recall that the current CGT exemption is £5,800 of real gains per annum, anyway, so the PEP exemption is of absolutely no addi-

Table 3.10 The Take-up of PEPs

Period	Number of New Plans Taken Out (thousands)	Amount Invested (£ million)	Average Amount per Plan (£)
1987	270	480	1,800
1988	120	200	1,650
1989/90:1	580	1,600	2,750
1990/91	500	1,600	3,200

Source: Inland Revenue (1991).

tional value to most of the population. The income tax exemption is also clearly of more value to higher-rate than to basic-rate taxpayers, and from 1983 to 1988 the average dividend yield was typically around 4.5 percent compared with average capital gains of 17.5 percent, so the income tax incentive was less important anyway (Lee and Saunders 1988). Consequently, PEPs have received criticism for being incorrectly targeted and failing to appeal to the small, first-time investor.

Against these tax advantages, saving through PEPs also has three negative features. First, they have relatively high administration charges compared with other forms of investment, such as unit trusts, mainly due to government regulations on the administrative responsibilities of plan managers and the fact that stamp duty and dealing costs are borne by the investor. Second, initially there were substantial restrictions on the way that PEP investment was allocated, with only one-quarter allowed to be invested in unit trusts and most equity being restricted to shares in one to five companies. This was not sufficient for investors to achieve a diversified portfolio within the plan, and PEPs were relatively risky to the small investor. Finally, at their introduction, the one-year holding period meant that the PEP investor was effectively locked into the U.K. equity market with a relatively illiquid asset.

As shown in table 3.10, the relaxation of PEP rules in the light of this poor initial response appeared to have significant effects on the amount of saving through PEPs,[7] with the number and size of new plans increasing almost two-fold after 1988. The targeting of PEPs (through income tax and CGT exemptions) has remained problematic, with some of the drawbacks outlined above remaining relevant, and the overall effect seems to be one of deepening share ownership among current investors rather than widening the holdings of equity among noninvestors. Despite this, the government remains committed to PEPs and promises to expand the scheme in the future.

7. There is now a lower limit of £1,500 for PEPs that fail to meet a 50 percent EC equity criterion in addition to the split into single-company and general PEPs, the change in holding periods, etc.

3.6.3 The Business Expansion Scheme

The Business Expansion Scheme (BES; formerly the Business Start-Up Scheme) was designed to help small unquoted companies raise finance, but, viewed as a personal savings vehicle, also presented considerable tax advantages to the individual investor. The BES was introduced in 1983 and provides full tax relief at the investor's highest rate on new investments of up to £40,000 in qualifying U.K. trading companies, provided that the shares are held for a minimum of five years and that the shares were being newly issued (i.e., not traded). In 1988 the scheme was extended to cover investment in companies letting properties on assured tenancies. Individuals may invest in an approved investment fund or may use unapproved funds or syndicates provided that the individual becomes the actual owner of the shares. Dividends are taxed in the normal way but any capital gain will be free of CGT.

Indeed, the attractiveness of BES funds that is derived from their tax position completely dominates any incentives arising from the expansion of the business itself, encouraging investment in companies that do little more than hold assets for the five-year period. Consequently, the BES has fallen out of favor. It is already essentially a lame duck, and all the major political parties are committed to abolishing the scheme in the near future.

The take-up of BES shares since the scheme's inception in the early 1980s has not been spectacular despite the massive concessions available, with £211 million being raised between 916 participating companies in 1989–90. With the introduction of rental companies into the scheme the year before, however, the figure was temporarily higher—raising £420 million for 2,511 companies.

3.7 Conclusions

In this paper we have tried to sum up the main issues in the taxation of saving in the United Kingdom and to describe to some extent the form in which personal-sector wealth is held. The tax regime for savings is far from simple, even when one chooses to ignore the complexities of the distinction between saving and direct investment, but, even so, many anomalies of the past have been (or are in the process of being) ironed out.

Broadly speaking, the tax system gives high privileges to saving through housing and pensions, mild privileges to gilts, equity, National Savings, and some unit trusts, and penalizes bank and building society accounts (sight accounts). The size of tax privileges, however, depends on time-, asset-, and individual-specific factors. There also seems to be some systematic relationship between risk and fiscal privilege, and this has sometimes been interpreted as the tax system's encouraging risk-taking.

The government has introduced a number of initiatives to encourage saving in various forms but, with the exception of personal pension plans, these have

appeared so far to simply deepen savings from existing savers rather than widen particular asset holdings among first-time or small investors. In contrast to savings plans such as the individual retirement account in the United States, these incentives have been asset-specific rather than simply encouraging any form of saving. The schemes are really too young for an evaluation of their success or failure, whether this be measured by a redirection of or an increase in personal saving. Initial evidence, however, seems to suggest that aggregate saving has not been strongly affected by special incentive schemes (with the possible exception of personal pensions).

Finally, in the past 20 years there have been substantial reforms to the taxation of savings and capital income and also marked trends in the personal sector's holdings of assets. Most noticeable of these is the enormous increase in the proportion of wealth held in pension funds, which has resulted in the two most privileged forms of household saving (pensions and housing) now accounting for over 50 percent of net personal sector wealth.

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