Pointmaker

INTRODUCING THE LIFETIME ISA

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SUMMARY

- The UK's debt accumulation, and lack of a savings culture, potentially places the nation on a conveyor belt to fiscal calamity.
- Currently the UK relies on imported capital to bridge the gap between its addiction to debt and the absence of a savings culture.
- Under-35s are so disengaged from private pensions that the industry's next cohort of customers will be very thin. One could conclude that, in the long term, the private pensions business is finished.
- Generation Y[1] is, however, embracing ISAs, perhaps the last trusted brand amongst savings products.
- This paper proposes a solution to boost UK savings in the form of a new savings product: the Lifetime ISA. This improved ISA should appeal to under-35s, and re-engage them with retirement saving. The Lifetime ISA would be a savings chameleon: incorporating both ISA-like and pension-like features.
- Introducing the Lifetime ISA would involve assimilating today's two Junior ISAs with the two forthcoming New ISAs into a single Lifetime ISA.
- Crucially, the Lifetime ISA would be eligible for a Treasury incentive of 50p per £1 saved, up to an annual allowance of £8,000, as described in a sister paper, published in April 2014.[2]
- In addition, the Lifetime ISA would provide a degree of ready access to savings while simultaneously justifying the Treasury incentive, which demands a term commitment to saving. It would be able to hold cash and investments and serve savers from the cradle to the grave, thereby signalling the emergence of a lifetime savings agenda (as opposed to "pensions").
- Establishing the Lifetime ISA would formally bring the ISA brand into the retirement savings arena, as well as representing a marked simplification of the savings landscape.
- This paper advances eight proposals for reform, as summarised overleaf.

1 The generation born in the 1980s and 1990s.

2 *Retirement saving incentives: the end of tax relief, and a new beginning;* Michael Johnson, CPS, 2014.

EIGHT PROPOSALS

Proposal 1: The Chancellor should signal his intention to merge the cash New ISA and stocks and shares New ISA into a single Lifetime ISA, by 2017, for example.

Proposal 2: Junior ISAs should, in due course, be folded into the Lifetime ISA. For the under-18s, the Lifetime ISA would behave like today's Junior cash and stocks and shares ISAs.

Proposal 3: A Lifetime ISA should be automatically established when a baby's name is registered, with a provider nominated by the parents. A lump sum kick-start (perhaps up to £500) could be offered to low earning parents, resuscitating the Child Trust Fund concept, albeit within the Lifetime ISA. Existing CTFs could be assimilated into the Lifetime ISA.

Proposal 4: The Lifetime ISA should be eligible for the same Treasury incentive as proposed in the sister paper when saving within a pensions product: 50p per £1 saved, up to an annual allowance of £8,000. The Treasury incentive, capped at £4,000, would be paid irrespective of the saver's taxpaying status. Further savings, up to an annual limit of £30,000, would not receive any Treasury incentive. The proposed annual allowance and annual limit would be shared with pension products.

Proposal 5: The Lifetime ISA's withdrawal rules:

(i) Before the age of 60: ready access to incentivised savings, provided 50p were repaid to the Treasury for every £1 withdrawn. No deduction in respect of withdrawals of non-incentivised savings.
(ii) Incentivised savings made after the saver's 50th birthday must remain in situ for at least ten years (along with the Treasury's 50p).
(iii) At 60 and beyond, withdrawals up to the equivalent of the total non-incentivised amount saved (less any pre-60 withdrawals) would be tax-free. Any further withdrawals (representing incentivised savings and any accumulated income and capital growth) would be taxed at the saver's marginal rate of income tax.

Proposal 6: All Lifetime ISA providers should be required to offer a default fund, which would have to meet a set of quality criteria. Dividends should be reinvested in the fund, rather than paid out as cash. There should be stringent disclosure requirements, and a cap on the underlying fund costs of 0.35% per annum.

Proposal 7: The Lifetime ISA should be included in the auto-enrolment legislation's definition of a "qualifying" scheme, and eligible to receive employer contributions, provided that they were taxed as part of employees' gross income.

Proposal 8: Savers should be permitted to bequeath unused Lifetime ISA assets to beneficiaries' Lifetime ISAs free of Inheritance Tax (perhaps limited to £100,000).

1. INTRODUCTION

The retirement savings arena faces a fundamental issue: the word "pension" does not resonate with Generation Y. Thus it is no surprise that saving within a pension product holds little appeal. Pension pots' lack of immediate utility is a huge deterrent to engagement with retirement saving, and this is at odds with how Generation Y, weaned on immediate consumption, are living their lives. They want to be in control; pensions are just too inflexible.

In addition, the pensions industry is widely distrusted, which partly explains why so many people do not respond to tax relief on pension contributions. Furthermore, pension products do not suit an environment in which rising labour market volatility is becoming in-built to people's working lives. The stark truth is that the pension product is from another time, before college debt, fragmented careers, unaffordable housing and a rapidly retreating State Pension Age (SPA). From Generation Y's perspective, why save for retirement if we are unlikely to retire? Indeed, it is a major challenge to encourage Generation Y to save anything at all.

If one accepts that most of Generation Y will never engage with private pensions, the next cohort of pension-purchasing clients will be very thin. One could conclude that, in the long term, the private pensions business is finished. This matters because the UK desperately needs to catalyse a savings culture. Consequently, a new approach is required if we are to encourage the mass market (i.e. everyone other than the wealthiest 10%) to save more for retirement.

2. CAPITAL CRISIS COMING

2.1 We are exposed

(a) Sovereign debt

The UK relies on imported capital to bridge the gap between our addiction to debt and the absence of a savings culture. This is risky, not least because international competition for capital is likely to rise. Developed countries in particular, with their sluggish economic growth, face rising state spending to meet the needs of their ageing populations: this will have to be funded from somewhere.

During 2013-14, the UK Government borrowed an additional £108 billion, increasing national public sector net debt to the equivalent of 76.1% of GDP (£1,273 billion, i.e. £48,200 per household). This debt is expected to reach 84% of GDP by 2064, and this sum excludes the additional debt consequences of recent financial interventions to support the banks, as well as unfunded liabilities, such as state and public service pensions.[3]

(b) Consumer debt

Britons have more personal debt than the citizens of any other nation: Table 1 summarises some of the key statistics.

[3] OBR; Fiscal Sustainability Report, July 2014.

Table 1: UK personal debt statistics, end-February 2014

	Mortgages	Consumer Credit	Total
Personal debt	£1.280 billion	£159 billion	£1,439 billion
Average debt per household	£48,454	£6,018	£54,472
Average debt per adult	£25,505	£3,168	£28,673
Average interest paid per household	-	-	£2,242

Source: Bank of England.

The average debt per adult is equivalent to some 115% of average earnings and, with minimal real earnings growth, many households are very exposed to the risk of rising interest rates. The Bank of England's base rate has been held at 0.5% since March 2009: complacency has understandable crept in.

(c) Paltry savings

Table 2, ranked by savings, compares our household net saving rate with that of other OECD countries, alongside public sector net debt as a percentage of GDP. It is clear that, when it comes to saving, the UK lags behind almost all other OECD nations. This places us at a serious competitive disadvantage because household savings are the main domestic source of funds to finance capital investment, a key spur for long-term economic growth, and *that* underpins our quality of life. In addition, the UK is expected to continue to be a nation of under-savers. The DWP forecasts that the number of people facing inadequate retirement incomes will only fall by 1 million, to 12 million, notwithstanding the introduction of auto-enrolment into workplace pension schemes and the recent State Pension reforms.[4]

2.2 Debt and savings: conclusion

Our on-going debt accumulation, and lack of a savings culture, potentially places the UK on a conveyor belt to fiscal calamity. Without radical action, the real cost of capital is likely to rise, compressing individuals' disposable incomes and squeezing government budgets.

There are no obvious remedies. Faster economic growth would help, but the pre-requisite improvement in productivity would require huge investment (initially likely to lead to more debt). Tougher austerity measures (i.e. cutting state spending) come with the risk of slowing the economy (the Chancellor is already targeting a balanced budget in 2017-18). Other approaches, such as confronting our (debt-fuelled) consumer culture, could pitch the Treasury (keen on collecting VAT) against the DWP. What is clear is that we will have to place greater emphasis on internal sources of capital. That means saving more.

3. THE CURRENT ISAs

3.1 Ready access: of paramount importance to most people

Basic rate taxpayers (87% of all taxpayers) are increasingly convinced that the lure of a 20% tax relief on pension contributions is insufficient to overcome pensions' lack of flexibility. Immediate access to savings is, for most people, the key requirement. Industry

4 DWP; *Framework for the analysis of future pension incomes*, September 2013.

Table 2: The UK compared, 2012

	GRC	JPN	UK	ITA	NLD	ESP	CAN	IRL	USA	NOR	DEU	AUS	FRA	SWE
Household net saving ratio (%)	-14.6	-0.8	2.4	3.6	4.1	4.4	5.0	5.2	5.8	8.2	10.3	10.4	11.7	12.2
Net debt as %GDP	102	140	69	113	42	60	59	83	100	-167	50	27	70	-24

Source: OECD; National Accounts at a glance 2014. – The household saving rate is calculated as the ratio of household saving (plus the change in net equity of households in pension funds) to household disposable income.

surveys[5] confirm people's growing preference for stocks and shares ISAs over pensions; with ready access, they are immensely popular and, importantly, the brand is still reasonably trusted.

In 2012-13, some 2.9 million people contributed £16.5 billion to stocks and shares ISAs (£5,629 per account), up 59% over the last six years, taking the total market value to £222 billion.[6] This is more than double the £7.7 billion that individuals contributed to personal pensions (averaging £940 per person, a figure which includes basic rate tax relief), down 25% over the same period.[7] An additional £40.9 billion was subscribed to 11.7 million cash ISA accounts (averaging £3,501 per account), taking the ISA cash mountain to £220 billion.[8]

3.2 The New ISA

In his 2014 Budget speech, the Chancellor, George Osborne, announced that today's cash ISA and stocks and shares ISA will become New ISAs (NISAs). The overall annual subscription limit will be substantially increased to £15,000, and the full amount will be permitted to be held in either cash, stocks and shares, or any combination of the two.[9] In addition, the Junior ISA's annual allowance will be raised to £4,000.

The cash NISA and the stocks and shares NISA will remain as two separate accounts, alongside cash and stocks and shares Junior ISAs: in total, four different ISAs. While the improved transferability between the two NISAs is welcomed, it would appear that the Chancellor has missed an opportunity to significantly simplify the savings arena.[10]

4. THE LIFETIME ISA (LISA)

4.1 The vision: one ISA for all

Savers, surely, only require a single ISA account, to be held from childhood until death, and capable of holding cash and investments? It may be that the Chancellor shares such a vision, but has initially decided to keep the cash NISA and the stocks and shares NISA as two separate accounts for practical reasons. Today, some cash ISA providers may be operationally unable to accommodate securities (such as shares) in cash accounts. Whatever the reasoning, the industry should be forewarned of the single Lifetime ISA objective.

Proposal 1: The Chancellor should signal his intention to merge the cash NISA and stocks and shares NISA into a single Lifetime ISA, by 2017, say.

A Lifetime ISA would combine the asset eligibility of the cash and stocks and shares NISAs although, operationally, cash and investments would have to be treated as if they were in separate accounts. But, to the saver, they should appear as a single account. The design challenge is further discussed in section 8.

5 For example, more people (38%) view cash savings (including ISAs) as a better route to a reasonable standard of living in retirement than personal pensions (30%). Source: Scottish Widows, *UK Pensions Report 2009,* June 2009.

6 HMRC; *Individual savings accounts statistics*, Tables 9.4 and 9.6, September 2013.

7 HMRC; Table PEN 2, Personal pensions, February 2014. Official data excludes SIPPs and SSASs, which attracted perhaps another £6 billion in 2012-13).

8 As at April 2013: HMRC; *Individual savings accounts statistics*, Table 9.6, September 2013.

9 With effect from 1 July 2014. Prior to the 2014 Budget, the stocks and shares ISA allowance for 2014-15 was to total £11,880, with up to half, £5,940, being eligible for a cash ISA.

10 From July 2014 it will be permitted to transfer from a stocks and shares NISA to a cash NISA, and vice versa. Under previous rules, transfers could only occur from a cash ISA to a stocks and shares ISA.

4.2 The Junior ISA: no longer needed

Junior ISAs should, in time, be folded into the Lifetime ISA to further simplify the ISA landscape (and justify the lifetime label). For the under-18s, the Lifetime ISA's cash and investment pots would behave exactly like today's Junior cash and stocks and shares ISAs, respectively.[11] The Junior ISA would no longer be required.

> **Proposal 2:** Junior ISAs should, in due course, be folded into the Lifetime ISA. For the under-18s, the Lifetime ISA would behave like today's Junior cash and stocks and shares ISAs.

4.3 A savings shove at birth

When a baby's name is registered, a Lifetime ISA should be automatically established for the child, with a provider nominated by the parents from an approved list. This would represent an early shove, rather than a nudge, towards establishing a savings culture across the country, regardless of family circumstance.

Some political parties may wish to consider offering a cash incentive when a Lifetime ISA were opened, to encourage (low earning) parents to take it more seriously. This would be somewhat reminiscent of the now defunct Child Trust Funds (CTF), albeit under the Lifetime ISA banner.[12] Existing CTFs could be assimilated into the Lifetime ISA.

> **Proposal 3:** A Lifetime ISA should be automatically established when a baby's name is registered, with a provider nominated by the parents. A lump sum kick-start (perhaps up to £500) could be offered to low earning parents, resuscitating the Child Trust Fund concept, albeit within the Lifetime ISA. Existing CTFs could be assimilated into the Lifetime ISA.

Other countries offer state-funded incentives to "kick-start" a work-based savings account, notably New Zealand's KiwiSaver (NZ$1,000). The Lifetime ISA could perhaps incorporate a similar approach.

4.4 Incentivise saving in a Lifetime ISA

It is time to formally bring the ISA brand into the retirement savings arena, by making the Lifetime ISA eligible for the same Treasury incentive as saving within a pensions product.

The sister paper[13] to this report proposes scrapping all income tax and NICs reliefs on pension contributions, replacing them with a simpler, more redistributive, 50p Treasury contribution for every post-tax £1 saved for retirement ("the Treasury incentive"). The Appendix contains the eight specific proposals, which include an annual allowance of £8,000 - meaning the Treasury's annual contribution (shared with pension products) would be capped at £4,000 - to be paid irrespective of the saver's taxpaying status.[14] The Lifetime ISA and pension products should share an annual combined contribution limit of £30,000.

The 50p per £1 saved from post-tax earnings is akin to a 33% rate of tax relief (but, to be clear, it would not be a tax relief). All taxpayers would

[11] The annual contributions limit for Junior ISAs (cash and stocks and shares combined) is £3,720 which, from April 2014, will be updated annually in line with the Consumer Price Index.

[12] All babies born between September 2002 and January 2011 got between £50 and £500 from the government to save in a Child Trust Fund (CTF). For children older or younger, Junior ISAs replaced CTFs, but over six million children are still locked into CTFs, and up to £3,840 a tax year can still be added, tax free.

[13] *Retirement saving incentives: the end of tax relief, and a new beginning*; Michael Johnson, CPS, 2014.

[14] Divorcing eligibility from taxpaying status means that this is not a tax relief.

benefit from saving in a Lifetime ISA, with basic rate taxpayers doing particularly well (see Table 3).

> **Proposal 4:** The Lifetime ISA should be eligible for the same Treasury incentive as proposed in the sister paper when saving within a pensions product: 50p per £1 saved, up to an annual allowance of £8,000. The Treasury incentive, capped at £4,000, would be paid irrespective of the saver's taxpaying status. Further savings, up to an annual limit of £30,000, would not receive any Treasury incentive. The proposed annual allowance and annual limit would be shared with pension products.

4.5 Lifetime ISA: the basics

Outlined below are the principal rules governing the Lifetime ISA. Crucially, they are designed to overcome a core conundrum: how to offer ready access to savings while simultaneously justifying providing a Treasury incentive on the first £8,000 of annual savings ("incentivised savings"). Savings in excess of £8,000 in any given year are "non-incentivised savings".

(i) Before the age of 60, there would be ready access to the total capital amount saved. In respect of incentivised savings, for every £1 withdrawn, 50p would be deducted by the provider, and transferred back to the Treasury. There would be no deduction in respect of withdrawals of non-incentivised savings (deemed withdrawn ahead of incentivised savings). The saver's passbook (digital or otherwise) would display a cumulative record of both categories of savings.

(ii) Incentivised savings made after the saver's 50th birthday must remain in situ for at least ten years (along with the Treasury's 50p). This ensures a term commitment from the saver (justifying the Treasury's 50p).

(iii) At 60 and beyond, withdrawals of remaining incentivised savings, and any accumulated income and capital growth, would be taxed at the saver's marginal rate of income tax, with the basic rate deducted at source.[15] Withdrawals of amounts up to the equivalent of the total non-incentivised amount saved (less any prior withdrawals) would be tax-free.

15 Any higher or additional rate income tax due would be paid via the saver's tax return, with non-taxpayers receiving the basic rate back via their tax return.

Table 3: £100 of gross earnings contributed to a Lifetime ISA

		A	*+*	*B*	*=*	*C*	*C-A*	*(£100-C) /£100*
Saver's marginal rate of income tax	**Income tax paid**	**Post-tax LISA contribution**		**HMT 50p Incentive**		**Total into LISA**	**Advantage over not contributing to LISA**	**Effective rate of income tax on LISA contribution**
20%	£20	£80		£40.0		£120.0	£40.0	-20.0%
40%	£40	£60		£30.0		£90	£30.0	10.0%
45%	£45	£55		£27.5		£82.5	£27.5	17.5%

Proposal 5: The Lifetime ISA's withdrawal rules:

(i) Prior to the age of 60: ready access to incentivised savings, provided 50p were repaid to Treasury for every £1 withdrawn. No deduction in respect of withdrawals of non-incentivised savings.

(ii) Incentivised savings made after the saver's 50th birthday must remain in situ for at least ten years (along with the Treasury's 50p).

(iii) At 60 and beyond, withdrawals up to the equivalent of the total non-incentivised amount saved (less any pre-60 withdrawals) would be tax-free. Any further withdrawals (representing incentivised savings and any accumulated income and capital growth) would be taxed at the saver's marginal rate of income tax.

4.6 The withdrawal rules explained

(a) Ready access to savings

The key feature of the Lifetime ISA is that savers would have ready access to an amount equivalent to the capital amount saved, net of any fall in the market value of any investments (offset by accumulated income). This would overcome one of pension products' most serious deterrents to retirement saving: lack of ready access.

However, withdrawals of incentivised savings would be discouraged by the requirement to repay 50p back to the Treasury for every £1 withdrawn. This penalty protects the Treasury by preventing "round tripping" of its contributions.[16] It is akin to an early withdrawal penalty of 33%, i.e. more than the basic rate of income tax that almost all savers would subsequently have to pay on withdrawals after reaching the age of 60.

(b) The ten year rule

The ten year "lock-in" of incentivised savings made after the saver's 50th birthday is to prevent people taking the Treasury's 50p in return for a short-term saving commitment. Without such a restriction, a basic rate taxpayer with a gross income of £100, say, could, in extremis, reduce his rate of income tax to 4%.[17] This would not be an effective use of Treasury funds (albeit that workplace pensions salary sacrifice schemes exploit a similar costly arbitrage today, at the taxpayers' expense). This restriction could also encourage some people to start saving for retirement much earlier than otherwise.

(c) Accumulated income and capital growth

With pre-60 withdrawals limited to the capital amounts saved (incentivised and non-incentivised), there could be significant accumulated income and capital growth, net of any investment losses. Long-term Lifetime ISA savers, in particular, would be unlikely to reach the age of 60 empty-handed.

Table 4 shows the composition of a pot after 30 years of saving £1,000 at the start of each year, with annual Treasury contributions of £500. The three real growth scenarios are represented as a combination of capital growth and accumulated income.

Thus, for example, after 30 years of saving in a 3% real growth environment, over 40% of the

[16] Round tripping: whereby a saver could withdraw £1 and re-contribute the "same" £1 later, to receive another 50p from the Treasury.

[17] A day before reaching the age of 60, and after paying £20 in income tax, the saver could contribute £80 to a LISA, to which the Treasury would add £40, taking the total to £120. Two days later, £96 could be withdrawn, with £24 being paid in income tax, to empty the account. Thus £100 of gross income would have been turned into £96 of net income: a 4% rate of income tax.

LISA's assets would have been derived from accumulated income and capital growth. The contribution that this makes to the total pot size is clearly very sensitive to the growth rate, underlining the importance of capturing the positive power of compounding.

4.7 Lifetime ISA: include a default fund

(a) Follow the NEST example

Default funds are known to be an important feature for passive savers, i.e. most people (perhaps 85% of the population): witness the 99%+ take-up rate of NEST's default fund. Each Lifetime ISA provider should be required to offer a passively managed default fund, which would have to meet a set of quality criteria. In addition, like NEST's default fund, it should be "cautious" in terms of risk appetite. As a liquidity consideration, stock-exchange listed assets should be strongly preferred, exceptions being made in respect of infrastructure investments (up to 10% of total assets, say).

(b) Automatic reinvestment

As we have seen, capital appreciation via the compounding of reinvested dividends can be, over the long term, substantial. Consequently, default funds should be accumulation-based, with underlying shareholdings set up to automatically take scrip dividends or, if available, to participate in dividend reinvestment plans (DRPs), rather than taking cash dividends.[18]

In addition, savers should be encouraged to elect for reinvestment of any dividends derived from self-managed income-producing assets. Alternatively, cash dividends could be automatically reinvested into the provider's default fund (although savers should have the right to "opt out" and take cash).

(c) Transparency

Lifetime ISA providers should be required to disclose every cost and charge arising within the default fund, i.e. in respect of the whole chain of service providers. This includes not just asset managers' annual management charges, and all initial and exit charges, but all other implicit and explicit costs including all transaction, fiduciary, advisory, life company product wrapper and platform costs.[19] Any actively managed investments should be required to disclose their prior year's fund turnover rate and allied transactions costs (including the cost of crossing the bid-offer spread).

(d) A cost cap

We have just seen how important it is to capture the positive power of compounding: annual charges and costs have the opposite

[18] Amazingly, today's ISAs are not permitted to take stock dividends.

[19] As more fully detailed in Chapter 2 of *Put the saver first,* Michael Johnson, Centre for Policy Studies, 2012.

Table 4: Asset sources after 30 years of regular saving (no withdrawals)

Real growth rate per annum	**2%**		**3%**		**4%**	
Saver's contributions	£30,000	47.4%	£30,000	39.6%	£30,000	33.0%
HMT's 50p per £1 contributions	£15,000	23.7%	£15,000	19.8%	£15,000	16.5%
Retained income and capital growth	**£18,311**	28.9%	**£30,709**	40.6%	**£45,992**	50.5%
Total assets after 30 years	**£63,311**	100%	**£75,709**	100%	**£90,992**	100%

impact, deleteriously eroding capital. Consequently, the underlying cost of running the Lifetime ISA default funds should be capped at perhaps 0.35% per year, not least to ensure that savings suffer much less capital erosion, over time, than that incurred by traditional pension products.[20] This is realistic given Lifetime ISAs' emphasis on passive management, and should help exert downward pressure on the charges levied by the pensions-focused part of the industry.

Proposal 6: All Lifetime ISA providers should be required to offer a default fund, which would have to meet a set of quality criteria. Dividends should be reinvested in the fund, rather than paid out as cash, there should be stringent disclosure requirements, and a cap on the underlying fund costs of 0.35% per annum.

5. AUTO-ENROLMENT AND EMPLOYER CONTRIBUTIONS

5.1 Strategic perspective: employers really matter

The aforementioned proposals are premised upon action by individuals, but roughly 75% of pension contributions, for example, come from employers: their crucial role in increasing workers' retirement incomes should be acknowledged. In addition, the tripartite covenant that emerged between the state, employers and employees, following the Pensions Commission's work led by Lord Turner, should not be forgotten.

5.2 Include the Lifetime ISA in the auto-enrolment legislation

The Lifetime ISA should be included in the auto-enrolment legislation's definition of a "qualifying" scheme, thereby formally embracing it within the retirement savings arena (as well as offering employees an alternative destination for their employers' contributions). In addition, employer contributions to Lifetime ISAs should be eligible for the Treasury's 50p per £1 (limited to £8,000 per year), provided that employer contributions be treated as part of employees' gross income, and taxed as such (as proposed in the sister paper to this report).

The sister paper considers the relative attractiveness of employer and employee contributions following (i) adoption of the proposed 50p incentive; (ii) the end of NICs relief on employer contributions; and (iii) employer contributions being treated as part of employees' gross income and taxed as such.[21] The principal finding is that for those who pay 20% income tax while working and 20% in retirement (i.e. most people), employer contributions would remain more tax efficient than giving employees cash to then make their own contributions, albeit less so than today. However, 40% taxpaying workers would find that the relative attractiveness of employer contributions (up to the annual allowance) would increase, helping to reinforce the tripartite covenant.

[20] Vanguard's US Equity Index (i.e. tracker) fund is priced at 0.2% p.a. and the Exchange Traded Fund (ETF) alternative can be bought for 0.09% p.a. without an additional administration charge. Its Emerging Markets Stock index funds currently has a Total Expense Ratio (TER) of 0.4% p.a., and Vanguard's Global Bond index tracker's TER is 0.2% p.a. But these are *retail* prices: large default funds should be able to either negotiate significantly lower costs and charges, or conduct fund management "in house".

[21] See section 7.6 of *Retirement saving incentives: the end of tax relief*, and a new beginning; Michael Johnson, CPS, April 2014.

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Proposal 7: The Lifetime ISA should be included in the auto-enrolment legislation's definition of a "qualifying" scheme, and eligible to receive employer contributions and the Treasury's 50p incentive, provided that they are taxed as part of employees' gross income.

5.3 Ready access to employer contributions: for debate

Should employer contributions be subject to the same access rules as employees' own Lifetime ISA savings? From the latter's perspective they are indistinguishable: both would be derived from post-tax income, but how would employers feel about this? We would not want to risk employer disengagement from retirement saving. Depending upon employer feedback, we may need to consider excluding employer contributions from pre-60 access, which would have the effect of also trapping the allied Treasury 50p within the Lifetime ISA, until the age of 60. In addition, section 11.1(b) of the sister paper explores the possibility of retaining the NICs rebate on employer contributions.

6. FLEXIBILITY AROUND WITHDRAWALS

(a) Incentivised savings: a savings chameleon

The Lifetime ISA would incorporate both ISA-like (TEE) and pension-like (EET) features.[22] Crucially, savers would be able to choose between the two: they would be in control.

Consider a 40 year old making incentivised savings of £100 in a Lifetime ISA, with the Treasury adding another £50. If the saver were to decide to spend his £100 the following week, he could, after repaying the Treasury its £50.[23] This repayment effectively unwinds the up-front incentive, so withdrawn incentivised savings would be "ISA-like" because today's ISA savings come from post-tax income.

Alternatively, if the £150 were left in situ until at least the age of 60, the saver would then only pay his marginal rate of income tax on any withdrawals: this is "pension-like". Note that the Treasury would be assuming investment risk alongside the saver: if the assets were to perform badly, the Treasury would receive less in income tax from the over-60s. It would therefore be in a similar position as today, with pension pots, its income tax receipts being partly dependent on asset performance.

Such flexibility would help overcome a major barrier to traditional pension saving: lack of access to savings. It may also help to keep automatic enrolment opt-out rates low (expected to rise as smaller employers, in particular, pass their staging dates).

(b) Non-incentivised savings

Savings in excess of £8,000 per year (net of any pension contributions in the same year) would not receive the Treasury's 50p incentive, but they could be withdrawn at any time without penalty: they are "ISA-like", as per the tax treatment of today's stocks and shares ISA.

(c) Accumulated income and capital growth

Withdrawals of any accumulated income and capital growth could only occur from the age of 60 (net of any investment losses), and they would be taxed at the saver's marginal tax rate. This would be "pension-like" in respect of incentivised savings, but for non-incentivised savings such treatment would mark a departure from today's tax treatment of ISAs.

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22 A product's tax status can be described chronologically by three letters, either E for exempt or T for taxed. The first letter refers to contributions (of capital), the second to investment income and capital gains, and the last letter to how post-retirement income is treated.

23 This assumes that the assets are still worth at least £150.

This is a simplification measure: it would be too complicated to require providers to distinguish between the two sources of income and capital growth (i.e. incentivised or non-incentivised savings), but it would raise a bit of extra tax revenue.

Section 8, below, discusses how providers could keep track of a saver's withdrawal potential, and the associated requirement to either repay the Treasury (i) nothing; or (ii) its 50p; or (iii) pay income tax if the saver where aged 60 or more.

7. LIFETIME ISA: OTHER BENEFITS

7.1 Simplification: a single ISA product

The Lifetime ISA would combine the principal attributes of Junior ISAs and the new cash ISA and new stocks and shares ISA (NISAs), while also incorporating a financial incentive, the Treasury's 50p on incentivised contributions. In addition, it would include several default features that would be attuned to the saver's best interests. These would rely on passive acceptance, to reflect how most savers actually behave.

7.2 The Lifetime ISA: for saving and investing

Assimilating the cash and stocks and shares NISAs within a single Lifetime ISA would place the UK's largest pool of cash savings (£220 billion in cash ISAs, as at April 2013) in close proximity to a capability to invest.[24] This nudge would give the provider (and the Government) an opportunity to encourage people to save in a form that is potentially more rewarding (and riskier) than simply holding cash. Ideally, it would help promote an investing culture, encouraging savers to develop some empathy with the concept of risk and return. Many cash ISA savers are, in practice, long-term savers, and numerous analyses conclude that exposure to a diversified pool of shares and bonds, rather than simply holding cash, is a more fruitful way of saving for the long term. In addition, the UK needs more investment to stimulate economic growth.

7.3 For most people, a generous savings incentive

The proposed Treasury 50p incentive per £1 saved is double the incentive that basic rate taxpayers currently receive on pension contributions (25p per £1 contributed from net income).[25] It is therefore highly redistributive (i.e. progressive). Thus, for example, a worker contributing £1,000, with an enlightened employer doing likewise, would find that his £1,000 had become £3,000 following the Treasury's contribution of £1,000: a very attractive proposition.

The Treasury's 50p could be actively promoted, perhaps as a "teaser" to encourage people who are traditionally cash-based savers to take their first investment step, by putting a

[24] HMRC; *Individual savings accounts statistics* , Table 9.6, September 2013.

[25] This is not necessarily intuitive; the doubling arises because tax relief is calculated on gross (i.e. pre-tax), rather than net amounts.

Table 5: Withdrawals summary

	Incentive	Pre-60 withdrawals	60+ withdrawals
Incentivised savings	50p per £1 saved	Repay 50p to HMT	Taxed at marginal rate
Allied capital growth and income	n/a	No access	Taxed at marginal rate
Non-incentivised savings	None	No penalty	No penalty
Allied capital growth and income	n/a	No access	Taxed at marginal rate

small amount into a LISA default fund, for example. Once invested, savers would also benefit from the capital growth and reinvested income attributable to the Treasury's contributions (free leverage), no different to saving within a pensions product today.

An important feature of the Lifetime ISA is that eligibility for the Treasury's contributions would be divorced from the saver's taxpaying status, particularly beneficial to low earners (and more so for women).

7.4 Other defaults

In addition to a default fund, other (nudging) features could be considered, such as putting in place arrangements for wage rises and tax refunds to be automatically contributed to a Lifetime ISA, each with a 21 day opportunity to opt out.[26]

7.5 Inheritance tax

(a) Harness the emotional power of family

Today, most ISA assets are potentially subject to Inheritance Tax (IHT), which breaks the unwritten rule that income is only taxed once (ISA contributions are made from post-tax income).[27] Conversely, most pension assets (i.e. occupational schemes, and SIPPs and SSASs) are held within trust-based structures. Consequently, following death, undrawn pension funds legally remain in the hand of the scheme's trustees, i.e. they fall outside of a person's estate for IHT purposes. Lifetime ISAs, in respect of IHT, would therefore be at a relative disadvantage to the pensions world: they should be on an equal footing. In addition, IHT undermines efforts to catalyse a savings culture.

It would be sensible to permit Lifetime ISA assets to be bequeathed free of IHT limits and the seven year rule, provided that they were transferred to beneficiaries' Lifetime ISAs. Leaving something for children (and grandchildren) is a powerful savings motivator: a controlled trickle-down of wealth through the generations should be encouraged, not least because Generation Y could be the first generation to experience a deterioration in their quality of life, relative to their parents (baby boomers and Generation X[28]).

Bequeathed contributions should have no impact on the beneficiary's own annual allowance, but the tax treatment of their subsequent withdrawal should be treated as per their pre-bequeathed status (i.e. incentivised or non-incentivised, or a combination thereof). If that were, operationally, to be deemed too complicated, then they should probably be treated as incentivised contributions, i.e. pre-60 withdrawals would require a 50p Treasury repayment, and post-60 withdrawals would be taxed at the beneficiary's marginal rate of income tax.

Such a proposal would, however, only benefit the relatively rich, i.e. those with estates in excess of the IHT threshold.[29] Consequently, it would be appropriate to impose a limit on the amount per beneficiary, perhaps £100,000.

Proposal 8: Savers should be permitted to bequeath unused Lifetime ISA assets to beneficiaries' Lifetime ISAs free of Inheritance Tax (perhaps limited to £100,000).

[26] Suggested by Jeremy Cooper, former chairman of Australia's Super (Pension) System Review.

[27] The exception is qualifying AIM-listed stocks held for at least two years.

[28] Baby boomer were born between 1946 and 1964, Generation X from the early 1960s through to the early 1980s.

[29] £325,000 for 2014-15, set to remain frozen until at least 2017.

(b) Bequeathed LISA contributions: uncertainty prevails

Following the 2014 Budget's liberalisation of annuitisation requirements, the Treasury launched a review of current tax rules that apply to certain pensions on death. The outcome is currently unknown (July 2014), but it could have an impact on how bequeathed contributions to Lifetime ISAs should be treated, not least to ensure a degree of parity between pension and Lifetime ISA assets.

8. THE LIFETIME ISA DESIGN CHALLENGE

8.1 A simple user interface required

The challenge facing the Lifetime ISA design team would be to make the user interface simple, when what is "under the bonnet" may be sophisticated. In addition, they would have to ensure that there were no opportunities for "round-tripping" of savings, to repeatedly capture the Treasury's 50p with the same £1.

Savers would require a clear presentation of what was available to be withdrawn, and its treatment in respect of any obligations to repay the Treasury (i) nothing; or (ii) its 50p; or (iii) pay income tax if the saver where aged 60 or more. The underlying complexity should be the concern of the Lifetime ISA provider (and regulator), not that of consumers. The ipod is technically advanced, but very easy to use.

8.2 Under the bonnet: tracking

Providers would have to keep track of every cashflow that crossed a Lifetime ISA account, maintaining the distinct identities of incentivised and non-incentivised savings, and any bequeathed contributions. But in this digital age, that should not be beyond them.

Pre-60, the amount available for withdrawal would be capped at the capital sum of past savings. Any non-incentivised contributions should rank senior to incentivised contributions, i.e. they would be deemed to be the first withdrawals (with no 50p repayment required). The underlying investments would be comingled, i.e. not specifically attributed to non-incentivised or incentivised contributions. Retained income would be available to offset any net capital loss (which require market value data feeds). It would be the provider's responsibility to ensure that any obligation to repay the Treasury's 50p would be met ahead of transferring a withdrawal.

Once the saver reaches 60 years old, retained income and capital growth become available for withdrawal, simplifying the operation of a Lifetime ISA. The distinction between incentivised and non-incentivised contributions would, however, have to remain because the former would be taxed at the saver's marginal rate of income tax. Non-incentivised contributions would still be deemed to be the first to be withdrawn. Consider an example to illustrate this.

8.3 An example of running down a LISA, after the age of 60.

Upon reaching 60, a saver's Lifetime ISA assets are worth £100,000. He has made a total of £50,000 of incentivised and £30,000 of non-incentivised contributions, and has already withdrawn £20,000, which was treated as non-incentivised (so no 50p was repaid). Thus retained income and net capital growth represent £40,000 of the £100,000 total.

The saver decides to run down his LISA. The first £10,000 of withdrawals would be made without penalty (representing the remainder of his past non-incentivised savings), but the remaining £90,000 would incur income tax at his margin rate. If this were 20%, the provider would deduct a total of £18,000 before transferring the remaining £72,000 to the saver.

9. THE LIFETIME ISA COMPARED TO PENSION PRODUCTS

Table 6 compares some of the principal attributes of the Lifetime ISA with today's pension products.

On the spectrum of access to assets before the age of 55, incentivised savings within the Lifetime ISA would sit between non-incentivised savings (akin to today's stocks and shares ISA) and pension products.

Today, ISA assets are treated as capital for means-testing purposes, whereas pension assets are not (not least because the latter are not accessible until 55). Given the Lifetime ISA's ready access to capital contributions, today's arrangements should remain in place.

10. CONCLUSION

The writing is now on the wall for private pension products. Complex, expensive, inflexible and widely distrusted, the next cohort of customers (today's Generation Y) is unlikely to emerge. Without fundamental change, some parts of the pensions industry could go the way of much of Britain's early 20th century heavy industry.

Adopting the proposals (or variants thereof) for a more redistributive incentives framework, as detailed in this paper's sister paper, is a pre-requisite to transforming Britain's retirement savings landscape. They would ensure that low earners, in particular, at least have the possibility of acquiring a retirement savings habit, and hence a decent income in retirement.

But financial incentives alone are insufficient to catalyse a savings culture. The Lifetime ISA, with its investment capability placed in close proximity to the nation's largest cash pool (today's cash ISAs), and incorporating features that rely on passive acceptance, is designed to introduce much more flexibility to retirement saving. More specifically, the LISA offers an important compromise in terms of pre-retirement access to assets, thereby countering many people's principal objection to pension product-based retirement saving.

Table 6: Lifetime ISA vs. pension products

	Lifetime ISA savings		Pension products
	Incentivised	**Non-incentivised**	
Eligibility for Treasury 50p incentive*	Yes	No	Yes
Pre-60 access to savings	Yes, but repay 50p per £1 withdrawn	Yes, no penalty	Pre-55: none
60+ access to savings	Yes, but taxed at marginal rate	Yes, no penalty	55+: tax at marginal rate**
Access to capital growth and accumulated income	None until age 60, taxed at marginal rate	None until age 60, then taxed at marginal rate	Pre-55: none 55+: tax at marginal rate**
Charge cap on default fund	Yes: 0.35% p.a.	Yes: 0.35% p.a.	No
Interaction with means-tested benefits	Treated as capital	Treated as capital	Exempt

** Up to £8,000 p.a. shared between the Lifetime ISA and pension products*
*** But with the 25% tax-free lump sum reducing the overall tax rate*

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APPENDIX

Retirement saving incentives: The end of tax relief, and a new beginning[30]

The proposals

Proposal 1: Pension contributions from employers should be treated as part of employees' gross income, and taxed as such.

Proposal 2: Tax relief on pension contributions should be replaced by a Treasury contribution of 50p per £1 saved, up to an annual allowance, paid irrespective of the saver's taxpaying status.

Proposal 3: ISA and pension products should share an annual combined contribution limit of £30,000, available for saving within ISA or pension products (or any combination thereof). This would replace the current ISA and pensions tax-advantaged allowances.

Proposal 4: The 25% tax-free lump sum should be scrapped, with accrued rights to it protected.

Proposal 5: The Lifetime Allowance should be scrapped. It adds considerable complexity to the pensions landscape, and with a £30,000 combined contributions limit for pensions and ISAs, it would become less relevant over time.

Proposal 6: The 10p tax rebate on pension assets' dividend income should be reinstated.

Proposal 7: People should be able to bequeath unused pension pot assets to third parties free of Inheritance Tax (perhaps limited to £100,000), provided that the assets remained within a pensions framework.

Proposal 8: The annual allowance should be set at £8,000, with prior years' unutilised allowances being permitted to be rolled up, perhaps over as much as ten years, all subject to modelling confirmation.

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[30] Published by the Centre for Policy Studies, Michael Johnson, April 2014.

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