Pointmaker

THE WORKPLACE ISA

REINFORCING AUTO-ENROLMENT

MICHAEL JOHNSON

SUMMARY

- Today's workplace savings environment includes some disgruntled employers, a defensive pensions industry and an under-saving population deterred from engaging with an industry that is widely distrusted. What simple elixir would satisfy all parties?

- Following the government's adoption of the Lifetime ISA, this paper proposes the introduction of a Workplace ISA to complement it, and the inclusion of both ISAs in the auto-enrolment framework. This would discourage opt-outs, thereby enhancing employee engagement with saving. The key features of the workplace are summarised overleaf.

- Including the Lifetime and Workplace ISAs within the auto-enrolment framework would enable employees to choose where auto-enrolment (AE) contributions would be accumulated. The choice would be between a Lifetime ISA (employee contributions), a Workplace ISA (employer contributions) and the employer's own occupational pension scheme (all contributions). Auto-enrolled Lifetime ISA contributions would provide employees with the benefit of flexible access, which would likely *discourage* them from opting out of auto-enrolment. This is important given that within the next three years, employees' statutory minimum contributions are set to quintuple. Being in control is closely allied to being motived (perhaps, in this case, to save *more*), and therefore engaged.

- Given that more than half of the working age population is ineligible for auto-enrolment, including 23% of employees, the DWP should sponsor a Workplace ISA for them, perhaps delivered through NEST. NEST should, of course, be exposed to private sector competition.

- NICs relief on employer contributions goes to shareholders rather than savers: employees are oblivious of it. Consequently, as an incentive to encourage *individuals* to engage with saving, it is ineffective. NICs relief should be redeployed as the 25% bonus, paid directly into the employee's Lifetime and Workplace ISAs. Thus visible, it would be more appreciated by the individual.

KEY FEATURES OF THE WORKPLACE ISA

- The Workplace ISA should be included in the auto-enrolment (AE) legislation. This is fundamental: employers are integral to auto-enrolment's success. It should be open to all auto-enrolled employees under the age of 40.
- Employer contributions, taxed at the employee's marginal rate, may be paid into a Workplace ISA until the age of 50 (as per the Lifetime ISA). They should be accompanied by the same 25% Treasury bonus as the Lifetime ISA.
- Withdrawals from the Workplace ISA should not be permitted until the age of 60; thereafter, they would be tax-free.
- Auto-enrolled employee contributions, made with post-tax income, may be paid directly into the employee's Lifetime ISA. They would be subject to the same tax, withdrawal and penalty rules as other Lifetime ISA savings. They should also be eligible for the Treasury's 25% bonus.
- Employer and employee contributions should share an annual contributions cap of £10,000, subject to Treasury cost modelling.
- The Workplace ISA could be housed *within* the Lifetime ISA, leaving the individual with a single retirement savings vehicle.
- Workplace ISA assets should enjoy the same Inheritance Tax treatment as today's pension pots and should be excluded for means testing purposes, as per today's pension assets.

INTRODUCTION

Savings statistics and surveys suggest that, given the choice, many people would prefer to contribute to an ISA rather than a personal pension. For many, ready access to post-tax contributions is valued above tax relief. The Government has responded with the Lifetime ISA, to be introduced in April 2017 (summarised in Appendix I). It will provide some competition to the private pensions arena.

Similar positive sentiments towards the ISA framework are held in respect of occupational pension provision. Consequently, a Workplace ISA should be introduced within the auto-enrolment legislative framework. It would complement the Lifetime ISA and compete with occupational pensions schemes.

1. AUTO-ENROLMENT (AE)

1.1 Opt out rates likely to rise

In February 2016 the number of workers automatically enrolled in a pension scheme passed six million, with another 9.5 million already active as members of a qualifying scheme.[1] Opt-out rates have been pleasingly low (roughly 10% so far), albeit that the opt out data does not take into account workers who did not opt out initially, but subsequently stopped paying in; they are reported as "non-active" members.

More than 100,000 employers have now enrolled their staff, but over 1.5 million have yet to do so, and these include the small and micro employers, many without HR departments to discourage opting out. In addition, employees' statutory minimum contributions under auto-enrolment are set to *quintuple* by October 2018, from 1% of qualifying earnings (including basic rate tax relief) to 5% (as 4% plus 1% tax relief).[2] Consequently, from hereon it will be tougher to contain the opt-out rate.

1.2 Employer contributions matter

Last year over £100 billion was contributed to occupational and personal pension pots, and roughly 70% of this came from employers. The DWP estimates that by 2019-20, auto-enrolment will lead to an extra £15 billion of saving per year, with nine million workers estimated to be newly saving, or saving more, as a result of auto-enrolment.

Clearly, employers are integral to auto-enrolment's success. But they have long complained that their pension contributions are undervalued by employees, and therefore represent poor value for shareholders.

1.3 The pensions industry's perspective: mixed

Several major pensions industry providers quickly committed to marketing the Lifetime ISA, including Standard Life and Hargreaves Lansdown. But a small minority in the industry have embraced the risk of rising opt-outs to damn the very existence of the Lifetime ISA. They are claiming that its early access features could undermine auto-enrolment by encouraging savers to opt-out, thereby missing out on employer contributions. But this is no surprise: the Lifetime ISA will be a competitor product to personal pensions.

An alternative industry perspective is provided by a recent survey, which asked 600 pensions professionals what impact the Lifetime ISA would have on opt-out rates.[3] Some 58% responded that it would have no material

[1] *Automatic enrolment: Declaration of compliance report;* The Pensions Regulator, February 2016.

[2] The minimum employer contribution rate will rise to 2% (April 2018) and then 3% in April 2019.

[3] Aon Hewitt, April 2016.

impact on opt-out rates, 38% thought a modest impact and 2% a significant impact.

It is ironic that industry failings are partly responsible for necessitating auto-enrolment in the first place. Witness the "savings gap", the gap between current savings for retirement and what is required to generate a desirable income from retirement.

In addition, industry critics, perhaps focused on self-preservation, are conveniently forgetting the consumer's perspective. Early indications are that the Lifetime ISA is likely to prove popular. A post-Budget survey of 1000 adults aged between 18 and 35 found that 57% positively welcomed it, and were significantly more interested in saving this way than into a pension.[4] 15% said they preferred the idea of a pension and 28% said that they had no savings and no interest in either a Lifetime ISA or a pension.

1.4 Auto-enrolment: conclusion

We have disgruntled employers, a defensive pensions industry and an under-saving population deterred from engaging with an industry that is widely distrusted. What simple elixir would satisfy all parties? One approach would be to expand auto-enrolment's reach, and include Lifetime and Workplace ISAs within its legislative embrace.

2. THE WORKPLACE ISA: KEY FEATURES

- The Workplace ISA should be included in the auto-enrolment legislation. This is fundamental: auto-enrolment must be given every chance of success. It should be open to all auto-enrolled employees under the age of 40.
- **Employer contributions**, taxed at the employee's marginal rate (i.e. salary and employer pension contributions would be indistinguishable) may be paid into a Workplace ISA until the age of 50 (as per the Lifetime ISA). They should be accompanied by the same 25% Treasury bonus as the Lifetime ISA.
- **Auto-enrolled employee contributions**, made with post-tax income, may be paid directly into the employee's Lifetime ISA. They would be subject to the same tax, withdrawal and penalty rules as other Lifetime ISA savings. They should also be eligible for the Treasury's 25% bonus.[5]
- Employer and employee contributions should share an annual contributions cap of £10,000. Treasury cost modelling may determine that this should incorporate the Lifetime ISA's £4,000 cap (i.e. up to £10,000 could be contributed to Lifetime and Workplace ISAs combined).
- Workplace ISA withdrawals should not be permitted until the age of 60; thereafter, they would be tax-free. Thus, employer contributions would be pension-like, which some of the more paternal employers may prefer. Conversely, auto-enrolled employees' (post-tax) contributions into their Lifetime ISAs would be more accessible than pension contributions. The Lifetime and Workplace ISAs combination would accommodate a wide range of different employee age and socio-demographic profiles (and hence, a variety of saving objectives).
- The Workplace ISA could be housed *within* the Lifetime ISA (Figure 1), leaving the

[4] *Gorkana: Budget 2016 Reaction;* 16 March 2016.

[5] See *The Lifetime ISA: potential next steps*; Michael Johnson, CPS, April 2016.

individual with a single retirement savings vehicle.

- Workplace ISA assets should enjoy the same Inheritance Tax treatment as today's pension pots and should be excluded for means testing purposes, as per today's pension assets.

A Workplace ISA should be introduced and, along with the Lifetime ISA, included in the auto-enrolment legislation.

3. ISAS AS PART OF AE: ENHANCED EMPLOYEE ENGAGEMENT

3.1 The employee in control

Including the Lifetime and Workplace ISAs within the auto-enrolment framework would enable employees to choose where AE contributions would be accumulated. The choice would be between a Lifetime ISA (employee contributions), a Workplace ISA (employer contributions) and the employer's own occupational pension scheme (any contributions). Being in control is closely allied to being motived (perhaps, in this case, to save *more*), and therefore engaged.

3.2 ISAs within AE will discourage employee opt-outs

The Lifetime ISA would provide employees with the benefit of flexible access to their own contributions, which would likely *discourage* them from opting out of auto-enrolment. This is important, given the rising temptation to opt out as statutory minimum contributions are ramped up.

3.3 Provide for AE-ineligible workers

More than half of the working age population is ineligible for auto-enrolment, including 23% of employees.[6] Consequently, the DWP could sponsor a Workplace ISA to cater to workers who are without an employer sponsor, perhaps delivered through NEST. This should, of course, be exposed to private sector competition.

A Workplace ISA should be made available to those without an employer sponsor, via NEST and other competing private sector providers.

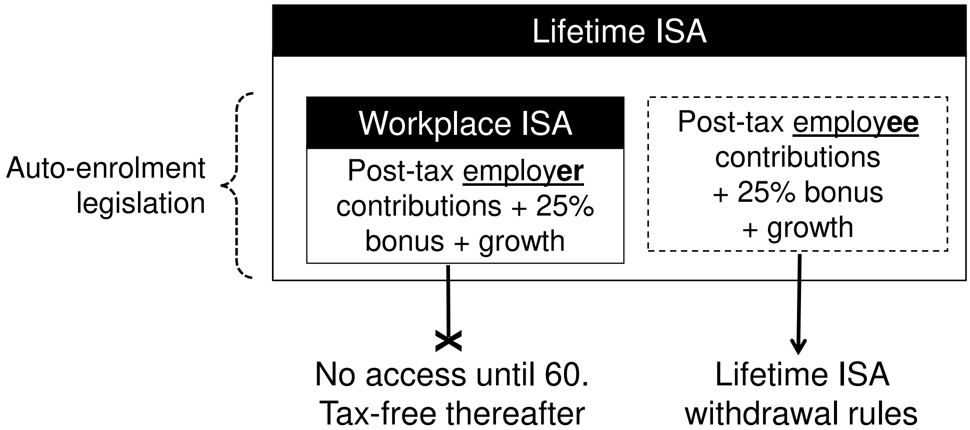
3.4 A single savings vehicle: an ISA warehouse[7]

The Lifetime and Workplace ISAs could reside within an ISA warehouse, which could house the complete suite of specific purpose ISAs, i.e. including:

6 *Briefing Note 75 - who is ineligible for automatic enrolment?* Pensions Policy Institute, Sept. 2015.

7 See *An ISA-centric savings world*; Michael Johnson, CPS, October 2015.

Figure 1: The Workplace ISA, inside the Lifetime ISA



- Junior and adult Cash ISAs, Stocks and Shares ISAs and outstanding Child Trust Funds (ideally all assimilated into one Daily ISA, for general purpose saving);
- the Help to Buy ISA (eventually to disappear within the Lifetime ISA); and
- the Innovative Finance ISA.[8]

There could be an over-arching annual contributions cap (£30,000, say) to limit the cost of "middle E", i.e. the extent to which income and capital growth are tax-exempt. The ISA warehouse could serve as the universal, all-purpose savings vehicle, with each ISA within it having its own (tax-based) incentives and deterrents to reflect prevailing policy objectives. A single savings vehicle to serve from cradle to grave. Simplicity to the fore.

4. FUNDING THE TREASURY'S BONUS

4.1 NICs relief: expensive and, worse, ineffective

Employers currently receive National Insurance contributions (NICs) relief on their pension contributions (roughly £69 billion), at a total cost to the Treasury of £13.8 billion last year.[9] This figure has two components: £9.5 billion in respect of employer contributions and a consequential £4.3 billion attributed to NICs not collected from employees.[10]

Buried within this data is the cost of tax foregone as a consequence of employer contributions made through salary sacrifice schemes.[11] Identifying the specific (opportunity) cost of such schemes is difficult (there is no official data), but it lies between £1.3 billion and £4.1 billion in foregone taxation, with the lower end of the range being the much more likely. Appendix II discussed this in more detail, and includes worked examples.

4.2 NICs relief: what to do?

The Chancellor has four options concerning NICs relief:[12]

(i) do nothing;

(ii) ban salary sacrifice schemes specifically, perhaps saving £2 billion per year;

(iii) water NICs relief down from 13.8% to 7%, say; or

(iv) end all NICs relief.

The annual saving from ending all NICs relief would, however, be less than £13.8 billion. Of the £9.5 billion in respect of employer contributions, £8.1 billion relates to contributions to Defined Benefit (DB) schemes,[13] and roughly 37% of this was in respect of DB scheme deficit repair, i.e. £3 billion.[14] If axing NICs relief, the Chancellor

8 From 6 April 2016. They will hold peer-to-peer loans, benefitting from tax-free interest.

9 *Table Pen 6;* HMRC, February 2016.

10 See footnote 14 in *Estimated costs of the principal tax expenditure and structural reliefs;* HMRC, December 2015 and footnote 3 in *Table PEN 6*; HMRC, February 2016.

11 Unlike employer contributions, employee contributions do not attract NICs relief. Consequently, employees accept a salary cut in return for a larger pension contribution from the employer, so that both parties save on NICs (which can be recycled into the additional contribution).

12 Note that in respect of (iii) and (iv), the savings assume that employers do not cut back their contributions to make up for the reduction in NICs relief. In addition, public sector use of salary sacrifice schemes is assumed to be very limited (i.e. circularity of any NICs savings to the Treasury is not an issue to consider).

13 85% of employer contributions were to occupational schemes, the other 15% to personal pensions (which will be DC); PEN6, HMRC.

14 As detailed in a forthcoming paper, *What of DB in a TEE world.*

would come under pressure to retain this element of it, so the saving to the Treasury would *initially* be reduced to £10.8 billion (i.e. £13.8 less £3), a figure which would (hopefully) rise over time as deficits were reduced.

This calculation does not, however, take into account that over one third of all employer contributions are made into public service schemes, part of which would be for deficit repair. If such schemes were to lose their NICs relief cashflow, it would have to be made up from other public sector resources, for no net saving.[15]

4.3 Budget 2016

The stance adopted in the recent Budget is slightly ambiguous.[16] Concern is expressed about the growth of salary sacrifice schemes, but it would appear that the Government intends that pension saving, childcare and health-related benefits should continue to benefit from income tax and NICs relief when provided through salary sacrifice arrangements. The author would encourage the Government to reconsider its position, but that is not to say that incentivising employer contributions should cease: it could be done more effectively.

4.4 Make NICs relief visible to the employee: use it to fund the 25% bonus

NICs relief on employer contributions goes to shareholders rather than savers: employees are oblivious of it. Consequently, as an incentive to encourage *individuals* to engage with saving, it is ineffective. NICs relief should be redeployed as the 25% bonus, paid directly into the employee's Lifetime and Workplace ISAs. Thus visible, it would be more appreciated by the individual: a far effective use of Treasury resource.

> NICs relief on employer contributions should be redeployed, with the saving to the Treasury used to fund the 25% bonus on auto-enrolment contributions paid into the Lifetime and Workplace ISAs.

Ending NICs relief would also implicitly put an end to the iniquitous salary sacrifice schemes, which are an arbitrage at taxpayers' expense.[17] Their disappearance is long overdue, not least because they are unavailable to workers without a scheme sponsor, including the 4.5 million self-employed (the fastest growing employment sector).

Politically, as well as being fiscally attractive, axing NICs relief would be "stealthy", given that the public at large is oblivious of it. Some employers may object, which prompts some questions concerning employer paternalism: just how real is it today, in what is an increasingly competitive global market? In addition, is the NICs relief incentive *really* required, given automatic enrolment? Employers should be reminded of a major *quid pro quo:* Corporation Tax has been reduced from 28% in 2010 to 20% today, falling to 17% in 2020-21.

4.5 Scrapping NICs relief: part of a package?

(a) The Lifetime Allowance

The Chancellor could consider, as part of a package of measures to include scrapping NICs relief, also scrapping the Lifetime Allowance (LTA). This has become one of his cost cutting tools of choice, but each time it is cut, it potentially exposes high earners,

15 Unlike the private sector, public sector schemes have no flexibility to reduce pension benefits. This is also the case in respect of the loss of NICs rebates following the end of contracting out (April 2016).

16 *Paragraph 1.147, Budget 2016*; HMRC, 16 March 2016.

17 The Centre for Policy Studies will shortly be publishing *What of DB in a TEE world?* which will include details of the cost to the Treasury of salary sacrifice schemes.

particularly members of final salary (i.e. defined benefit, DB) schemes, to adverse, and complex, tax implications.[18] This can only encourage employer (i.e. sponsoring corporate) disengagement from retirement saving, as well as spawning an array of economically unproductive consulting opportunities: the white collar equivalent of digging a hole and paying people to fill it in.

The LTA's £ value to the Treasury (less than £2 billion by 2019-20) is modest when compared to the overall cost of tax relief. Scrapping NICs relief would provide significant simplification, and create an intangible value from grateful higher earners, as well as putting an end to the disparity between how DC and DB schemes are valued for LTA purposes.[19]

As a fall-back position, the Chancellor could tinker with NICs relief, for example by limiting it to auto-enrolment's upper level of annual qualifying earnings (£43,000 for 2016-17). A more dramatic way of ending NICs relief would be to consolidate Income Tax and National Insurance into a single Earnings Tax (which would produce complete cost transparency in respect of incentivising retirement saving).[20] This, however, would be a much more substantial project.

(b) Income Tax relief

And then there is the fundamental question as to the future of Income Tax relief on pensions contributions. Scrapping all Income Tax would save the Treasury some £27 billion per annum.[21] Assuming that pensioner Income Tax would be scrapped as a *quid pro quo,* consistent with a TEE framework (pensioners paid £13 billion in Income Tax last year), this annual saving would fall to £14 billion. Note that any *anticipated* demographic-led increase in pensioner Income Tax receipts is likely to be more than offset by a rising tax relief bill driven by auto-enrolment, as well as the rapidly rising Personal Allowance.

Some of the net £14 billion annual saving could be redeployed (with NICs relief) as 25% bonus payments into Lifetime and Workplace ISAs. This would be consistent with the Government's four principles behind any reform of tax relief, as detailed in its consultation document.[22] Depending upon the level of the annual contributions cap, there should be sufficient sum over to help reduce the Budget deficit.

5. CONCLUSION

The Lifetime and Workplace ISAs, operating together within the auto-enrolment framework, would help many people of modest means achieve a goal that was originally proposed in a 2012 paper aimed at catalysing the broad-based savings culture that the UK so desperately needs.[23] The majority of the population should be encouraged to set themselves one simple goal at the point of retirement: to be a debt-free home owner (including no consumer debt). Thereafter, they

18 Notably in respect of the value of accrued pensions relative to lifetime (and annual) allowances. The LTA is the maximum amount of pension saving that can be built up over a lifetime that benefits from tax relief. It was reduced from £1.8 million to £1.5 million (2013-14), then £1.25 million from April 2014, and will be £1 million from April 2016.

19 DB schemes' valuation factor of 20 bears little resemblance to the market conditions (i.e. annuity rates) that DC schemes are now exposed to.

20 *NICs; the end should be nigh*, Michael Johnson, October 2014.

21 *Table PEN 6*, HMRC, February 2016. The 25% tax-free lump sum costs another c. £4.5 billion p.a.

22 *Strengthening the incentive to save: a consultation on pensions tax relief*; HM Treasury, July 2015.

23 *Proposal 103, Put the saver first;* Michael Johnson, Centre for Policy Studies, 2012.

could perhaps downsize to top-up their retirement income, and perhaps finance long-term care.

Ideally, the Workplace ISA will be announced in the 2016 Autumn Statement, after a summer spent assessing the public's response to the Lifetime ISA, perhaps for 2018 implementation. It would, of course, compete with today's occupational pensions savings schemes.

APPENDIX I

The Lifetime ISA: key features

- May be opened by anyone aged between 18 and 40.
- A Treasury bonus of £1 for every post-tax £4 saved will be added to any savings made, up to the age of 50.
- Maximum contribution of £4,000 per year.
- Withdrawals made before the age of 60 may be used, without penalty, to buy the first home (costing no more than £450,000). Pre-60 withdrawals used for any other purpose would lose the bonus *plus* any allied investment income or capital growth, *and* incur a 5% penalty.
- Withdrawals from the age of 60 will be tax-free, i.e. conventionally ISA-like.
- Assets may be held in the form of cash or securities, which is an improvement on today's requirement for *separate* Cash and Stocks and Shares ISAs. Any capital growth would be tax-free *except* on pre-60 withdrawals for non-house-related purposes.
- Post-death Lifetime ISA assets will form part of the estate of the deceased for IHT purposes.
- Savers diagnosed with a terminal illness can withdraw funds tax-free regardless of age.
- The (less flexible) Help to Buy ISA will be phased out.

APPENDIX II

Salary sacrifice cost to the Treasury: opaque

Employee contributions do not attract NICs relief, a glaring inconsistency which has spawned so-called salary sacrifice schemes, an arbitrage at taxpayers' expense. Employees accept a salary cut in return for a larger pension contribution from the employer, so that both parties save on NICs (which can be recycled into the additional contribution).

Many people have asked what the cost of salary sacrifice schemes is to the Treasury: there is no official data. What we do know is that most of it is buried within the £13.8 billion cost of NICs relief, but breaking out the specific cost attributable to salary sacrifice is difficult. If we assume that 30% of employer contributions are made via such schemes,[24] then they cost the Treasury roughly £4.1 billion in NICs relief.[25] But this assumes that were salary sacrifice *not* available, then *none* of the 30% of employer contributions would be made: an unreasonable assumption. If salary sacrifice were specifically banned, but NICs relief on employer contributions remained, then the saving to the Treasury would simply be the consequential £1.3 billion attributed to NICs not being collected from employees because of salary sacrifice.[26]

Salary sacrifice: conclusion

Salary sacrifice costs the Treasury between £1.3 billion and £4.1 billion in foregone taxation, with the lower end of the range being the much more likely. If the Treasury were to simply end NICs relief on employer contributions, ultimately to perhaps save £13.8 billion per year, a by-product would be the end of salary sacrifice schemes.

Salary sacrifice scheme: illustrations (tax year 2015-16)

	Basic rate taxpayer		Higher rate taxpayer	
	"Net pay"	Salary sacrifice	"Net pay"	Salary sacrifice
Gross income	**£30,000**	**£28,235**	**£50,000**	**£47,931**
Employer deducts contribution of £1200 plus income tax	£1,500		£2,000	
Post-contribution income	£28,500		£48,000	
Income Tax on post-contribution income	£3,580	£3,527	£8,603	£8,575
NI on gross income	£2,633	£2,421	£3,967	£3,925
Net income	**£22,287**	**£22,287**	**£35,431**	**£35,431**
Salary sacrificed, contributed by employer		£1,765		£2,069
Employer NI saving added to contribution		£244		£286
Pension contribution, net	£1,200		£1,200	
Pension gross up by HMT	£300		£800	
Total pension contribution	**£1,500**	**£2,008**	**£2,000**	**£2,354**
Increase in contribution vs. net pay		34%		18%

	Basic rate taxpayer	Higher rate taxpayer
Employee NI saving	£212	£41
Employee Income Tax net saving	£53	£28
Employer NI	£244	£286
Total extra cost of salary sacrifice to HMT	**£508**	**£354**
Total extra cost to HMT as % of total employer contribution	25%	15%

24 The author spoke to several industry participants and consultancies to canvas opinion on the percentage of employer contributions being made via salary sacrifice. 30% is the average response.

25 As 30% x £13.8 billion.

26 Applying to the £4.1 billion the same £9.5 employer to £4.3 billion employee ratio for NICs relief, to produce £2.8 billion directly attributable to employer contributions and £1.3 billion attributed to NICs not being collected from employees.

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