Steve Hughes | January 2015

BONUS ISAs

A Policy Exchange Policy Bite

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Overview

- The ability to save changes over the course of a lifetime. The ISA system should be made more flexible to recognise this.
- Unused portions of ISA allowances earlier in life should be rolled over and packaged into a "Bonus ISA", which could be utilised at any point in later life. The Bonus ISA would be available to use in a single year, or across multiple years.
- The policy would benefit those who repeatedly don't have the opportunity to use their full ISA allowance early on in life, and then later become constrained by the in-year ISA allowance.
- This is not a policy aimed at the very wealthy. Somebody that has an ordinary financial situation and who experiences a one-off financial event at some point within their life would be a beneficiary. This gain could be an inheritance, house sale, redundancy payment, or the drawdown of a pension. In other words, those people that accrue wealth but only have the flexibility to use it at certain points within their life. For the latest figures available, more than half of the one million ISA subscribers hitting the allowance limit in 2011-12 had an income of below £30,000.[1]
- There would be a cost to the Exchequer, but assuming that the policy is not backdated, the full cost of the policy change would not bite for several years, after Bonus ISA pots have been accrued. The cost could be controlled by capping the level of the Bonus ISA.
- Canadian tax free accounts allow unused allowances to be rolled over and utilised in future years, providing a precedent for this type of system.

The current ISA system

ISAs were introduced in 1999, replacing Personal Equity Plans (PEPs) and Tax-Exempt Special Savings Accounts (TESSAs) as saving products. ISAs protect an individual's savings interest or dividend payments from tax, up to an annual limit set by the Chancellor. An individual can only open one Cash ISA and one Stocks and Shares ISA each tax year, with the combined annual deposits into these accounts restricted to £15,000 in 2014/15, and £15,240 in 2015/16.

The ISA rules have been through several iterations. The 2014 Budget relaxed annual deposit restrictions, allowing – for the first time – the annual tax free limit to be held in any combination of cash and stocks and shares. The 2014 Autumn Statement reformed the system still further, allowing a surviving spouse or civil partner to keep the tax free status of ISA assets inherited upon the death of a product holder.

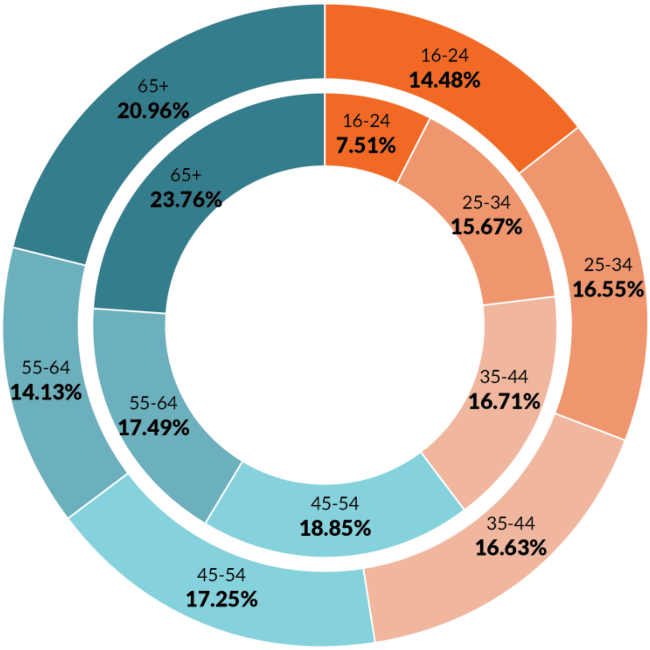
ISAs have proved to be very popular:[2]

- The estimated Exchequer cost of tax relief for ISAs in 2013-14 was £2.85bn.
- Over 23m individuals hold an ISA account, and around 13.5m people subscribed to Adult ISAs in 2013-14.
- A total of £57bn was deposited into Adult ISAs in 2013-14.

Why and how should ISAs be changed?

Income patterns are not consistent over a lifetime, and as a result neither is the ability to save. One example is that older people tend to earn more and save more than younger people,[3] reflected by the age of ISA holders relative to population size (see Figure 1, below). Another example is that some people receive windfall gains from one-off financial events, such as an inheritance, or drawing down funds from a pension pot.

Figure 1: ISA and Population Share by Age Group[4]



Outer ring: Share of total population by age group (2011)

Inner ring: Share of ISAs held by age group (2011-12)

The current ISA design does not recognise this, and offers no flexibility for people that cannot use their whole ISA allowances earlier in life, but become restricted by the allowance later in life. The system should change so that this is recognised. The Chancellor showed his desire to offer greater flexibility and choice for savers in the 2014 Budget by changing ISA rules, introducing Pensioner Bonds and making access to pensions more flexible. From a political perspective, these changes were almost universally popular.

Policy Exchange is proposing that an individual's unused ISA allowances should be packaged together so that they can be used flexibly later in life, when there is typically a greater capacity for individuals to take advantage of them. In other words, a "Bonus ISA" system should be created.

While this would incur a cost to the Exchequer, this cost could be controlled by placing a cap on the combined unused ISA allowances that could be rolled over for use in future years.

For example, if the Bonus ISA were capped at £10,000 then people could roll-over their unused allowances up to this limit. For maximum flexibility, the Bonus ISA could be used over multiple years or within a single year. In effect, it is a flexible add-on to the current ISA in-year allowances.

There are two main advantages of this system over simply making the ISA threshold more generous. The first is that it offers a potentially bigger pot to protect savings from tax within a single year. For example, if somebody made £30,000 from downsizing their house near retirement and had a full Bonus ISA, then more of the monetary gain could be deposited into ISA products and protected from tax in a single year, rather than being deposited over multiple years. The second is that the cost of the policy change could be controlled more easily. Increasing the generosity of ISA allowances essentially means increasing it indefinitely (it would be politically difficult to lower or freeze ISA allowances), meaning the extremely well-off could repeatedly take advantage of it.

The beneficiaries, the cost, and the precedent

The beneficiaries of the policy would be those that generate a Bonus ISA pot through unused allowances, and that become constrained by the in-year tax free allowance at some point later in life.

In 2011-12 – the latest figures available – just over one million subscribers used the maximum combined allowance of £10,680. More than half of these individuals had an income below £30,000, and could be maxing out allowances through a one-off gain. Examples would be: an inheritance, with over 800,000 people inheriting a value of over £10,000 between 2010 and 2012;[5] or, a redundancy payment, with the average settlement being £11,951 in 2011-12.[6]

The reforms to pensions in the last few years could also increase demand for the Bonus ISA product. Automatic enrolment into workplace pension schemes is expected to create millions of new pension savers, and billions of pounds of additional assets in private sector schemes.[7] When these savers reach retirement, they could withdraw the funds they have built up and use a Bonus ISA. The liberalisation of pension rules in the 2014 Budget could also result in more people drawing down large parts of their pension pot. The average pot size related to annuity sales is currently just under £40,000, after lump sums have been taken.[8]

The Bonus ISA would be available to anyone eligible for ISAs. There will be individuals that never hit the ISA allowance and, therefore, the Bonus ISA will not be a product they can utilise. But there are policies that could ensure capital ownership and saving is not just the preserve of the better-off. Policy Exchange has advocated creating a new generation of shareholders by giving anybody with a National Insurance number and who is on the Electoral Register the opportunity to apply for a stake in RBS and Lloyds. The shares would only be paid for upon sale, meaning that the holders would incur no financial risk.[9]

The cost to the Exchequer of the Bonus ISA policy would be the lost revenue from savings that would otherwise yield tax revenue on interest.[10] Without access to more data, it is difficult to know exactly what this cost would be, and would be dependent upon factors such as the numbers of people still using the entire ISA allowance after the Government's recent reforms, and the speed at which people would accrue Bonus ISAs pots. But it is expected that the cost several years after implementation would be in the hundreds of millions.[11]

The Canadian Tax-Free Savings Account (TFSA) provides a precedent for rolled over allowances, and protects up to $5,500 (approximately £3,000) from tax per year. Unused portions of the TFSA allowance are carried forward and accumulate for future years, with no limit on the amount that could be rolled over. TFSA's were introduced in 2009, but have proven to be incredibly popular. 48% of adult Canadians have signed up to the products, and as at the end of 2013 there $109bn worth of assets were held in the accounts.[12] One other notable distinction between the Canadian TFSA and the UK ISA is that withdrawing funds from the TFSA does not incur a penalty, and the full amount of withdrawals can be put back into the TFSA at any point in the future.[13]

The implementation

It is unknown if the Bonus ISA system could be backdated, and it could possibly only be backdated to 1999 anyway, when ISAs were introduced. Not doing so would cost less to the Exchequer, as it would take time for Bonus ISA pots to accrue in value.

There would be an obvious need to alter IT systems to administer a new system, but recent ISA alterations indicate that HMRC can cope with big policy shifts. There are also details that would need to be ironed out in design, such as: How would the Bonus ISA limit be indexed? How would the policy work alongside Junior ISAs? Could Bonus ISAs be transferred to other people?

The Bonus ISA model is just one blueprint of the principle that underpins the need for change, which is that income and ability to save is not consistent across a lifetime and this should be recognised by tax-free savings products.

Endnotes

[1] ISA Statistics, Table 9.7, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/348071/Full_Statistics_Release_August_2014.pdf

[2] ISA statistics, August 2014, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/348071/Full_Statistics_Release_August_2014.pdf

[3] IFS, "The wealth and saving of UK families on the eve of the crisis", http://www.ifs.org.uk/comms/r71.pdf

[4] Figures derived from ONS population statistics, and Government ISA statistics.

[5] ONS, Inheritance by Age, 08.10.14, http://www.ons.gov.uk/ons/about-ons/business-transparency/freedom-of-information/what-can-i-request/published-ad-hoc-data/econ/october-2014/inheritance-by-age.xls

[6] EMWLLP, http://www.emwllp.com/news/uk-redundancy-payments-soar-9-to-a-record-pound49bn/

[7] Pensions Policy Institute, "How will automatic enrolment affect pension saving", July 2014, http://www.pensionspolicyinstitute.org.uk/publications/reports/automatic-enrolment-report-3-how-will-automatic-enrolment-affect-pension-saving

[8] ABI, Retirement Income Statistics, 21/11/14, https://www.abi.org.uk/News/News-releases/2014/11/ABI-retirement-income-statistics-Q3-2014

[9] Policy Exchange, Privatising the Banks, June 2013, http://www.policyexchange.org.uk/publications/category/item/privatising-the-banks-creating-a-new-generation-of-shareholders

[10] The OBR estimates that the revenue from tax on savings interest will total £2.2bn in 2015/16. See Table 2.4 in the fiscal supplementary tables: http://budgetresponsibility.org.uk/economic-fiscal-outlook-march-2014/

[11] The 2014 Budget changes were expected to cost £560m five years after implementation.

[12] WSJ, 24/08/14, http://www.wsj.com/articles/amity-shlaes-and-chris-edwards-a-simple-tax-reform-can-help-families-and-promote-economic-growth-1408919408

[13] Government of Canada Tax Free Savings Account Web Page, http://www.tfsa.gc.ca/index.html

About the author

Steve Hughes is the Head of Economic and Social Policy. Before joining Policy Exchange, Steve worked at the Bank of England, where he conducted research into the circulation of banknotes, and helped manage the regulatory system that governs cash distribution in the UK. Prior to this, Steve worked at the British Chambers of Commerce, producing economic indicators and advising on tax, international trade and SME finance policy. He has also worked in Parliament, researching HM Treasury and Department for Work and Pensions legislation as it passed through the House of Commons. Steve read economics at the University of Nottingham.

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