How The British Save More for Retirement

By Kerry Pechter *Thu, May 19, 2016*

In Britain, if you contribute £100 to your defined contribution plan and have a 25% tax rate, the government adds £25 to your account. Our system doesn't work that way. All else being equal, we accumulate much less tax-deferred savings over a lifetime.

RIJ's cover story this week describes "auto-portability." This is a newly conceived process, based on a repurposed bit of financial technology, that would automatically consolidate your old "stranded" 401(k) accounts into your active 401(k) account, assuming you have one.

If it were practiced universally, auto-portability could rescue old accounts from the dead letter office of the retirement system and forward them to a participant's latest address. This would improve the current non-system, which encourages people to cash-out small accounts and squander the money on, stereotypically, flat-screen smart TVs.

The UK has taken a stab at DC account consolidation, but the effort has been a victim of politics and industry opposition. Last year the British authorities proposed instituting a policy called "pot-follows-member." It would make sure retirement accounts follow people from job to job. But there's no British counterpart to our rollover IRA, which is essential to the process.

The British out-do the US in one aspect of their defined contribution system, in my opinion. Their form of tax-deferral is arguably better than ours. When a DC plan participant in the UK contributes to a tax-deferred plan, the government adds the participant's "tax relief" to his retirement account.

To understand this, you have to look inside a paycheck. Assume that a hypothetical Briton has a £5,000 monthly salary and a 25% income tax rate. The government withholds £1,250 in taxes each month. If he contributes 10% of pay (£500) to a DC plan, the government credits 10% of his tax (£125) to his plan account. His plan balance after one month is £625. His take-home pay is £3,250.

In the U.S.—please correct me if I'm wrong about this—it works differently. Assume that a hypothetical American has a $5,000 monthly salary and a 25% income tax rate. If he contributes 10% of pay ($500) to a DC plan, the federal government withholds $1,125 in tax on the remaining $4,500 in his paycheck. His savings balance after one month is $500. His take home pay is $3,375.

The Briton saves 25% more each month than the American. The difference in savings adds up to a lot over the hundreds of months in a work-life. Ignoring investment gains or losses, the Briton in my example saves £7,500 in the first year; the American saves $6,000. Over a lifetime of tax-deferred saving and compounded returns, the Briton will end up with a lot more savings than the American.

How much more? I consulted two well-known retirement experts about the best way to calculate the difference in long-term results. It's not very complicated, said Wade Pfau of The American College. If the U.S. DC system switched to the British method of tax-deferral, participants in American would save 1 x (1 + 0.25 tax rate) as much as they do now, or an additional 25%. In my hypothetical, that would mean an extra $110,000 or so for the American retiree if he saves for 35 years and has a 4% rate of return. (For simplicity, we're ignoring inflation, etc.)

Alternatively, Moshe Milevsky of York University suggested that if Americans *kept* their current system but chose to invest their tax savings in their tax-deferred accounts (and invested the tax savings on the reinvestment of the initial savings), they would save 1/(1 – 0.25 tax rate) as much as they do now, or an additional 33%.

Somewhere, the gods of behavioral finance must be howling with laughter, or in frustration. Both participants chose to contribute 10% of pay to their DC accounts, but one of them has significantly more savings at retirement. It means that changing the design of our system could, without asking participants to change their habits or preferences, make millions of Americans much more secure in retirement.

As a nation, the Britons are at different stage in their transition from defined benefit pensions to defined contribution pensions. And the process isn't going very smoothly, according to what I read at IPE.com. But I admire the way they designed their tax-deferred savings system. By comparison, our method endows us with tax-deferred growth, but lets the tax savings on contributions slip away. (Another attractive feature of their system: retirees can withdraw 25% of their tax-deferred savings tax-free.)

The British system may have another advantage, although it's difficult to quantify. Their policies might produce a greater sense of shared purpose between the public and the government regarding retirement savings. If Americans saw their government, in effect, contributing directly to their retirement accounts, the government's demands for minimum taxable distributions at age 70½ might not seem so perplexingly intrusive.

I think we can agree that our retirement system offers many opportunities for improvement. We change jobs frequently and cash-out or leave unvested employer matches on the table; we may drop out of the system entirely for a few years here and there; our employers don’t always offer plans, let alone matching contributions; fees can reduce our rate of return by 25% or more over a lifetime; volatility slows down the accumulation process; taxes come due during retirement; and we’re prone to dumb investing mistakes along the way. With so many pitfalls along the road to a well-funded retirement, it might help if the system defaulted us into saving, not spending, the tax break on contributions.