

Saving Grace: reforming the presentation and composition of current savings policies

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Introduction

Saving money in the good times gives security against the bad times. It also helps to generate a pool of capital that can be drawn on when expensive things, like the university education of a child, need to be paid for. A high savings rate should also keep financial demands on the state down, as the more financially independent the population is the smaller the number of people likely to need emergency help. Since Labour entered government in 1997 it has developed several schemes for encouraging an increase in the rate of saving. But because much of it has been insufficiently co-ordinated it is now time to develop a holistic approach that makes saving consistently attractive.

In 2009, national saving as a percentage of GDP in Britain is expected to be 11.62%. In Germany it is expected to be 19.8%.¹ Judging by what people say in savings surveys, the amount of money that Britons regularly save is insufficient. This year, National Savings and Investments again found that most people want to save around 14% of their income, but even regular savers only manage around 11%. For the population as a whole the rate is only 6%.²

Across Britain, 70% of people have credit cards and but only 50% have a savings account.³ This suggests an imbalance between spending money and saving it. To some analysts the use of credit is regarded as a “mark of financial incapability.”⁴

A lot of evidence on how savings and investment schemes are used by the lay public shows that irrational and costly decisions are common. For example, according to research from the Financial Services Authority, 40% of people who own an equity ISA are not aware that its value changes with the performance of the stock market. At the time of the survey 33% of people who had purchased general insurance cover had done so without comparing one product to another.⁵

These problems are compounded by mistakes in government policy and insufficient trust in the products on offer. Back in 1999 the Treasury scrapped the Advance Corporation Tax scheme, which gave pension funds some tax relief. In the years since then this change has cut the value of those funds by up to £150 billion, a significant charge on the savings pool accumulated in the UK. There are also problems with the introduction of personal accounts:

the Pensions Policy Institute reckons that 45% of pensioners could lose out as they suffer from lower payments from means-tested benefits. In 2009, one survey found that 60% did not think that banks were looking after their interests properly.⁶

The background to all this is, of course, the increase in the value of residential property over the last decade or so and the subsequent storing of “savings ” by many people in their homes. It is because this is a risky approach to saving, plus the problems in policy elsewhere, that we recommend an approach to government savings policy along the following “jam jar” lines:

- Jam jar 1: long-term saving for retirement, which would include automatic enrolment into a personal account.
- Jam jar 2: saving for a big purchase, which the tax-free ISA allowance of £10,200 would contribute.
- Jam jar 3: saving for a regular annual event, which the Saving Gateway would bolster.
- Jam jar 4: saving for children, for which the free Child Trust Fund voucher would be the mainstay.

To support this approach we also recommend the following specific changes:

- That the extra payment made by the Child Trust Fund scheme once a child reaches seven years of age be made at birth;
- That the Saving Gateway be made easier for banks to use and that the interest rate be expressed as part of the “matched” funding;
- That flexible withdrawals be allowed from Personal Accounts;
- That the ISA ceiling be raised each year in line with inflation.

Together, these changes and the overall “jam jar” approach should improve the likelihood that Britain will increase its savings rate.

Why should the encouragement of saving be a policy goal?

Savings policy over the last fifteen years has largely been the by-product of attempts to achieve other goals, such as increasing home ownership, or redistributing incomes, rather than an end in itself. There have been numerous changes to the tax benefits for saving, with little explanation of what the changes were designed to achieve. Even work around increasing financial capability has been divorced from the larger issue of improving savings in aggregate.

The NICE (non-inflationary, consistent expansion) decade, as Mervyn King so aptly described it, contributed to government complacency about the role of savings in the economy. Saving was considered somewhat irrelevant over the sixty consecutive quarters of economic growth – something nice to have, rather than a necessity. It is time to set out more clearly why increasing saving should be a policy goal.

Let us first consider the economic argument. The fundamental macro-economic case for a higher savings rate is that it would create a capital base to fund sustainable economic growth, rather than relying on debt which cannot be refinanced forever. Savings funnel into wider economic investment – buyers of corporate bonds and equities provide the capital for ventures large and small. Without this money, investment relies on government borrowing – something that can be ill-afforded in the current climate.

The fundamental micro-economic case for a higher savings rate is that it will smooth an individual's consumption function over a business cycle. Both of these factors should then smooth the economic cycle, reducing volatility of output. This should also smooth inter-temporal imbalances: the burden of today's consumption would not be shifted onto future generations.

It is at this point that the political arguments start to wade into emotive, rather than rational, territory – excessive borrowing today leading to “tax bombshells” lurking in the future. As the credit crunch has shown, prudent savers are bailing out imprudent borrowers. If everyone saved something for a rainy day, from corporations to individuals to government, wouldn't that be “fairer”? Raising the spectre of fairness introduces a whole new set of issues that go to the heart of dividing lines in political discourse, and it is in this emotional minefield that the biggest obstructions to a comprehensive policy lie. Therefore, to win the political argument, there must be an appeal to more than just economic reasoning.

A clear savings policy would help to empower people to manage their own finances. Money may not bring happiness, but it brings freedom – the freedom to make your own choices. It also opens up opportunities – once people feel that they have the security to manage if things go wrong, then they can stop living from day-to-day and look to the long term. They feel able to change their future, rather than relying on anyone else. A 2001 study

shows that owning a financial asset of between £300 and £600 at age 23 is positively associated with a greater chance of employment and improved mental health outcomes at age 33, controlling for other factors.⁷

Savings provide a person with a cushion against “black swan” events, such as we have recently seen in the banking crisis. They also provide a cushion for the government, as a person’s savings can kick in before government help is required. A higher savings rate would mean that stronger private sector balance sheets would ease the burden on the public sector balance sheet, freeing up government resources to concentrate on delivering better public services. This is particularly the case during hard times such as the current recession, when the government is at its most stretched.

The message is therefore clear: everyone can benefit from an increase in household savings, both by achieving greater personal freedom, and by creating a sustainable path for economic growth.

How did Britain come to have such a low savings rate?

According to National Savings and Investments (NS&I), in autumn 2009 46% of Britons were saving regularly, with the average percentage of monthly take-home income saved being 6.06% and the average amount per head £83.87.⁸ That nearly half the population consistently saves some income sounds satisfactory, but a little more detail shows how insufficient the level of saving actually is.

In the five years that National Savings and Investments have conducted a savings survey they have found that the amount saved across the population has consistently fallen short of an ideal amount expressed by survey respondents, and that the gap between the money put away by regular and irregular savers is big enough to suggest that many people are not making enough provision for times when they will need, at the very least, emergency funds, as shown by figure 1. Britain’s national saving rate has often been at the bottom of international comparisons for the past thirty years, as shown by figure 2.

Figure 1: level of actual saving versus ideal level of saving (as a percentage of income)⁹

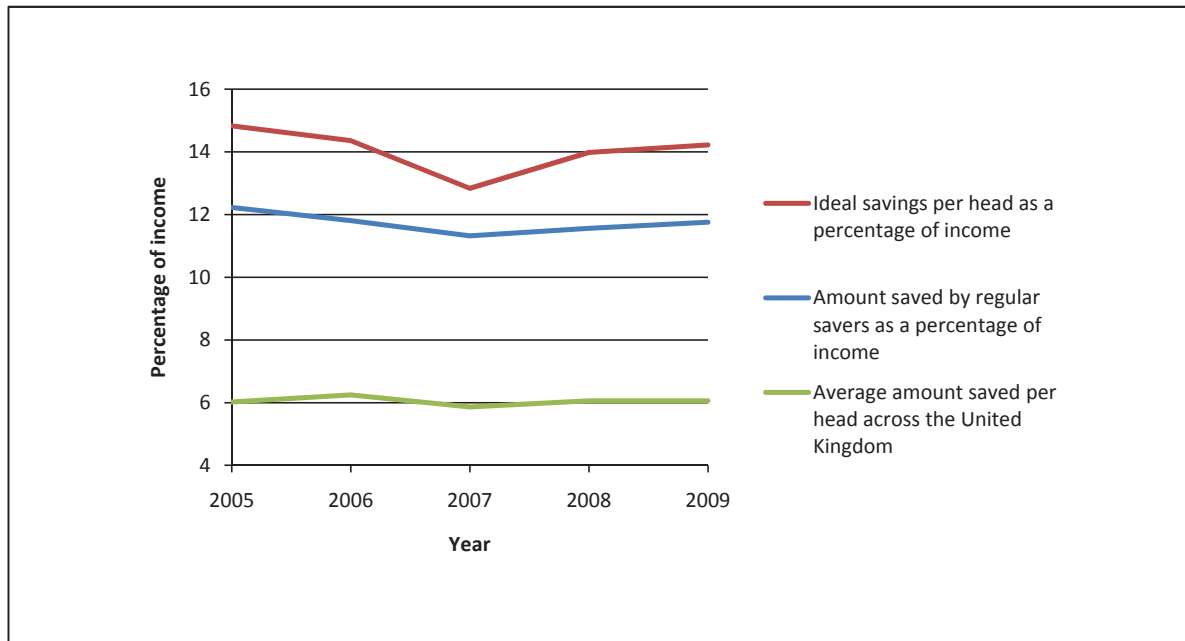
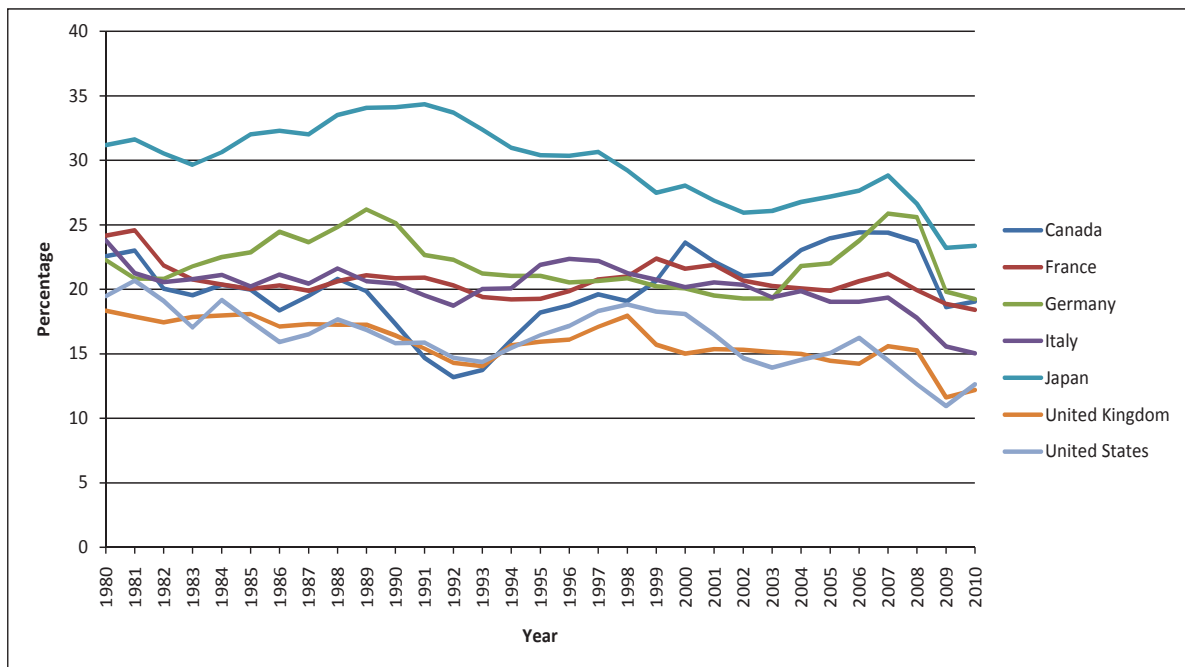


Figure 2: gross national savings (percentage of GDP)¹⁰



These consistently low levels of saving have been exacerbated by the failure to make the case for, and then deliver, a comprehensive savings policy.

Financial Capability

Upon its creation, the Financial Services Authority was tasked with “promoting public understanding of the financial system.”¹¹ Since 2003 it has tried to improve public understanding of saving by being the fulcrum for a national strategy aimed at building “financial capability” in the UK.¹² In 2004 it commissioned the University of Bristol’s Personal Finance Research Centre to look into this area, and in their June 2005 report *Measuring Financial Capability: An Exploratory Study*, they noted that:

“A number of research studies have identified relatively low levels of financial capability among consumers in the UK, and show that they encounter difficulties in dealing with the growing complexity and diversity of financial services provision.”¹³

A Financial Services Authority survey conducted in March 2006 found that:

- 33% of people, who held no more complex products than general insurance, bought their policy without comparing it to even one other product.
- 70% of people had made no personal provision to cover an unexpected drop in income.
- 40% of people who owned an equity ISA are not aware that its value fluctuates with stock market performance, and 15% of people who owned a cash ISA thought its value does.¹⁴

This paints a relatively bleak picture of the level of financial literacy amongst the UK population.

Lack of financial understanding is not just undesirable because it might cause people to fail to save; it is also destabilising if it leads to an explosion of debt. The imbalance between saving and borrowing is highlighted in the fact that 70% of people have credit cards, compared to the 50% of people who have a savings account.¹⁵ Two years before Northern Rock collapsed, the University of Bristol’s study established that “[r]eckless use of credit was regarded as a mark of financial incapability.”¹⁶ The lack of financial understanding, combined with low interest rates and easy lending standards, helped to fuel the credit boom that has now turned to bust with such disastrous consequences. Furthermore, homeowners possess a feeling of wealth owing to increases in house equity and the same low interest rates as is discussed below.

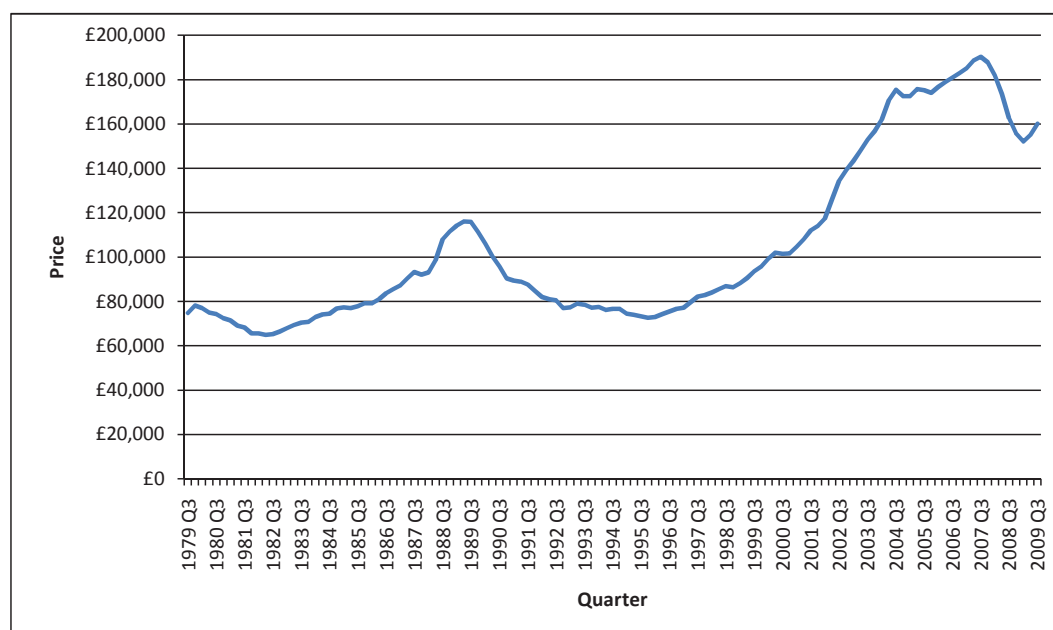
Obsession with the housing market

Much work has already been done to explain the UK's singular obsession with becoming a homeowner. There is a clear cultural bias towards home ownership that is best summarised by the colloquialism that "every man's home is his castle". To own a home is to have status, security and wealth.

From this cultural bias came the view that a house is regarded as a safe long-term investment. To some extent, this opinion is not entirely baseless. There are significant supply constraints that imply that the long-term trend for UK house prices will usually be up, such as population growth and planning.

Policy Exchange showed in its publication, *Unaffordable Housing: Fables and Myths*, how important this last factor is to the growth in house prices.¹⁷ Britain irrationally constrains the building of new houses through the use of the 1947 Town and Country Planning Act, which sought to use "green belts" to keep development in set areas and not, as is now assumed, to simply constrain the number of houses being built. Figure 3 shows the affect that this and other factors have had on the growth in house prices over the past 30 years.

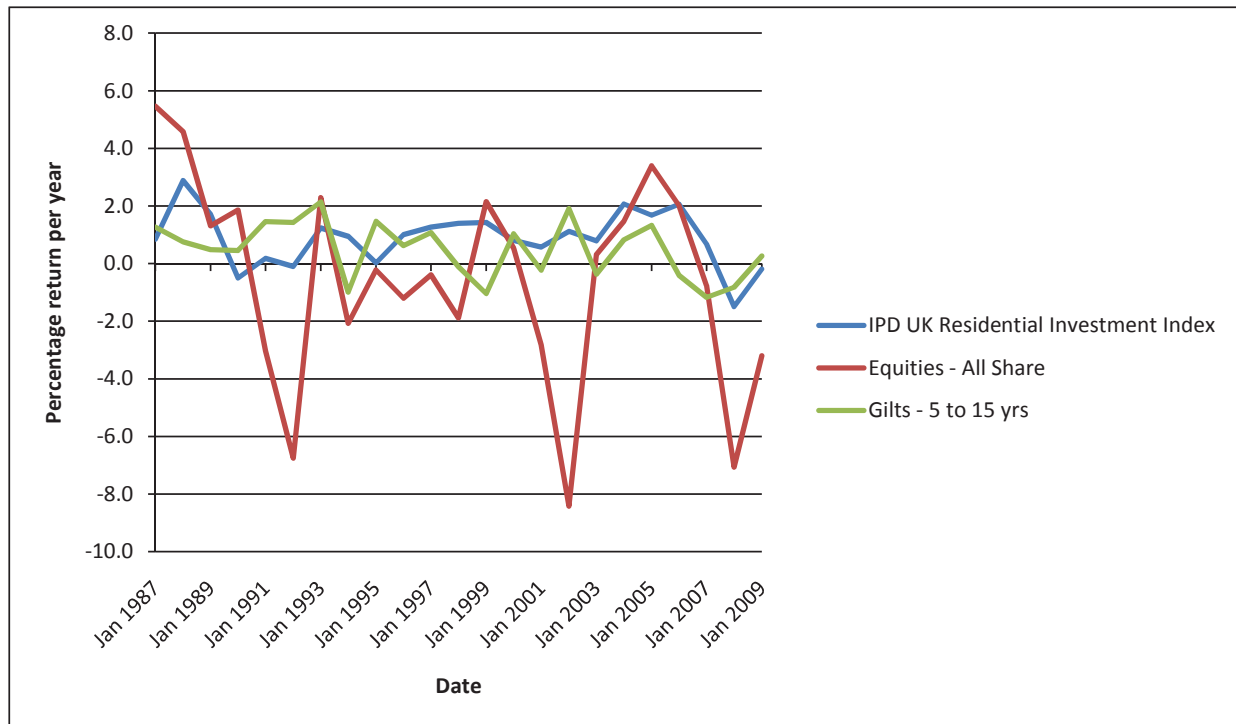
Figure 3: changes in real house prices, 1979-2009¹⁸



The problem is that the relatively high return one can achieve in property comes with high risks, especially for home buyers who are not investment professionals. Housing is one of the most illiquid asset classes – it's hard to compare houses as each is unique; and you can't always buy and sell when you want to. Property should be expected to outperform only over the very long term, and is suitable for an investor prepared to take high risks. Most people do not think that they fall into this category: a 2009 Department for Work and Pensions survey on

attitudes to financial risk noted that “...most participants were unwilling to take much risk with their money. This was the case even over the long term (five years or more) and few participants mentioned the potential for risk and return to balance out over time.”¹⁹ Figure 4 compares the yearly returns of investments in housing against the performance of equities and government bonds.

Figure 4: yearly returns from housing, equities and government bonds²⁰



The same Department for Work and Pensions survey also noted people’s different attitude towards property: certain respondents “...regarded property as a ‘safer bet’ over the long term than other types of investment, including pensions. In their view, therefore, investing in property was a risk worth taking.” Indeed, housing is the largest single asset held by UK households, often representing more than 40% of a household’s net wealth.²¹

The recent credit boom added another destabilising component to the housing market: higher leverage. As house prices rose, banks were happy to increase loan to value ratios, lending out ever higher multiples of income. The FSA considered a loan above 3 times income for a single person and 2 times for joint borrowers to be high even in 2000 but by 2006 the typical income multiples were 4 times and 3 times respectively, with the now infamous Northern Rock “Together” mortgage offering 5.9 times income.^{22 23}

Equity release schemes effectively meant that people came to regard their home as a cash-point, borrowing against the value of their home to buy new cars and kitchens. This isn’t necessarily a problem if the homeowner

remains in a position of positive equity, but that cannot be assured given the propensity for boom and bust in the housing market.

Even if homeowners don't borrow extra money, the very act of taking on a mortgage is itself inherently risky due to leverage. A 5% deposit means that house prices need only fall by 5% and you start to lose money on a mark-to-market basis. However, the flipside of this argument shows why leverage can be so alluring: a 5% deposit could generate a 20% return in one year, if there is a housing boom.

So why do people take on such a high risk, particularly given the fact that a house isn't simply an investment, it is also a home? Losing money on the stock market is painful, but it need not automatically mean the loss of the place in which you live. The answer to this lies partly in the tax system: no Capital Gains Tax is paid on primary residences. This means that when you sell your property, you receive the whole profit without deduction, whereas the sale of any other asset incurs a variety of taxes, as shown by the table below.

Table 1: taxation of UK equity, cash, gilts and residential property

UK equity

	Tax	Rate
Tax on purchase	Stamp Duty/SDRT	0.5% on purchase of shares in UK companies
Tax on company paying dividend	Corporation Tax on profits	21%/28% depending on size
Tax on dividend income	Dividend Tax	10%/32.5% depending on income (offset by a 10% tax credit)
Tax on Sale	Capital Gains	18% flat rate

Gilts/Bonds²⁴

	Tax	Rate
Tax on interest	Income Tax	20%/40% (at income tax rate)

Tax on savings in bank or building society accounts

	Tax	Rate
Tax on Interest earned	Income Tax	20%/40% (at income tax band)

Tax on residential property purchases

	Tax	Rate
Tax on purchase	Stamp Duty	1-4%, depending on the value of the property

It's clear that the tax system therefore skews the country's balance sheet, encourages investment in some asset classes rather than others and exacerbates an already ingrained predisposition by the British towards buying houses.

Lack of trust in the savings industry

Even before the credit crunch and banking bailout, the savings industry had suffered from a loss of trust. From mis-selling scandals (split-caps investments, endowment mortgages) to the collapse of investments (Equitable Life), many savers already felt the industry to be negligent. In 2005, for example, 61% of all complaints received by the Financial Ombudsman Service related to endowment mortgages – equivalent to 250 new complaints each day.²⁵ A 2004 *Which?* report showed that fewer than a third of people trusted financial institutions to manage their pensions properly.²⁶

Since the demise of Lehman, AIG, and the Icelandic banks, trust has been undermined in even simple banking products such as deposit accounts. A 2009 survey by Cohn & Wolfe showed that 60% of consumers believe that banks are not looking after their interests and almost half of respondents consider the banks to be greedy.²⁷

Complication by the Government

In such an environment it is even more important that the Government delivers and then remains committed to a coherent savings policy. The last decade has produced such a variety of tweaks to the system that it is not clear what might happen next. Given the background of low financial capability, Government should make saving as comprehensible as possible.

Of course, Government cannot prevent an individual from making poor decisions – but one of the easiest ways to improve decision-making is through the provision of clear and consistent information. Piecemeal amendments to complicated tax breaks are unlikely to offer this. Surveys that look to gauge awareness of ISA rules show that

- Four out of five had the wrong date for the end of the ISA season.
- Over one in ten believed they were only available to over 21s.
- A quarter thought that only taxpayers were entitled to open an account.
- One in five believed that ISAs are run by the Government.
- 40% thought that tax benefits were lost if any money was withdrawn from an account.

In fact, by making so many tax changes, the signalling impact of those changes are undermined, meaning that even the headline message to “Get Saving” is lost. Changes to the pension tax treatment in the 1990s have reduced the value of retirement funds by up to £225 billion.²⁸

The Treasury Select Committee noted in 2007 that “[s]aving is not accorded the same priority in the Government’s strategy for promoting financial inclusion as credit, advice and banking. The evidence we have received suggests that savings, and the problems of making saving worthwhile and beneficial for those on lower incomes, are integral to any effective strategy on financial inclusion.”²⁹ It is important that this mistake is not exacerbated in the future.

The effect of taxation on saving

Theoretically, reducing the net returns to saving by taxing capital income may reduce private savings. To an economist, the likely effects depend on whether “substitution effects” (people deciding to start doing something else when they see that an alternative course of behaviour has become cheaper) dominate “income effects” (people deciding to change their behaviour because their level of income has changed). It is generally presumed that substitution effects dominate over the longer run.

On balance, it appears that taxing capital income reduces savings, but not by very much. Results from one recent study of 21 OECD countries found that, if the average capital tax rate of 40% were eliminated across the countries, then private saving would only be raised by 0.5% of GDP.³⁰

Because the increase in total taxes over the recent past has put downward pressure on the total income that a person might receive over a lifetime, saving may have fallen as a result. The shift in taxation towards levies on labour could also have reduced savings, as by redistributing income it has taken money away from the high-saving working-age population and given it to the older generations with low or negative savings. Furthermore, poor households often do not have enough money to make ends meet, so spend any extra income they have rather than putting it into a saving scheme.

Lifetime saving will also be affected by other tax issues. In particular, the extension of tax-financed public pension schemes in OECD countries may have led to a reduction in private savings by eliminating some of the uncertainty associated with savings for retirement.³¹

There is ample cross-country evidence that aggregate rates of saving and rates of economic growth are positively correlated.³² However, the direction of causality – from saving to economic growth, or from growth to saving – is more ambiguous.

Gordon Brown's raid on pensions

Before 1999, pension funds were able to reclaim their corporation tax through the Advance Corporation Tax scheme. This relief allowed pension funds in the UK to accumulate assets that made them the envy of other rich European countries with much lower pension wealth to draw on.

But in 1999 this relief was scrapped. According to some analyses, as of a few years ago this change had cost pension funds anything from £100 billion to £150 billion. According to the Institute of Actuaries: "What happened in 1997 [when Gordon Brown, the then Chancellor, decided to get rid of the Advance Corporation Tax scheme] represented an enormous and ongoing raid on the assets of UK company pension schemes. [Our] research shows it would be very hard to justify an impact of less than £100 billion – and even £150 billion may still be a conservative estimate."³³

Along with poor returns from investments in government bonds and the stock market crash of 2001, this tax change by the government appears to have cut the rate of saving accumulated in pensions funds substantially.

Where do we go from here?

To increase the aggregate savings in the economy, it might seem a truism to state that, quite simply, there must be more savers, saving more. Within this simple formula, however, lie very different approaches to policy.

- Introducing more people to saving will mean creating new kinds of incentives or at least changing the way the current ones are marketed, as well as improving financial education.
- Increasing the amounts saved by those already saving is likely to require more innovative and flexible products that reflect the increasingly unpredictable path of modern life. In essence, a coherent savings policy will have to be differentiated in order to achieve two quite different goals: that of more savings, and that of more savers. There is no silver bullet "one-size-fits-all" policy.

Current savings policies attempt to address the goal of differentiation, but at the moment they are relatively unpublicised, and poorly understood. Below is an outline of these policies, and an analysis of how they are designed to influence savings behaviour.

Current Savings Products

Child Trust Funds

- The parents of every child born after 1 September 2002 receive a voucher from the government of £250, which cannot be accessed by the child until their 18th birthday. Lower income families (below the Child Tax Credit threshold) will receive an additional £250, starting with a £500 lump sum.
- The voucher can be used to purchase a number of different Child Trust Funds: either 100% cash, or shares, or a mandated mixture of shares initially, then cash and bonds that changes as the child grows up. Each year the account can be topped up with a maximum of £1,200.
- As of the 2006 Budget, there is a further payment made to children on the 7th birthday of £250 (or £500 for children from lower-income families). After 18 years, individuals can access the money and spend it on what they wish.

Saving Gateway

- From 2010, this new cash savings account will be available for working age people on lower incomes. People qualify for an account if they receive any of the following benefits: Income Support, Employment and Support Allowance, Severe Disablement Allowance, Tax Credits (income below £15,575), Incapacity Benefit or Jobseekers' Allowance. This comprises around 8 million people in the UK.
- Each month, the person can save up to £25, over a period of 2 years. The government will match every £1 saved with 50p. After 2 years, a person who has saved the maximum will receive £900. They can withdraw the savings if they need to without affecting the government contribution that has been earned up to that point.
- If they qualify for a Saving Gateway account they will be sent a letter of invitation and an information booklet, which can then be taken to any approved Saving Gateway provider to open the account.

Personal Accounts

- PADA (The Personal Accounts Delivery Authority) is a non-departmental public body set up to help implement the reforms of the Pensions Act 2007 and 2008, with the aim to make saving for retirement the norm.
- The pensions reforms mean that all employers must offer a qualifying workplace pension scheme and all eligible workers must be automatically enrolled into this chosen scheme.
- From 2012, these schemes will be available, where the employer contributes 3%, the employee contributes 4% and the Government 1%. The Government contribution is simply tax relief, but in expressing it in this way, it is hoped that people will better understand the incentive given its presentation as a "matched" contribution.

ISAs (Individual Savings Accounts)

- ISAs were established in 1999 to replace PEPs and TESSAs and provide everyone with a tax-free savings account. The overall amount that can be invested in an ISA will be £10,200 from next April, of which half can be held in a cash ISA, and the other half can be invested in shares via an equity ISA.
- ISAs are offered by private providers and offer two tax benefits: gains that are accrued by ISAs are not subject to capital gains tax; and income tax is not payable on capital that is held in an ISA when it is withdrawn.
- ISAs dominate the landscape for short-term and medium-term savings incentives: there are now over 18 million ISA accounts held in the UK

We will now consider each of these products in more detail to determine how they might increase the savings rate in the light of the two goals established above: do they introduce more people to saving, and do they increase the amount saved by those already saving? We will outline the main advantages and criticisms of each policy before concluding how each might be improved.

Child Trust Funds

Child Trust Funds are designed to introduce more people to saving, both by the creation of a new incentive, and by improving financial capability. They are meant to help children get into the habit of saving, as well as learning to understand the benefits of saving. As David White, chief executive of the Children's Mutual, one of the UK's biggest providers of CTF accounts, explains: "[p]eople who would never have had any form of children's savings in place now have something quite substantial. In addition, both parents and children are gaining a financial education from the whole CTF process."³⁴

Advantages of the scheme

- The scheme should mean that all children have at least a modest sum of money at their disposal when they reach adulthood.
- It encourages families to consider saving for the future, as they can top-up the CTF every year. Prior to the introduction of the CTF, the Children's Mutual estimate that only 18% of children were having long-term savings made for them; the proportion of people now topping up their account is 27%.³⁵
- CTFs should contribute to financial awareness among children. Indeed, the Government states: "[f]inancial education is a key part of the CTF."³⁶ Until the age of 16, the account will be managed by the "registered contact" (e.g. a parent) but between 16 and 18 the child will manage the account,

encouraging them to think about saving and financial security as the money still cannot be withdrawn until 18.

- CTFs have encouraged financial education to develop: in 2009 the Department for Children, Schools and Families introduced (via the Personal Finance Education Group) “My Money Week” into schools prompted by the introduction of the CTF.
- It is easy to open a CTF account: all families that receive Child Benefit are automatically sent a voucher. If an account is not opened before the voucher expires (usually 12 months from issue) then HM Revenue & Customs open a stakeholder CTF account for that child.³⁷
- The product has been well received – since their launch, 4.6 million children have opened accounts, and around £2 billion is currently held in them.³⁸ “According to figures from The Children’s Mutual, prior to the introduction of the CTF less than one in five families was saving regularly for their children. This has now leapt dramatically to almost six in 10, with regular payments being seen from every socio-economic background.”³⁹
- There is a choice about how the CTF is invested:
 - a) Standard savings account that pays a rate of interest
 - b) A non-stakeholder account that invests in shares
 - c) A stakeholder account that also invests in companies’ shares (the default option if no choice is made).

Within these, it is also possible to opt for an ethical account, which does not invest in, for example, arms companies, and a Sharia account which does not invest in un-Islamic sectors such as tobacco, alcohol or gaming.⁴⁰ The CTF is likely to offer many people their first taste of equity investment, through the provision of these choices. Evidence suggests that choice is desirable and motivating for consumers and individuals feel safer when they have a degree of control over their investments.^{41 42}

Having considered the benefits of Child Trust Funds, we now turn to analysing their potential limitations. The Conservative Party recently announced that it would look to change some parts of the scheme in order to reduce the amount of money spent on it if it were in power, so there is appetite for reform among some policy-makers.

Criticisms of the scheme

- The fact that there are no restrictions on how the CTF money can be spent at age 18 has attracted strong criticism. Polls have shown that parents are concerned that their child may spend the money on items such as plastic surgery, a motorbike or just “drinking and partying.”⁴³
- Critics claim the scheme is a tax break for the rich. When income of more than £100 a year is generated by assets given to a child by a parent, it is normally taxed as if it were paid to the parent. The £100 rule does not apply to the Child Trust Fund as all income and gains will be tax-free. Therefore those parents who can afford to contribute more will receive larger tax breaks.⁴⁴

Saving Gateway

This scheme has been introduced to help people of working age on lower incomes to “kick-start” a savings habit. In this way, they are designed to introduce more people to saving, by creating a new incentive (Government matching) and improving financial inclusion – “[e]ncouraging people to engage with mainstream financial services.”⁴⁵

Advantages of the scheme

- This scheme specifically targets those for whom tax breaks do not encourage a savings habit, because they pay little or no direct tax. It is this group that needs new incentives to save, as those on lower incomes are the least likely to feel able to put money aside. Evidence has shown that households with lower incomes are those least likely to save. According to the most recent Family Resources Survey, 43% of households with a total weekly income of less than £100 have no savings at all.⁴⁶
- The pilot schemes for the Savings Gateway had broadly positive results: between the two pilots undertaken, more than 22,000 people took part, saving an aggregate total of over £15 million. The Government claims that “[t]hose who participated were overwhelmingly positive about the effect of the saving gateway.”⁴⁷

Criticisms of the scheme

- The time-limited nature of the accounts (2 years) has raised two main concerns. Firstly, it is argued that the lower income groups targeted by the scheme are penalised by comparison to higher earners, as most tax benefit schemes have no imposed time limit.⁴⁸ Secondly, the time horizon appears arbitrary: the only time-limited savings goal for most households is Christmas, implying that the scheme might be better targeted if it ran on an annual basis.

- The scheme is unattractive to commercial providers: both the British Bankers' Association and the Building Societies' Association have explained that the current business case for creating Saving Gateway accounts is unlikely to prove viable, despite their sympathy for the goals of the scheme.^{49 50}
- Although matching has been welcomed as an innovative way to kick-start the savings habit, it need not supplant the requirement for an interest rate. In fact, by failing to provide interest on the account, the ultimate goal of improving financial capability might be compromised. Citizens Advice have raised this issue, arguing that if the product does not include the key feature of a standard savings account – the interest rate – then the opportunity is lost to “...engage people with the idea that they earn interest on the money that they put aside.”⁵¹

Personal Accounts

According to PADA, there are currently around seven million people in the UK who are not saving enough to generate the pension income they are likely to want, or expect, in retirement.⁵² The scheme is therefore designed both to introduce more people to saving and to increase the amounts saved.

Advantages of the scheme

- It should ensure that low to middle income workers have access to sufficient pensions.
- The personal accounts scheme is flexible – employers will be able to choose to use the personal accounts scheme or another qualifying workplace pension.
- It is also portable – employees can take it on to another job, which is particularly useful in sectors with a high turnover of staff.
- The scheme will combat the problem of employee inertia in making pension arrangements, as employers will be required to enrol all eligible employees automatically into the scheme unless the employee concerned has exercised the right to opt out.⁵³
- The maximum administration charge is lower than most pension schemes, capped at 0.3% of the fund under management.

- There will be a choice of investment funds. They will include options such as social, environmental and ethical investments, as well as branded funds. For those not wishing to make an investment choice, there will be a default fund.⁵⁴
- In a DWP survey into attitudes towards personal accounts reform, there was broad support for the key elements: the majority of people (64 per cent) found the idea of automatic enrolment attractive; over nine in ten (91 per cent) found the employer contribution attractive; and seven in ten people (72 per cent) found the idea of automated individual contributions attractive.⁵⁵ Most people (69 per cent) said that, if enrolled into personal accounts tomorrow, they would remain in the scheme.⁵⁶

Criticisms of the scheme

- Pension providers argue that the upper limit for contributions is too high. The cap has been reduced from £5,000 to £3,600 but the pensions industry has argued that anything above £3,000 would compete against existing pension provision and possibly damage it.⁵⁷
- The Government is anxious to support good existing schemes, but critics say some employers may cut their contributions to the minimum levels set for Personal Accounts. Employers will have to provide 3% of workers' salaries into the scheme. As a result of the increased uptake by employees, employers are likely to have to reduce contributions to their current schemes (or close them down). A report by the Association of Consulting Actuaries suggests that the personal account reforms will result in the closing of many existing pension schemes, as 55% of current schemes would fall short of the proposed exemption tests.⁵⁸
- Those who criticise the low contribution rates to the scheme claim that it could restrict the pension incomes of millions of savers and force them into a trade-off with means-tested benefits. The Pensions Policy Institute has estimated that up to 45% of pensioners could lose out on means-tested benefits. When their small savings are taken into account it would mean cuts in their Pension Credit, Council Tax Benefit or Housing Benefit.

ISAs

Given that ISAs are now well established as the main vehicle to meet short and medium term savings goals, it is well known that their aim is to increase the amounts saved.

Advantages of ISAs

- ISAs are one of the few ways to invest tax-free, which is of particular benefit to high rate taxpayers. Those on higher incomes are likely to have the most available to save, and therefore should be encouraged to put it aside.
- It is easy to open an ISA, either by phone or on the internet.
- There is generally no lock-in period for ISAs and withdrawals can be made at any time, without loss of the tax advantages.
- The ISA allowance is annual, so that over a period of time a relatively large pool of savings can be accumulated.
- Most investments are covered by either the cash ISA or equity ISA option:
 - Cash (includes National Savings & Investment products, bank and building society accounts and cash funds).
 - Equity (includes equities, unit trusts, OEICs, investment trusts, life assurance, gilts and corporate bonds).
- Cash ISAs can now be transferred into equity ISAs, allowing for greater flexibility when choosing between the two options. By being able to progress from a cash ISA to an equity ISA, consumers can understand that equity is the next level of investment when they have understood the nature of investment risks. They can move on from a short-term cash investment to a longer term equity investment
- These options raise awareness of the benefits of equity investing. The UK has a particularly low level of investment in stocks and shares, which can be explained by 3 main reasons:
 - 1) the cultural obsession with housing,
 - 2) the penalising taxation associated with equity investment, such as Capital Gains Tax and Stamp Duty which can reduce a typical pension by over £10,000 and erode almost the entire initial value of the CTF (reducing the funds available after 18 years by up to £202, according to London Stock Exchange estimates), and
 - 3) a lack of understanding of how equities work.

Equities can outperform other asset classes over the long-term, as shown by the table below, suggesting that it would be beneficial for more of the UK savers who have a large appetite for risk to invest at least some of their assets in shares. The table below shows that over the long term, such as 18 years, there is a 99% chance of equity outperforming other asset classes.

Table 2: equity performance against cash and gilts⁵⁹

<i>Number of consecutive years</i>	2	3	4	5	10	18
Outperform cash	72	75	78	78	92	91
Underperform cash	36	32	28	27	8	1
Total number of years	108	107	106	105	100	92
Probability of equity outperformance	67%	70%	74%	74%	92%	99%
Outperform gilts	75	81	82	79	81	83
Underperform gilts	33	26	24	26	19	9
Total number of years	108	107	106	105	100	92
Probability of equity outperformance	69%	76%	77%	75%	81%	90%

Over an inflationary period, which we might expect to follow the current period of low interest rates, it is even more rational to invest in equities, as the table below demonstrates:

Table 3: real returns to equities, bonds and cash in different inflation environments⁶⁰

	Deflation	High inflation	The stable years
US equities	-15%	0.34%	11%
20-year bonds	4%	-3%	6%
Cash	5%	-1%	1%

Criticisms of ISAs

- The flexibility is not complete, which leads to a somewhat complicated system of rules. The whole amount cannot be invested exactly as desired: there is always a limit on the cash component, and if a cash ISA is turned into an equity ISA, it cannot be turned back at a later stage. This restriction was brought in to prevent account holders from switching to cash upon falls in the stock market.
- Although it is laudable that ISAs maintain their predecessors' (PEP and TESSA) commitment to equity investment, this leads to the complications mentioned above – to achieve maximum tax benefits, and invest the entire allowance, at least half of it must be invested in equities. In an ideal world of rational investors, consumers should be able to choose how to diversify their assets without restriction – from 100% equity to 100% cash.

- The tax benefits are not as advantageous for equity ISAs – since the abolition of the dividend tax credit, there is effectively a 10% tax on dividends. Furthermore, as the personal allowance for Capital Gains Tax is £9,600 (for 2008/09), there is no real tax advantage to an ISA being free from Capital Gains Tax unless you are a higher rate taxpayer

Overall

Despite some design flaws that have engendered criticism for these reforms, it is clear that these policies intend to introduce more people to saving. On further inspection, they could also create a base from which to increase the amounts saved:

- The CTF will mean that every young person has a financial asset. It should also improve financial education, meaning that when the child turns 18, they can continue with their savings habit, and use other kinds of savings products, such as ISAs.
- The Saving Gateway should improve financial inclusion, making those on a lower-income more acquainted with mainstream financial products. Once the 2 years are up, they should have also picked up the savings habit, and can go on to other kinds of savings products, such as a savings account.
- Personal Accounts should increase the amounts saved, both as people become used to seeing their pension pot increase over time, and due to the required employer contribution of at least 3%.
- On top of these products, there is the existing tax-free saving vehicle in the form of the ISA, which is one of the more attractive forms of saving for a higher rate taxpayer. by increasing the tax-free amount, the amounts saved should increase. Indeed, The Scottish Widows Savings and Investment Report 2009 notes that cash ISAs were held by nearly half of survey respondents, and equity ISAs by over 10%.

There are two problems that need to be solved in order to improve the situation from here:

Firstly, there are design flaws within the current policies that need to be ironed out. Secondly, the policies need to be joined up in order to present a comprehensive savings approach that delivers the goal of promoting savings as an end in itself.

We will now address each of these problems in turn, before drawing our final conclusions.

Improvements to the current system

Design of current policies

The biggest criticisms of these policies arise when it is felt that certain sectors of society lose out, and other sectors are “unfairly” rewarded. But as our analysis shows each of these policies is designed for a different audience with different needs. This is a sensible approach but the Government needs to make it clearer that each policy is in fact designed to be different in this way. Different sectors have different needs. Once all the policies are put together and presented in unison, then it will become clear that where some seem to benefit, they can also lose out elsewhere.

Furthermore, each policy can be amended in order to deliver the incentives that they were designed to achieve. We will now consider each policy in turn and outline our recommendations for how it could be improved.

Child trust funds

This is the only truly universal benefit on offer. It is important that at least one savings policy can apply to everyone, to convey the message that saving is too important for anyone to neglect it.

However, the second tranche of cash given once the child is 7 is a curious approach to encouraging saving – what behaviour is it rewarding? It would be better to offer this extra payment at the beginning of the process; that way, there will be an extra seven years of return to add to the original voucher.

The costs of the scheme have prompted some to argue that it is an expensive luxury in the current climate of budgetary belt-tightening. Reducing or scrapping CTFs now would seem unwise:

- having only been in action for 7 years, we have yet to see its full benefits, particularly the improvement in financial capability for 16-18 year olds when they manage their funds for the first time;
- the scheme has been well received, with parents choosing to invest the vouchers three quarters of the time (rather than leaving it to be automatically invested by the government);
- their universal application means that CTFs can form the foundation of a comprehensive saving policy.

We recommend that the anomaly of the extra payment at age 7 should be removed and paid at the start, and that the scheme should remain in place for all children.

Saving Gateway

The innovation of providing a matched saving product should help to trigger savings behaviour in a sector of society that is currently poorly provided for in the area of savings products. In the 2009 Scottish Widows Savings and Investment Report, matched saving ranked third in the list of incentives to save. A matched savings product could therefore tap into a group that have never saved before. Academic studies into incentives support this view. A 2003 study showed that participants agreed unanimously that matched funding "...was the most effective way of encouraging people like them to save."⁶¹ A poll conducted after the second Saving Gateway pilot scheme confirms that "...the match rate was very important in their decision to open a SG account."⁶²

There are three ways, however, to improve the SG scheme:

- Involve the savings industry in its design. At the moment, the scheme contains too many unknowns for the private sector to be able to act as providers: how is the matching calculated - on the highest amount over a period, or on average? Why is it a requirement that people can transfer the account within the 2 year period – this is very costly and time consuming given the short time period and relatively small sums of money involved? Upon maturity, will there be a delay in crediting the person with the interest or will the provider make the payment and then claim it back from the government?

If providers were able to design the product then they could make sure that it was consistent and, most importantly, clear to the customer. It should be noted that PADA's work has been very well received, and this is in large part due to the private sector background of the implementation team. They knew what private sector providers would be looking for in the creation of personal accounts.

Most banks also now provide basic bank accounts. Given that the goal of this scheme is to improve financial inclusion, it would be useful if SG account holders could open basic bank accounts to facilitate the matching payments. This would mean that once the SG time period elapses, the person could move onto other products; and they would already have a relationship with the bank, ensuring that they became part of the mainstream financial system.

- Delivery of the product is key, and must be considered in more detail. The current requirement that any provider must offer an over-the-counter cash option is potentially harmful in this regard. It adds to the cost of providing the product, and it also fails to understand how lower income groups might be incentivised to join the scheme. Benefits are often received electronically – it is therefore less likely that once this has been converted into cash, the recipient will make a special trip to deposit it over the counter

into a Saving Gateway account. An alternative approach would be to deduct the money at source: this taps into the behavioural finance idea that “what you don’t have, you don’t miss.”

If an individual did want to make a cash payment, it might be better to use providers who are currently set up to receive such small cash payments, rather than banks. Although the Post Office could fulfil this role, it might prove to be a costly burden on the state. An alternative idea would be to encourage private sector providers such as PayPoint to accept SG payments. PayPoint facilities exist in around 18,000 outlets, and Credit Unions already use PayPoint to accept loan repayments. Many users of the system prefer the anonymity of it, as no-one will know whether a late loan is being repaid, if you are depositing money or simply paying a utility bill.

- The matching rate should in some way be linked to interest rates. This is important because the goal of SG is to make savings products clear to those who might never have saved before. Matching is certainly the easiest way to express the reward for saving, but it must not be divorced from interest rates. Even the most simple of savings accounts earn a rate of interest. If the goal of this policy is to improve financial literacy and promote financial inclusion, then those who participate must learn what to expect when they progress to the next level of mainstream financial services.

We recommend that providers should be involved in a re-design of the scheme; that the channels of delivering the scheme are reconsidered; and that the matching rate should in some way be an expression of the interest rate.

Personal accounts

Understanding why people regard their house as an investment provides us with the clues for how to incentivise pension saving. It is not just about the tax break, it is also about flexibility. Demand for housing increased as people learnt that they could release some of the equity from their investment. Pensions should provide similar flexibility – people should be able to tap into some of their savings, should an emergency need arise. With no jobs-for-life any more, it seems unrealistic to expect savers to plan only for their retirement rather than more immediate “rainy day” needs.

Unfortunately, the ticking time bomb of pension provision is so important that schemes cannot be too flexible, and the Personal Accounts scheme does not offer any early withdrawals. The UK can learn much from the 401(k) plans in the USA, as well as Canada, on how to structure the schemes.

USA

Through a 401(k) plan, employees authorise their employer to deduct up to 15% of salary up to a limit of \$16,500 per annum. Contributions are made from gross income and are tax deductible. Employers can match the contribution but it is not mandatory. The plans allow both outright withdrawals and loans, usually for the following reasons:

- **Hardship Withdrawals**

This is allowed under certain conditions, such as medical expenses or disability. There is a 10% penalty of the sum withdrawn and it is liable for income tax, to discourage frequent usage.

- **Non-Hardship Withdrawals**

Some plans allow for this kind of withdrawal, again with penalties and taxes to pay if the funds are not rolled over into another retirement saving vehicle.

- **Loans**

Holders can borrow up to a limit of half their accumulated balance or \$50,000, though some plans restrict the uses to which the loan can be put. The loan must be paid back, usually within 5 years; or sooner if you leave a company with any loan outstanding.

CANADA

In Canada, withdrawals from Registered Retirement Savings Plans (RRSPs) can be made, penalty-free, for buying a house or for educational fees. There are restrictions on the house purchase: the amount is capped at C\$20,000, they must not have owned a house in the previous five years, and it must be repaid within 15 years. Once that period has elapsed, and the money has not been repaid, then the pension pot will be permanently reduced by this amount.

There is also a C\$20,000 limit for educational fees, with only C\$10,000 permitted to be withdrawn in any one year. Repayment can be delayed until 5 years after the first withdrawal, and then must be paid back within a 10 year window. Other withdrawals can be made, but at a graduated fee: 10% for all withdrawals under C\$5,000 up to 35% over C\$15,000.

Research has shown that giving such flexible options increases the rate of contribution by plan participants. A report, *Contribution Behaviour of 401(k) Plan Participants* by the Employee Benefit Research Institute and the Investment Company Institute showed that contribution rates were raised by 10% in plans that offered loans.⁶³

Furthermore, the option to borrow does not mean that every participant uses the facility. The same report showed that just 18% of the participants actually had a loan outstanding. Indeed their loan balances amounted to only 14% of total account balances (net of the unpaid loan). This implies that allowing the option to borrow does not render the concept of retirement planning redundant – people can be trusted to use the facility wisely. In turn, they contribute more to their pension, safe in the knowledge that their saving can be accessed if a short-term emergency need arises.

Therefore the personal accounts initiative should at some point offer the flexibility to access pension pots ahead of retirement. Auto-enrolment in personal accounts will take time to become familiar to people, and it is preferable to retain simplicity at the start of an initiative that is designed to change behaviour. In the longer term, however, flexibility should increase pension provision, and it should be introduced once the start-up period of the personal accounts scheme is complete.

We recommend that once the scheme is familiar to people, a flexible component to the scheme that permits early withdrawals should be introduced.

ISA

The recent significant increase in the maximum amount that can be invested is certainly welcome, given how much the economy has grown since they were first introduced over a decade ago. An annual rise in the ceiling in line with inflation should be introduced. Although this might only raise the amount a little, it sends a wider signal that inflation should be considered when making saving decisions. It also signals a wider intent that ISAs are here to stay, reassuring consumers and creating consistency.

We recommend that the maximum amount that can be invested in an ISA should every year be raised by the rate of inflation.

Delivering the policy goal

The signalling power of policy is important when attempting to embed a shift in cultural behaviour. Having considered some of the ways to improve savings products, they must then be presented in a coherent fashion, so that they don't undermine the very goal of making saving an end in itself.

Simplicity is key, as the DWP Survey explains: “[f]indings from previous research indicate that, while people value choice they are easily overwhelmed by it – particularly in contexts where the costs associated with making a ‘wrong’ choice are perceived to be high (such as making major financial decisions).”⁶⁴

The saving framework outlined in this note could be described as a combination of 4 “jam jars” for people’s savings:

Jam jar 1) long-term saving, for retirement:

- Automatic enrolment into a personal account, possibly with the added benefit of being able to unlock some of the money in a specified emergency situation

Jam jar 2) saving for a big purchase, such as the down-payment on a house:

- The tax-free ISA allowance of £10,200 could contribute to this

Jam jar 3) saving for a regular annual treat, such as a holiday or Christmas:

- Using the Saving Gateway, a matched savings scheme

Jam jar 4) saving for your children:

- Take up the free CTF voucher

To some degree, people’s choices of jam jars will then be self-selecting. Some people might not ever save up for a house deposit; some people might just save for Christmas. Behavioural Economics has shown that we commonly divide accounts into different objectives in this way, something known as Mental Accounting.⁶⁵ People are likely to focus just on the savings goals that are important to them.

People will continue to think that their homes constitute a large proportion of their savings. But if they start to use other products and see that they deliver preferable outcomes, then that might be the first step towards weaning the country off its unsustainable housing addiction.

Presenting the policy in this way will offer people simple choices and, in so doing, emphasise the importance of saving. There will be a product for everyone. To deliver the political argument of why saving can and should apply to everyone, the focus should fall on the maxim stated earlier: money may not bring happiness, but it can bring the freedom to make choices.

The political argument will also be supported by the reduction of criticisms that specific policies are unfair: it will be easier to see that if a certain sector of society cannot benefit from jam jar 2, they are still able to benefit from 1 and 4, for example. This should reduce the need for the temptation to tweak policies, and a more consistent and stable approach to savings should help to embed a long-term cultural change.

There will still be the risk that politicians try to influence voters in a specific section of society by promising to deliver more government help for certain policies. Such a problem is in the future, however, and the current parlous state of savings within this country means that more people must be encouraged to save now.

Conclusion

Although there is no silver bullet to restore the indebted consumer to balance, the current financial crisis provides an opportunity to build on a shift in consumer behaviour. Saving will come to the forefront of everyone's minds, and it is time to concentrate on increasing the number of savers, as well as the aggregate amount saved, over the long term.

There is no one policy that will achieve this goal. The answer comes in a change of approach towards savings policy – instead of piecemeal amendments, there should be a new, coherent and comprehensive set of savings policies.

To do this, the current policies should undergo a re-design, and then be repackaged as part of a new, jam jar, approach to saving. Our recommendations are as follows:

Child Trust Funds

- Make the extra payment at age 7 part of the original voucher awarded at birth.

Saving Gateway

- Ask providers to re-design the scheme;
- Consider alternative methods of delivery;
- Express the interest rate as a match.

Personal Accounts

- Introduce flexible withdrawals once the scheme is up and running and people are familiar with how it works.

ISA

- Raise the ceiling each year by the rate of inflation.

Place each in its own jam jar and then present this new framework to consumers.

Embedding a new savings culture will help to recapitalise the economy. Despite the low level of saving in Britain, the tools to solve the remedy have already been laid out. They must now be strengthened and assembled to create a sustainable framework for improving the saving rate over the long term.

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