



SAVINGS ON A SHOESTRING

A whole new approach to savings policy



Jeff Masters and Emily Farchy

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CHAPTER 1: INTRODUCTION AND SUMMARY

Saving is difficult. It requires us to take money we could happily spend today, and put it aside for tomorrow. The needs of today crowd in on us. Even if we can meet these needs, our wants can be inexhaustible. Although we understand the value of having saved, we are less keen on doing the actual saving.

Saving means standing against our impulse to spend; against entire industries of advertisers who feed this impulse; against real and imagined pressures to keep up with those around us. In the face of these psychological and cultural tides sweeping in, any decision to save is a heroic one.

This might be a problem for us as individuals. It is also a problem for us collectively. As we emerge from the deepest post-war recession a central issue is debt: the private debt that lay behind the financial crisis; the sharp increase in the stock of public debt that has resulted from it; and the financial vulnerability of many households trying to cope with it.

After the binge comes the reckoning. Our savings ratio is low. Asset inequalities are large. More than one fifth of households have more debts than savings. Too few people are making sufficient provision for their long term needs. Too few are benefiting from the increased security, freedom and opportunity that having a store of assets brings. These are big challenges that policy must address.

The coalition government has made dealing with public debt its number one priority. But it is also seeking a reassessment of the approach to private debts and savings. Before the election, George Osborne talked about the need "*to restore our savings culture*".¹ In

¹ George Osborne, Speech at the British Museum, "A new economic model", 2 February 2010, http://www.conservatives.com/News/Speeches/2010/02/George_Osborne_A_New_Economic_Model.aspx.

government, the outlines of the policy framework are starting to take shape.

It is then timely to take a fresh look at savings policy. It is a chance to reflect on the progress made by the previous government, and consider the lessons that have emerged from their policy innovations, such as the Child Trust Fund. There is a wealth of academic research that can inform policymakers.² And there is a new source of data to explore: the Wealth and Assets Survey 2006/08 offers the most comprehensive picture to date of the financial dynamics of households, and whether, how and why they accumulate assets.

This paper seeks to put savings policy in its proper context, and provide direction for the future. What should be the objectives? How do they interrelate? How can they be achieved in practice? In answering these questions, the paper offers a critique of past and present government approaches to savings policy; an overview of the literature on savings behaviour; and new empirical evidence based on data from the Wealth and Assets Survey 2006/08 and administrative data from the Child Trust Fund. These sources offer rich insight into the financial dynamics of households – the kinds of characteristics and household circumstances that are conducive to saving, and the likely effectiveness of policy interventions.

Together, these argue for a whole new approach to savings policy.

ENCOURAGING SAVINGS BEHAVIOUR

Traditional approaches to savings policy tend to focus on how to get more people to become savers, and how to get those savers to save more. The two policies that most closely defined Labour's approach – the Child Trust Fund and the Savings Gateway – fall

² See Box 1.3, page 13

into this category. Reflecting a difference in temperament and governing philosophy, the Coalition's emerging approach is less specific and prescriptive – focusing on the parameters and functioning of the market for savings products rather than the products themselves. Despite these differences, the objectives are broadly the same – getting more people to save, and more savers saving more.

There is a clear rationale for these kinds of approaches to policy, and it is both sensible and inevitable that they should form the centre piece of any government strategy. It is right to encourage people to take a longer term approach to their finances; to value their future selves more highly today; to encourage responsibility; and to ensure – one way or another – that suitable products are available.

Encouraging savings behaviour offers the most secure route to increasing the level of savings overall, and increasing the numbers of people with sufficient savings to meet retirement and other future needs. Getting people into the habit of savings has real, long-term benefits, both to the individual and collectively.

Here policy can make a huge difference. It can ensure that a range of suitable products are available; it can guide us towards the products that best fit our needs; opt us in to them; offer incentives to encourage us to save more into them. Given the tide of pressures that can undermine our good intentions, policy can help to amplify the nagging voices of our reflective selves and support the angels of our reflective selves, to listen to the angels of our better nature.

There are many improvements that can and should be made to traditional savings policies, particularly from more systematic application of insights into human psychology from behavioral economics and related disciplines.

But that is not the only way.

GENERATING OPPORTUNITIES FOR SAVINGS ACTIVITIES

The central argument of this paper is that saving could be much easier than it is: if only policy focused on creating more opportunities for savings **activities**, as well as the traditional policy approach of encouraging savings **habits**.

What does this mean? The first best solution might be to encourage people to align their shorter term behaviours with longer term goals, to encourage more 'virtuous' habits and behaviours. But this is difficult to do. There might be smarter ways to try to do this compared with past attempts. Even then, though, the evidence presented in this paper suggests it will always be a limited strategy.

A more pragmatic approach would be to facilitate many more **activities** that result in the accumulation of assets, *whether or not they promote savings habits*. Instead of seeking to encourage more virtuous savings habits, it would make a virtue of impulses to consume or procrastinate. Instead of requiring deliberate planning and forethought, the approach would do everything to help saving become a 'crime of opportunity'.

The evidence from this paper suggests there is much to recommend these kinds of approaches, especially effective for those of us that traditional savings policies have struggled to reach. For the most part, they would be complementary to policies encouraging savings behaviours, extending the reach of savings policy by having most impact on a different group of individuals and households.

MAKING GOVERNMENT CONSISTENTLY PART OF THE SOLUTION

The maxim to '*first, do no harm*', is as relevant to governments thinking about savings policy as it is to anyone else. **How** money

is paid by governments, and **who** it is paid to can have real consequences for the goals of savings policy. Aligning policy more consistently towards these objectives would make a real difference. For example:

- **Paying money differently:** Money is money is money. Or that's what you might think. But it turns out that what money is called can affect how people treat it. Most government transfers are paid as income. Some are paid as lump sums and given a label. A recent IFS study has shown how calling a cash transfer a 'Winter Fuel Payment' results in a relatively high proportion of the money being spent on heating bills.³ Tax credits are paid as income. By contrast, the less generous US equivalent, the Earned Income Tax Credit, is mostly paid as a lump sum. This affects how recipients view, value and spend the money.⁴ Government could use these signaling powers more deliberately and extensively, shifting perceptions of transfers as income for immediate consumption towards savings objectives.
- **Using existing resources more effectively:** The size of the deficit and the resulting fiscal constraints put a premium on extracting the most value from every £1 of taxes spent or foregone. At present, policies such as pensions tax relief provide relative large benefits to a relatively small group of people. Better alignment of this expenditure to the goals of spending policy might see it used to offer smaller savings incentives to a much wider group.

3 Timothy K. M. Beatty, Laura Blow, Thomas Crossley, Cormac O'Dea, "Cash by any other name? Evidence on labeling from the UK winter fuel payment", Institute For Fiscal Studies Working Paper (2011).

4 Jennifer L. Romich and Thomas Weisner, "How families view and use the EITC: Advance payment versus lump sum delivery", National Tax Journal, LIII, no. 4, Part 2, (2000).

OUR ANALYSIS AND FINDINGS

Box 1.1: Our analysis

In addition to reviewing lessons from relevant literature, the paper includes new empirical analysis based on two data sources.

The Child Trust Fund (CTF) administrative data^a

The CTF was an important component of the Labour Government's approach to savings policy, now ended by the Coalition Government. It was a policy with fairly ambitious objectives stretching far into the future. For this reason it is much too soon to make definitive judgements about the success or otherwise of the policy for the cohort who benefited. We have not tried to do so. Our more limited objective was to use the administrative data to understand emergent patterns and consider any lessons for policy makers. Even at this level it is not a comprehensive analysis – it looks only at what parents did in relation to the CTF, and not its general impact on savings and other behaviour.

The Wealth and Assets Survey 2006/08 (WAS)

The WAS is the first wave of the largest domestic survey of household finances. The survey was designed specifically to address weaknesses identified by the research and policy community in data relating to household assets. Building on initial analysis by the ONS,^b our analysis aimed to unpick the underlying correlates of wealth accumulation. We use multivariate regression analysis to isolate the independent statistical relationship between characteristics (such as income, age, gender and attitudes) and outcomes of interest (such as wealth or particular attitudes).

a HM Revenue and Customs, "Child Trust Fund statistics," <http://www.hmrc.gov.uk/ctf/stats.htm>.

b Chris Daffin, ed., *Wealth in Great Britain: main results from the wealth and assets survey 2006/08* (London: Office of National Statistics, 2009), http://www.statistics.gov.uk/downloads/theme_economy/wealth-assets-2006-2008/Exec_Sum_Wealth_in_GB_2006_2008.pdf.

Box 1.2: Lessons from the literature

In Chapter 4 we review the relevant literature on asset accumulation and savings policy. Rational perspectives – such as Milton Friedman’s emphasis on income smoothing and Franco Modigliani’s life cycle hypothesis – have been particularly influential. Policy solutions have frequently focused on removing barriers to rational decision making – for example, by closing information gaps on life cycle income requirements and the implications for saving today, and by reducing market frictions through ensuring appropriate savings vehicles are available and accessible.

The limitations of this model of decision making has been increasingly challenged by behavioural economists and those from related disciplines. Led by Daniel Kahneman, they have demonstrated how common traits of human psychology impede purely rational approaches, and weaken the transmission between decisions and actions.

Individuals have developed a range of strategies to build assets, despite countervailing impulses. For example, some create different ‘mental accounts’ to commit to using certain sources of income in particular ways. Some set targets. Others make contractual commitments – to save or to repay purchase of an asset. Indeed, the literature confirms that a lot of asset accumulation owes little to explicit ‘savings’ habits, and more to other mechanisms such as paying off a mortgage.

Increasingly, policy makers have sought to take account of these insights in the design of policy. But complexity adds to the challenges for policy. Household level studies can obscure different interests, motivations and behaviours of those within the household. Work from the Personal Finance Research Centre at Bristol University has demonstrated that savings motivations are not homogeneous – with a clear distinction between those saving for a specific purpose (instrumental savers), and those saving to create a financial cushion (‘rainy day’ savers). Others have highlighted the importance of tailoring policy motivation, design and communication towards the needs of different groups, particularly lower income groups. One size will rarely fit all. Finally, the chapter catalogues policy approaches that have been identified for their likely effectiveness.

These are important insights for policy makers. They suggest that an effective framework for policy must take account of:

- The explanatory power of neoclassical models of rational behaviour, but also their limitations
- The insights of behavioural economics and related disciplines in understanding how people actually make (or avoid making) decisions to save, the strategies and commitment devices they use to convert decisions into actions
- The vital role that institutional rules, frameworks and signals can play in reinforcing or undermining efforts to save in a multiplicity of ways.

Box 1.3: Early lessons from the Child Trust Fund, Chapter 5

Accounts opened and investment choices

- By 2009, almost 5 million CTF accounts had been opened, three quarters by parents, one quarter assigned to a provider by HMRC.
- Children from lower income households were almost twice as likely to have their accounts allocated by HMRC (34%), compared with children from higher income households (18%).
- Stakeholder accounts accounted for 76% of all CTF accounts, with 2.5 million of these accounts opened by parents, and 1.1 million opened by HMRC.
- Almost a fifth (18%) of accounts were savings accounts opened by parents. Only 7% were invested in a share portfolio controlled by the parents.
- Where parents made an assignment, the investment decisions made by higher and lower income households were virtually identical.

Additional contributions

- Family and friends had made additional contributions to 22% of CTFs, averaging £289 a year. Contributions were more frequent in higher income households (27%) and higher on average (£313 per

year) than in lower income households (12%, averaging £181 per year), although it is difficult to isolate the impact of higher income alone without additional statistical controls.

- Contributions were most frequent (32%) and on average highest (£366 per year) in parent controlled share accounts. They were least likely in HMRC allocated accounts (just 2%).

The value of CTF accounts

- Accounts of higher and lower income children have, on average, both grown in value. But those of higher income children have grown much faster.
- The initial £250 advantage enjoyed by children from lower income households has quickly eroded. CTF accounts (from all years) opened with a £500 voucher were worth an average of £675, compared with £673 for CTF accounts (from all years) opened with a £250 voucher, owing to the higher savings rates for the latter.
- Initial parental choices about whether and how to invest the CTF voucher are highly predictive of subsequent behaviour.
- HMRC allocated accounts have the lowest average values of all types of accounts, due to very low rates of parental contributions.
- Accounts managed by higher income households have increased in value the most, as parents who have made the most active investment choice have also made the largest additional contributions.
- If current trends continue, it is clear that the value of CTF accounts for children from higher income households will substantially exceed the value of CTF accounts for children from lower income households on maturation.

Overall

- In static terms, the policy was straightforwardly redistributive, giving a £250 advantage to children from lower income households. It is too early to evaluate many of the most important dynamic effects expected from the policy, including any categorical benefits of having a store of assets on children's expectations and behaviours.

- Shorter term effects on parental behaviour are easier to observe. The availability of the policy may have induced more parents to save on behalf of their children. If that was the case, the initial investment decision proved an excellent sorting mechanism between those who were induced to save, and those who were not. Parents who made a positive choice about where to invest the initial CTF voucher were much more likely to contribute than parents who passively allowed an HMRC allocation. And the more active the choice, the more likely they were to contribute subsequently.
- It is more difficult to distinguish between those in the group of active investors who would have saved anyway, and those induced by the policy. It is also difficult to distinguish how far parental contributions into CTF accounts were additional savings, rather than substitutes for other types of saving that would have happened anyway. The imminent interim evaluation of the CTF is expected to shed light on these questions.
- If the benefits of having assets are mostly categorical, then differences in the actual values of matured CTFs are of little concern. But if differences in the amount accrued do make a substantive difference to a child's opportunity and security, then the evidence to date that the policy reduced inequalities is less positive.
- To the extent that these additional parental contributions were induced by the policy, the overall effect will have been to increase absolute inequalities (even if relative inequalities are mathematically reduced by every child having at least some assets).
- On the limited evidence to date, the positive dynamic impacts of the policy appear to have accrued to households who were already more motivated to save for their children (and may have done so anyway). Within this group, any benefits are more likely to have accrued to households with higher incomes.

Box 1.4: Our findings from the Wealth and Assets Survey 2006/08, Chapters 6, 7 and 8

The detailed findings from our analysis of the WAS are set out in Chapters 6 to 8. They are summarised here.

- Some of the findings from the analysis were fairly intuitive, and can be explained using standard neoclassical approaches. For example:
 - There is a positive association between income and wealth
 - Household wealth increases with age up to retirement, then declines
 - Those with lower incomes are more likely to borrow to make ends meet and pay bills, and have to borrow in less efficient ways
 - Those on higher incomes are more likely to pay off credit card debts completely, avoiding higher interest payments.

They are a useful reminder that, for all the insights of behavioural economics and related disciplines, many simple truths still hold. The important association between income level and better household finances is a stark reminder of the limits of what savings policy might achieve - but other findings give those specifically interested in savings policy greater reason to hope.

- A substantial proportion of asset accumulation does not result from direct savings out of income. A potential role for policy is highlighted by the contrast between the notable association between income, and financial and pension wealth (assets that require an element of deferred consumption) and the more limited association between income and the accumulation of assets that have an element of consumption – such as physical wealth and housing. Not all financial wealth requires direct savings. Households might gain financial wealth as a result of inheritance or other windfall but maintaining a stock of financial wealth does require the deferral of consumption.
- For the accumulation of those assets where actual saving may be required (financial and pension wealth), institutional factors appear

to make a difference to the level of asset accumulation. Household heads in occupations that were more likely to offer occupational pensions were more likely to have higher pensions savings. This occupational impact was distinct from other factors associated with higher accumulated wealth such as income or education.

- Beyond the influence of income on the financial dynamics of households, what is striking from the analysis is the role that attitudes play. Certain attitudes - such as a longer term perspective, a tolerance for financial risk, and a 'savings orientation' - all have a significant and positive relationship to levels of accumulated wealth, even after the impact of income and other relevant characteristics has been taken into account.^a
- While some of these attitudes are associated with innate characteristics, others are associated with characteristics that policy might more easily influence. Holding all other factors constant, being female and having a child are both associated with having a spending orientation, whereas being retired and single reduce the likelihood. On the other hand, impatience (wanting more immediate returns) is positively associated with a spending orientation, suggesting a role for policy in encouraging people to think longer term about their patterns of consumption.
- On debts and debt repayments, the analysis found that households with lower incomes are more likely to borrow to meet more immediate needs, and through more costly vehicles. In contrast, those with higher incomes were more likely to borrow for income generating purposes such as financing a business. In addition, the wealthier are more likely to borrow in more efficient ways. Behaviour in relation to credit card repayments is illuminating. The likelihood of clearing a balance rises sharply with income, and is higher among savers, the more patient, and the more educated.

^a Note that these are just associations, and it is not possible to draw conclusions about the direction of causality. It could be that having greater wealth makes people more patient, more tolerant of risk and gives them more excess income to save, rather than the other way around.

- The likelihood of taking financial advice similarly increases with income and education. Again, attitudes are very important predictors of who might seek advice. Holding all else constant, spenders, the impatient and the risk averse were all less likely to seek financial advice of their own volition.

IMPLICATIONS FOR POLICY MAKERS

The review of the literature and the new empirical evidence in this paper give plenty for policy makers to chew on. Five themes have emerged of particular relevance.

1. There are tensions between different, legitimate goals of savings policy: clear priorities are needed.

The scale of the challenge for savings policy is large. The savings ratio is low. Asset inequalities are large. Too many households are financially vulnerable today, and too few are accumulating sufficient assets for the future.

But in seeking to address these goals, there are genuine tensions. Efforts to increase the aggregate level of savings may conflict with policies that seek to increase the numbers of households with savings or to reduce asset inequalities. Approaches best suited to increasing the savings ratio may not be ideal for increasing the proportion of financially resilient households.

The CTF offers a good illustration of these tensions. The policy allowed every child to enjoy any categorical benefits from having even a small store of assets – its primary objective. It may also have increased the amount of savings for children overall. But, to the extent that it did, it will also have widened the gap between the assets available to the richest and poorest children.

Different political traditions may attach different weightings to the importance of increasing overall savings as against distributional concerns. As times and problems change, this balance may also change. The important thing is to understand the interrelationships and tensions between the different objectives, be clear about priorities, and allow these priorities to shape the policy design.

2. It is important to do traditional savings policy better, and there is plenty of scope for improvement.

Overall, the findings offer strong support for traditional policy approaches that encourage savings behaviour: getting more of us to become savers, and encouraging us to save more. Two reasons stand out:

- As neoclassical economists understand, **individuals and households have strong rational incentives to save**. There is evidence of income smoothing across the life course, as people accumulate assets in anticipation of retirement. In line with predictions of rational life cycle models, there is a positive association between income and wealth, with savings increasing in response to higher permanent incomes. Policies that work with the grain of individual self interest are therefore likely to be successful. There is some suggestion in our empirical findings – and much more from the wider literature – that institutional arrangements which help to support this self interest enable individuals and households to save more.
- **Attitudes really matter to the development of a savings habit:** considering yourself a saver not a spender; having a comfort level with financial risk; being patient about financial returns. These are the kinds of people who are most likely to respond to positive encouragement to save, and might be easiest to persuade to save more. The parents most likely to contribute to their child's Child Trust Fund were those who made a positive investment choice when they opened it. Policies that build on these attitudes and propensities are likely to succeed. If the policy priority is to increase the level of savings overall, improving the savings ratio, then those with a pre-existing savings propensity

should be the first to be helped and encouraged to save more. This is the low hanging fruit of savings policy.

The findings also suggest that there is plenty of room for improvement in traditional approaches. They emphasise the importance that institutional arrangements and system messages can make in supporting good intentions to save and converting them into savings habits. For example, if the public subsidy in the CTF had been a marginal incentive rather than a lump sum then this might have strengthened incentives for parents to save more into the fund.

Savings decisions are complicated and easy to put off. Anything that can precipitate savings decisions, or make staying in a savings programme the default option reduces the psychological costs.

3. There are limits to the effectiveness of a ‘savings habit’ approach.

Our analysis of the WAS revealed the strong association between attitudes and asset accumulation (particularly financial assets). This was also implied by our analysis of the CTF administrative data.⁵

Changing attitudes might be a desirable aim of policy but, in practice, it is difficult. Few policy challenges are as difficult as trying to engender a savings habit among people who don’t have one. As a result, a ‘savings habit’ strategy that succeeds in encouraging existing savers to save more, might not succeed in encouraging saving among those not already inclined to save.

This is an important insight. A ‘savings behaviour’ strategy may well help in raising the level of savings overall, a valuable goal. But it is likely to fail in other goals for policy, such as increasing the share of households with savings, or reducing asset inequality. To

⁵ Of course, it is not certain whether savings attitudes precede savings habits, or savings habits are justified by savings attitudes.

this extent, such policies – including ISAs and the Child Trust Fund – carry high deadweight costs.

4. There are good – mostly complementary – alternatives: focus on ‘savings activities’

Savings attitudes might make the accumulation of assets more likely, but they are not imperative. They are most relevant to the accumulation of financial assets (where the largest disparities in wealth are found). They are less relevant to assets with a consumption element – such as housing and physical wealth.

This insight could have much wider implications. Accepting that people don't have to develop a savings habit in order to build a pot of savings or other assets opens up many other possibilities for savings policy. A lack of a savings habit need not be a barrier to building assets in the right policy environment.

And unlike in many areas of policy, there is little conflict between a dominant ‘savings habit’ strategy, and other approaches. Indeed, many of the insights that point towards ‘savings activities’ strategies could also be used to increase the effectiveness of the dominant ‘savings habit’ strategies.

Pursuing both strategies together could increase saving overall as well as increasing the share of households with a pool of savings. Pursuing a ‘savings habit’ strategy alone runs the risk of increasing asset inequalities. To the extent that asset inequalities are viewed as a priority, pursuing a ‘savings activities’ strategy as well might help to mitigate this risk.

5. The role of government is nuanced

Many of the findings in the paper are things that government can act on directly. These range from the design of specific policies or tax incentives to the signals that government sends in the way it makes cash transfers. But other things depend on cooperation from a much broader range of actors. Below we summarise nine specific ideas for

policy, based on the findings in the paper. For many of these ideas the role of government will not be to carry them out itself, but to catalyse, persuade, guide, reward and regulate so others will do.

BRINGING IT ALL TOGETHER – APPLYING THE INSIGHTS

How could these insights be applied to policy? Using the framework for policy set out above, the table below offers a range of ideas for policy makers. Some of ideas for policy makers. Some of these ideas, particularly around encouraging savings behaviour, are close to actions the Coalition Government is already doing or contemplating. Others go well beyond. The point here, however, is not to be prescriptive. Rather it is to encourage policy makers to be creative, working within a framework of ideas that has solid roots. The ideas summarised here are developed further in Chapter 9.

Table 1.1: New ideas for savings policy

Theme	Ideas for policy
<p>1. Encouraging savings behaviour – cultivate attitudes and habits associated with asset accumulation, and help people in converting positive intentions into savings behaviours</p>	<ul style="list-style-type: none"> • Ensure accurate and simple information is more available • Build financial capabilities and precipitate decisions by offering proactive advice about budgeting, saving and longer term financial planning • Stimulate provision and adoption of ‘jam jar’ accounts to help with budgeting and saving • Stimulate a diverse range of financial products, making it more likely that prospective savers will find a product that matches their needs • Capitalise on points of change by promoting the ‘Save More Tomorrow’ concept in which employees pre-commit to putting future pay rises into a pension or savings plan

Theme	Ideas for policy
<p>2. Generating opportunities for savings activities</p> <p>– make it easier for people to accumulate assets without ever developing a ‘savings habit’ in the traditional sense</p>	<ul style="list-style-type: none"> • Exploit passivity: extend the use of opt ins beyond NEST to other savings plans • Link Save More Tomorrow to NEST: so that future pay rises are added to minimum 4% employee contributions • Make saving a ‘crime of opportunity’: establish a generic platform, similar to an Oyster card, to channel small amounts of savings into savings accounts. This Savings Smartcard would allow multiple applications to be developed, increasing opportunities to save • Bill round ups: encourage supermarkets to offer to round up customers’ shopping bills to the nearest £5 or £10, channeling the difference into savings accounts using the Savings Smartcard • No lose lottery: make savings a form of consumption through a new lottery that pays a proportion of the ticket price directly into savings accounts using the Savings Smartcard, while still giving opportunities to win major prizes • Give citizens assets in things they already ‘own’: for example, by distributing shares in assets transferred from public ownership
<p>3. Making government consistently part of the solution – using government itself to encourage asset accumulation</p>	<ul style="list-style-type: none"> • Pay a portion of tax credits as a lump sum • Use existing resources more effectively: for example, by replacing the pensions tax relief with a more broadly based pension contributions matching scheme • Understand and use the differential power of particular incentives for different income groups

CHAPTER 2: THE SCALE OF THE CHALLENGE

"It would be something of an understatement to say that savings levels were too low. In fact household saving was negative in 2008 for the first time since the 1950s. Far too few were saving for a rainy day. Before the crisis more than a quarter of households had no savings at all; almost half had less than £1500 in savings; and of those who were in debt, many were in arrears, at an average level of £1,100. As a Government, we are committed to helping families to take greater responsibility for their finances and to cushion themselves from future shocks."

Mark Hoban MP, Financial Secretary to the Treasury⁶

This chapter sets the context for the savings policy by outlining the scale of the challenge. The challenge manifests itself in three ways:

- The differences between the savings ratio in the UK and other comparable countries, as well as over time;
- The stark disparities in household wealth; and
- The large number of households without a sufficient stock of assets.

The large number of households with insufficient assets are financially vulnerable during periods of temporary falls in income, particularly due to a lack of liquid assets. As a result they are likely to be dependent on additional public support in retirement due to a lack of pension saving. Throughout their lives, they will also miss out on the benefits of increased security, freedom and opportunity that having a store of assets brings.

⁶ Mark Hoban, Speech at the Consumer Financial Education Body conference, "Promoting a responsible approach to personal finance: the government's vision", 14 July 2010, http://www.hm-treasury.gov.uk/press_26_10.htm.

This chapter argues that action is needed on all three of these fronts: on the amount of savings overall, on the distribution of household assets, and on the number of households with adequate savings to create financial resilience, independence and opportunity. Whichever approach is taken to policy solutions, the scale of the challenge involved suggests a step change in focus is required.

THE SAVINGS RATIO

Going into the recession the state of many households' finances was poor. Overall, the household saving ratio was low by historical standards, and low by comparison with the Euro area average.

As Chart 2.1 below shows, the UK household saving ratio has declined since the late 1970s, with rebounds in the ratio during subsequent recessions in the early 1990s and 2008. This is especially marked following the recent recession which led to the saving ratio increasing from a low of -0.7% in the first quarter of 2008 to reach 8.4% by the third quarter of 2009. This was as a result of falling expenditure both on services and on durable goods as households sought to repay their debts.

Chart 2.1: UK household savings ratio*



*Current prices, seasonally adjusted. Source: Office for National Statistics

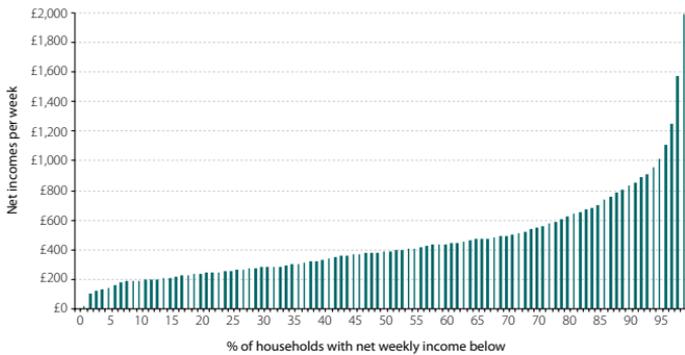
Viewed comparatively, the UK has a markedly lower saving ratio than the Euro Area 16, which varied between 13% and 16%

throughout the ten years up to 2009, though the gap has narrowed since the recession. The UK saving ratio has closely matched the savings ratio of the USA over quite a long period of time, with only some divergence in the 1990s as the UK saving ratio rose over the start of that decade. Convergence with the USA rather than the Euro Area might be a result of similarly cheap and available credit in the Anglo-Saxon economies as compared with the Euro Area 16.

ASSET INEQUALITY

Moving from the aggregate levels of saving to the distribution of assets, the context is of large scale asset inequality. Whether it is a lack of assets that increases financial vulnerability and reduces the freedom people have to pursue opportunities, or the lack of ability to accumulate assets, the problem is significant. This was well documented in the National Equalities Panel’s comprehensive tome, *An Anatomy of Economic Inequality in the UK*.⁷ As a comparison of Charts 2.2 and 2.3 taken from the report show, household asset holding in the UK is much more unequal than household income.

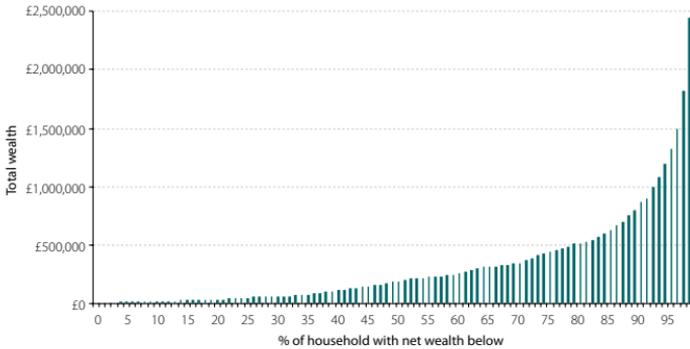
Chart 2.2: Equivalent net income before housing costs, UK, 2007/08



Source: DWP, based on HBAI dataset. Incomes are adjusted to be equivalent to those for a couple with no children. For a single person, divide actual net income by 0.67; for a couple with child under 14 by 1.2; for a couple with 2 children under 14 by 1.4; etc, following 0.2 for each additional child under 14, and 0.33 for children aged 14 and over, or add additional adults.

⁷ John Hills et al, *An anatomy of economic inequality in the UK: report of the national equality panel* (London: Government Equalities Office, 2010).

Chart 2.3: Total net wealth, UK, 2006/08



Source: ONS based on WAS.

While the overall picture is clear, trying to quantify the differences in inequality between income and wealth is more difficult. In particular, comparing the top and bottom of the income and wealth distributions (through, for example, a 90:10 ratio) can be misleading. This is because those in the bottom 10th of the wealth distribution have little or no wealth. Comparing the 90th percentile to the median (the 90:50 ratio) the NEP find that the ratio for total net wealth (4.2 to 1) is twice the ratio for equivalised net income. Comparing the top percentile to the median (the 99:50 ratio), they find the ratio is 5 to 1 for equivalised income, but 13 to 1 for total net wealth. Overall, they calculate that the Gini coefficient – a number between zero and one that measures the degree of inequality – for total net wealth is 61%, compared with 36% for net income.⁸

While these inequalities are stark, they are not necessarily unique to the UK context. As the NEP report shows using data

⁸ Ibid., 60.

from the Luxembourg Wealth Study, wealth inequality in the UK is not only lower than the US (wealth Gini of 81% or 84% dependent on data used), but also Germany (80%) and Sweden (89%).

As well as the many other differences between countries and national contexts, the cross-national differences suggest that policy can and does make a difference to levels of overall saving as well as incentives to save.

For some countries this is not surprising. The US has a relatively unequal income distribution. It also has a concentration of wealth at the top (and particularly in the top 1%). These two facts are likely to be related as any differences between income and consumption compound over time.

But Sweden – with a much less unequal distribution of income – also has a very unequal distribution of private wealth. The NEP suggests that this reflects differences across welfare regimes in the need for private savings to ensure financial security. A generous public pension system, for example, would reduce the importance of private savings for a comfortable retirement for citizens.⁹

This is an important point for policy makers to remember. Policies to encourage savings do not exist in a vacuum. Incentives and disincentives to save are shaped by the broader economic and policy environment. Specific savings policy can only do so much: sometimes the solutions will lie elsewhere.

9 Ibid., 61.

THE HIGH NUMBER OF FINANCIALLY VULNERABLE HOUSEHOLDS

Chart 2.3 showed that only 1.6% of households actually have negative wealth, with the bottom 1% having negative wealth of £3,140. This included all types of wealth – physical wealth, as well as pension wealth, financial wealth and housing wealth. But pension, housing and physical assets are of little use to protect families against financial distress. They need more liquid assets. Here the picture is more bleak.

According to the Wealth and Assets survey 2006/08, Households in the bottom decile have, on average, negative household wealth to the tune of £12,100. Meanwhile those in the second decile also have negative levels of this form of savings. Net financial wealth in the third decile, meanwhile, averages just £3,200.¹⁰

This reveals the scale of the problem for households with very low levels of assets, and particularly liquid assets. At least a fifth of all households have negative financial wealth – the most liquid and therefore useful source of wealth in times of need. It highlights their vulnerability to – even temporary – financial shocks; their likely longer term reliance on additional public support in retirement; and their inability to enjoy the security, freedom and increased opportunity that come from having a store of assets. The immediate priority must be to increase the resilience of household finances in the UK, by increasing the number of households with a store of liquid assets.

CONCLUSION

This chapter has reviewed the scale of the challenge facing policymakers: The savings ratio is low, asset inequalities are large,

¹⁰ Office for National Statistics, *Wealth and assets survey 2006/08* (London: Office for National Statistics, 2009).

and too many households are financially vulnerable today and are not accumulating sufficient assets for the future.

Given this challenge, what has been the policy response to date? Compared with the previous Labour Government approach, how much more successful is the Coalition Government likely to be? This is the focus of the next chapter.

CHAPTER 3: THE GOVERNMENT'S APPROACH IN CONTEXT

The deepest recession in modern times has led to a reassessment of many of the accepted axioms of economic policy. What was the cause of the recession, what is the best strategy for recovery, and how can we ensure that future growth is more balanced and sustainable?

A central issue in this debate is debt: the private debt that lay behind the financial crisis; the sharp increase in the stock of public debt that has resulted from it; and the financial vulnerability of many households trying to cope with their debts.

The coalition government has picked over the bones of the legacy from Labour. In some areas of policy there will be continuity. Recommendations from Turner's review of pensions will continue to be implemented. ISAs have been retained and improved with a commitment to index contribution limits. The Financial Inclusion Taskforce was allowed to complete its programme of work.

In other areas, however, there is a clear change in direction. The two savings policies that most closely defined Labour's approach – the Child Trust Fund and the Savings Gateway – have been scrapped. In time, the Child Trust Fund will be replaced by Junior ISAs – similar in intent, but without state contributions that were a defining feature of the Child Trust Fund. The Savings Gateway – a savings matching policy for low income savers – was years in gestation and piloting, but was cancelled before the national rollout planned for July 2010.

Mark Hoban, the Minister responsible, has begun to develop the government's strategic approach in a series of speeches. Framed within the Government's core themes of freedom, fairness

and responsibility, the focus is on promoting responsibility in personal finance:

"...families themselves need to take responsibility for providing for their future, especially as the cost of doing so is rising inexorably. ...the key question remains: how do we get all people at all stages of life to think ahead and plan for their future? And what can the Government do to help?"¹¹

For the Coalition Government, the policy response to these questions should be built around three components:

- **Advice** – improving the financial advice available to people, equipping them to plan and manage their finances more effectively.
- **Products** – developing the supply of financial products that are both commercially viable and meet the needs of customers.
- **Information** – improving the quality and comparability of information on financial products to allow consumers to make informed choices.

In this area of policy, as in many others, the Coalition Government has been quick to criticise the Labour legacy, and unpick many of its policies. It is still early days in terms of the detail and application, but it is not too soon to be asking how far the Coalition's broad approach is likely to be more effective, and for whom? And even if it is successful in raising the overall level of savings in the economy, will it be able to increase the number of households with sufficient savings to rely on, or reduce large inequalities in household wealth?

11 Hoban, "Promoting a responsible approach to personal finance: the government's vision".

Box 3.1: The growing interest in savings policy, and the new sources of data

In recent years, there has been a growing interest in understanding how policy might influence the financial dynamics of households, savings behaviour, and asset accumulation - particularly for lower income families. In this time, a range of (efficiency and equity) arguments have been advanced for why the distribution of assets should be a concern for policy makers: from the impact on wellbeing, to the nature of citizenship, to the positive behavioural effects of asset holding.^a

Michael Sherraden's groundbreaking 1991 study, *Assets and the Poor*^b generated widespread interest around the world in ideas of asset based welfare. Although more frequently discussed than implemented, this work has inspired policy innovation - most notably in the UK with the Child Trust Fund.^c This has created new evidence which can be used to evaluate the claims of those who advocate this approach, and to understand how to improve future policy design.

A substantial body of research has emerged devoted to understanding how and why people save, with much of it in the UK led by the Personal Finance Research Centre at the University of Bristol.^d There has been widespread interest in how the insights of behavioural economics might inform policy, popularised by Richard Thaler and Cass Sunstein's bestseller, *Nudge*.^e The Coalition Government has set up its own Behavioural Insight Team in the Cabinet Office, led by David Halpern. New sources of data have been generated to respond to gaps in knowledge, most importantly the Wealth and Assets Survey 2006-08.^f

a Omar Khan, *Why do assets matter? Assets equality and ethnicity: building towards financial inclusion* (London: Runnymede Trust, 2010).

b Michael Sherraden, *Assets and the poor: a new American welfare policy* (Armonk: M.E. Sharpe, , 1991).

c Michael Mendelson, "Asset-based social programs: a critical analysis of current initiatives", *OECD Social Issues/Migration/Health 2007*, (2008), 204-236. The author notes that, for all the rhetoric about asset based welfare policies around the world, "the UK seems to be alone in introducing a large new country wide asset-based program.... [S]ixteen years after Sherraden's study the sum total of asset-based programs remains modest indeed".

d <http://www.bristol.ac.uk/geography/research/pfrc/>.

e Richard H. Thaler and Cass R. Sunstein, *Nudge: improving decisions about health, wealth, and happiness* (USA: Caravan Books, 2008).

f Office for National Statistics, *Wealth and assets survey 2006/08*.

LABOUR AND THE COALITION: DIFFERENT JOURNEYS, SAME DESTINATION?

In setting out its rationale for action, the Coalition Government has emphasised:

- How savings can increase the financial resilience of households in the face of income shocks;
- The importance of personal responsibility in generating these savings;
- Fairness, and
- How savings can increase the freedom people have to pursue the lives they choose.

In many ways, these objectives are not dissimilar from the policy goals articulated by previous Labour governments. In 2000, the principles underpinning Labour's approach to savings policy were explained as providing people with: *"independence throughout [life]; security if things go wrong; and comfort in old age"*.

The strategy for solutions also seems quite familiar. Having identified failures in both the supply and demand for savings products, the focus of the government's strategy in 2000, the focus of the Government's strategy was to: *"create the right environment for saving; create the right incentives for people to save; and provide information and education to help people to make the right saving choices."*¹²

In 2003, the Labour government explained its approach in language even more similar to the Coalition Government:

"The Government's strategy for promoting saving and asset accumulation is founded on its core welfare principles:

¹² HM Treasury, *Helping people to save: the modernisation of Britain's tax and benefit system, number seven*, (London: HM Treasury, 2000), 1.

- *security – helping individuals accumulate a stock of financial assets for times of adversity;*
- *opportunity – assets enable individuals to take advantage of opportunities throughout life and widen choice; and*
- *responsibility – developing the saving habit to promote independence.*

Building on these principles, the Government aims to widen the opportunities for saving, especially for those on low to moderate incomes.¹³

This change in emphasis – towards “responsibility” – was presaged by a further HM Treasury publication at the time of the 2001 Budget.¹⁴ This paper introduced three ideas that proved influential in Labour’s policy approach:

- It linked savings and assets to life chances;
- It argued that having savings and assets produced positive feedback effects on behaviour; and
- In the context of policy solutions, it emphasised how institutional factors could influence savings behaviour, not just level of income.

It proposed that policy should be based on:

- *“Developing saving habits: policy should tap into and develop positive attitudes towards saving, with a particular focus on saving by and for children.*
- *Targeting: to extend the reach of Government saving policy, new measures should be targeted at those who currently have low levels of savings.*
- *Incentives: policy should deliver incentives for people to develop a regular and sustainable saving habit. The limited*

¹³ HM Treasury, *The strength to take the long-term decisions for Britain: seizing the opportunities of the global recovery* (London: HM Treasury, 2003).

¹⁴ HM Treasury, *Savings and assets for all: the modernisation of Britain’s tax and benefit system, number eight* (London: HM Treasury, 2000).

*value of tax reliefs for lower-income households means that policy should consider a wider range of incentive mechanisms.*¹⁵

This shows that there is substantial overlap between the previous Labour and current Coalition Government's objectives. In their different ways, both governments have followed variations on the traditional approach to savings policy explained in Chapter 1. There are differences of emphasis and priority, and there are some differences in language: where Labour talked of "opportunity" the coalition use the language of "freedom". But overall, the similarities are more striking than the differences.

Where the difference lies is in how these objectives are brought to life. The Coalition's starting point is almost identical to Labour's in 2000, but very different from Labour by 2010. Partly this reflects the more constrained fiscal environment, given as the Coalition's primary rationale for scrapping the Child Trust Fund and the Savings Gateway rollout. It will limit policy options in the foreseeable future. Partly it reflects the Coalition Government's concerns about the effectiveness of its policy inheritance. Partly it reflects the natural desire of new governments to develop their own solutions, just as the newly elected Labour government replaced TESSAs with fairly similar ISAs.

But it also reflects genuine differences in governing philosophies. Both the previous Labour and current Coalition governments talked of individuals and households taking greater "responsibility", but understood from this quite different implications for the role of government.

For the Coalition, government should step back so that households can step forward. Government should ensure that the

15 Ibid., 15.

right advice and information are available. This will help households navigate their way through a richer variety of market offerings to find the products most suitable for them.

For Labour, government needed to do more to help households assume greater responsibility. It did this by creating very specific products designed to increase the number of people with savings and to develop savings habits. Key to this was the inclusion of financial incentives: a lump sum to kick-start saving for children in the Child Trust Fund; and strong marginal incentives to save in the Savings Gateway.

Aside from the fiscal considerations and a weakness all governments have for 'newness', these differences perhaps explain why the Coalition has embraced ISAs, but abandoned the Child Trust Fund and the Savings Gateway. So while the route might be different for the Coalition from its predecessor, the destination is very much the same: to turn more Britons into good habitual savers.

CONCLUSION

This chapter has sought to put the current Government's approach to savings policy in its political context. It has teased out the similarities and differences in strategy, language and approach to understand the continuities of policy as well as the divergence. Although there are differences, both approaches fall firmly within traditional savings policies as defined in Chapter 1: trying to get more people to become habitual savers, and to get savers to save more.

But given the scale of the challenges outlined in Chapter 2, these responses seem inadequate – particularly to the task of dealing with the financial resilience of those families without assets. Instead, we need to supplement this approach by asking

“What kinds of policies are likely to make the most difference to the accumulation of assets across the board, particularly among lower-income families?” To answer this means first understanding what motivates households to accumulate assets; considering how they go about doing so; and the kinds of things that stand in their way.

CHAPTER 4: WHY DO PEOPLE SAVE?

DAVE SEVILLE: They're savings bonds. You know, in seven years, you're gonna get to buy something really nice.

ALVIN: Do you have any that you maybe bought seven years ago?

from Alvin and the Chipmunks¹⁶

This chapter looks at the theoretical and empirical understandings of asset accumulation and savings behaviour. Understanding both what motivates people to accumulate assets and what barriers they face is essential to developing a successful policy approach to tackle the challenges outlined above.

The chapter begins with John Maynard Keynes' catalogue of eight distinct motivations to save, and the neoclassical reaction based on assumptions of rationality: that households are simply trying to smooth their consumption over the lifecycle.

These assumptions have proved helpful in understanding general tendencies at the aggregate levels. Having 'surplus' income makes a difference to the likelihood of accumulating assets. The greater concentrations of wealth, compared with income, demonstrates that differences in the ability of those with higher incomes to save compounds over time.

But the neoclassical perspective is of less value in understanding variations in assets amongst those with similar incomes and at similar points in life. Other than encouraging more rationality and increasing everyone's incomes, it does not lend itself towards policy solutions. It does not have a sufficiently nuanced account

16 Alvin and the chipmunks, Film, Directed by Tim Hill USA, 20th Century Fox, 2007.

of individual and household decision making and behaviour to suggest an effective policy framework which might – at the margin – increase the level of savings, flatten the distribution, or increase the number of more financially resilient households.

More helpful are the insights of behavioural economists from Daniel Kahneman onwards on how individuals actually navigate life. Theoretical and empirical research points to the importance of attitudes, disposition and institutional constructs in understanding who, how and why people save and where policy might make a difference.

The chapter considers the struggles that we face to defer consumption (which can be made harder depending on our attitudes). It looks at the ‘internal’ strategies that we use to overcome problems of self control. It then considers how ‘external’ institutional factors can help or hinder our decisions to save and our ability to follow through on them.

KEYNES’ THEORY OF SAVING AND THE NEO-CLASSICAL RESPONSE

A pound of income today can be spent or saved. If it is saved today it can be spent tomorrow. In this way, saving can be understood as deferred consumption. Given all the demands on income today, why do people save?¹⁷

In his 1936 opus, *The General Theory of Employment, Interest and Money*, Keynes explained the overall level of consumer demand as being determined by subjective as well as objective factors. Objective realities include the level of interest rates and taxes, as

17 The framework used in this chapter (the limitations of rational models, the relevance of psychological factors and the importance of institutional context) owes much to the review of relevant literature in Margaret S. Sherraden, Amanda Moore McBride and Sondra G. Beverly, *Striving to save: creating policies for financial security of low-income families* (Michigan: University of Michigan Press, 2010).

well as the overall distribution of income. For a particular individual deciding whether to spend or save a pound of income, subjective factors – or psychological motivations – such as future uncertainty or a desire to make a bequest to heirs, might also be relevant.¹⁸ Overall, Keynes identified eight distinct motivations for saving:

- **Precaution** – establishing a cushion against financial shocks
- **Foresight** – in anticipation of future falls in earnings, such as through retirement
- **Calculation** – to earn interest from capital
- **Improvement** – to enjoy a progressively better standard of living over time
- **Independence** – to have the means to make changes to our lives
- **Enterprise** – to be able to make investments when favourable to do so
- **Pride** – to be able to leave money to heirs
- **Avarice** – or simple miserliness.¹⁹

Keynes argued that consumption was a function of income, with consumers spending a particular fraction of their next pound of income, known as the marginal propensity to consume. On the assumption that consumption preferences were relatively stable over time, an increase in incomes should lead to this fraction becoming smaller and its inverse – the marginal propensity to save – becoming larger. Higher incomes would lead to more saving, not more consumption.²⁰

Keynes views on saving were subject to challenge by Friedman in 1957 in *A Theory of the Consumption Function*.²¹ Friedman rejected

18 Steve Pressman, *Fifty major economists, 2nd Edition* (Oxford: Routledge, 2006), 152.

19 Gina Canova, Anna Marie Manganelli Rattazzi and Paul Webley, "The hierarchical structure of saving motives," *Journal of Economic Psychology* 26, no. 1 (2005), 21-34.

20 Gianni Vaggi and Peter Groenewegen, *A concise history of economic thought* (Hants: Palgrave Macmillan, 2003), 303; Sharon A. Devaney, Sophia T. Anong and Stacy E. Whirl, "Household savings motives," *Journal of Consumer Affairs* 41, no. 1 (2007), 174-186.

21 Milton Friedman, *A theory of the consumption function* (Princeton: Princeton University Press, 1957).

the need for psychological explanations for savings motivations, in favour of a more straightforward rational approach. Incomes tend to fluctuate over a lifetime more than patterns of consumption, often in predictable ways. It is therefore very rational for an individual to save, so as to 'smooth' their consumption across the lifecycle. As Paul Krugman explains:

"Friedman argued that the best way to make sense of saving and spending was not, as Keynes had done, to resort to loose psychological theorizing, but rather to think of individuals as making rational plans about how to spend their wealth over their lifetimes."²²

Friedman also questioned the empirical basis for Keynes' assertion that the marginal propensity to save would increase as incomes increased. In his view, Keynes' mistake was a failure to distinguish between 'transitory' and 'permanent' income. 'Transitory income' is income as it is measured at a particular time. This is likely to vary substantially, depending on when the measurement is taken, and the time period that is considered. By contrast, 'permanent income' is "the income to which consumers adapt their behaviour." As such, it cannot be measured directly, only inferred from consumer behaviour.²³

Friedman's 'permanent income hypothesis' was largely consistent with the independent but contemporaneous work of Keynesian economist Franco Modigliani. In conjunction with colleagues Richard Brumberg and Albert Ando, he developed the 'life cycle hypothesis'.

Keynes had seen consumption habits as relatively sticky. If incomes rose, consumption habits would be slow to change, and the surplus income would become 'savings'. By contrast, Modigliani

22 Paul Krugman, "Who was Milton Friedman?" *The New York Review of Books* 54, no. 2, (2007).

23 Friedman, A theory of the consumption function, 221.

and Brumberg argued that savings were not simply a “passive residual” from higher incomes. Rather, households made active and rational adjustments to their stock of savings whenever their permanent income rose or fell, aiming to flatten consumption over the life cycle. As Krugman notes,

“This wasn’t necessarily an anti-Keynesian idea... But it did mark a return to classical ways of thinking – and it worked...Friedman’s ‘permanent income hypothesis’ and the Ando-Modigliani ‘life cycle model’ resolved several apparent paradoxes about the relationship between income and spending, and remain the foundations of how economists think about spending and saving to this day.”²⁴

In the neoclassical perspective – of savings as rationally deferred consumption – the level of permanent income is a key determinant of the level of savings.²⁵ Whether additional saving is a passive or active response to higher incomes, those with higher incomes have greater choice over their level of consumption today, and thus their saving for tomorrow. It is easier for them to meet the very basic costs of today, above which consumption is a choice. Above a certain point, they may also find declining marginal utility to additional consumption. By contrast, for those on lower incomes the ‘costs’ of foregoing consumption today are much higher. These differences are likely to compound over time, leading to much greater inequalities in wealth compared to income. This is exactly what was observed in Charts 2.2 and 2.3 from Chapter 2 – this is the challenge for savings policy.

This perspective has been very influential in informing policy. Policy solutions have sought to remove barriers that

24 Krugman, “Who was Milton Friedman?”.

25 Much of the rest of this chapter draws on Sherraden, McBride and Beverly, *Striving to save*, and Gerry Stoker and Alice Moseley, *Motivation, behaviour and the microfoundations of public policy* (London: 2020 Public Services Trust, 2010).

might inhibit rational decision making – by, for example, closing information gaps on life cycle income requirements and the implications for saving today, and by reducing market frictions through ensuring appropriate savings vehicles are available and accessible.

From theory to reality

The neoclassical perspective has intuitive appeal and empirical foundation, particularly at the aggregate level. So why is it that some people on relatively modest incomes are able to save and build assets, whereas others on higher incomes do not?

Partly this is to do with assumptions about how people make decisions, as well as the relationship between knowledge and action. The neoclassical perspective assumes that individuals constantly make utility maximising – read income maximising – decisions based on perfect information and rational discounting over time. These rational understandings then translate easily into action.

The experience of our lives suggests that this is not always the case. We frequently have to make decisions based on bad or incomplete information. Even where we can see good rational reasons to save, we often don't. Having good reasons to save is not the same as actually saving. Decisions to save and savings behaviour are not just a matter of rationality, but – as Keynes had argued – of psychology too.

Box 4.1: Limitations on purely rational decision making

Richard Thaler from the University of Chicago and Shlomo Benartzi from the University of California Los Angeles summarised how insights from behavioural economics help to explain why people do not save enough for the future despite it being rational for them to do so:⁹

1. Bounded rationality (limits on information and decision making capabilities) means that determining accurately how much you should be saving for the future is extremely difficult.
2. Even if this amount is known, people lack the self-control to delay current consumption in the form of spending in favour of future consumption in the form of savings because of:
 - I. Procrastination: 'I'll do it next year' which leads to
 - II. Inertia: 'I don't know where to start'
 - III. Loss aversion: 'I don't want to take home less pay'

Instead of trying to overcome these physiological traits they argue for prescriptive solutions that harness them to produce beneficial outcomes.

a Richard H. Thaler, and Shlom Benartzi, "Save more tomorrow: using behavioural economics to increase employee saving" *Journal of Political Economy* 112, no. 1 (2004).

HOW INDIVIDUALS AND HOUSEHOLDS MAKE SAVINGS DECISIONS

The gap between neoclassical assumptions about decision making and actual decision making behaviour – and the gap between decisions and action – is territory that behavioural economists have fruitfully explored.

As humans, our decisions are often impulsive and short sighted, rather than considered and long term.²⁶ We procrastinate.²⁷ In meeting our needs today, we hope against hope that the future will take care of itself.²⁸ Sometimes it does. Sometimes it doesn't. Losing what we already have troubles us more than the good feelings we get from gaining something new. This caution about holding on

26 David Laibson, "Golden eggs and hyperbolic discounting," *Quarterly Journal of Economics* 112, no. 2 (1997), 443-477.

27 George A. Akerlof, "Procrastination and obedience" *The American Economic Review* 81, no. 2 (1991).

28 Anver Offer, *The challenge of affluence: self-control and well-being in the USA and Britain since 1950* (Oxford: Oxford University Press, 2006).

to what we have – loss aversion – can mean we end up with less in the future.²⁹ Without wanting or having all the information we need, we use mental shortcuts to help us decide. Summarising this literature, Stoker and Moseley conclude that “we are boundedly rational in our decision-making and influenced by social norms and moral considerations”.³⁰

Understanding how individuals make decisions is difficult enough. Understanding how households make decisions adds another layer of complexity. The neoclassical perspective – most closely associated with the pioneering work of Nobel Laureate Gary Becker – assumes that the interests of all members of the household are basically the same, such that the household has a single utility function.³¹

This idea has been increasingly challenged. Household bargaining models, for example, acknowledge divergent interests within the household along with uneven distributions of decision making power. These differences in interests and bargaining power may result from differences in economic power, social determinants or cultural norms. Household decisions – to save, to spend, to move, to take a holiday – therefore reflect both the divergent perspectives represented within the household and the distribution of power to influence collective decisions.³²

These quirks in how we make decisions might be general tendencies of the human condition, but individuals (and households) differ. Our particular dispositions and attitudes can

29 Daniel Kahneman and Amos Tversky, “Prospect theory: an analysis of decisions under risk” *Econometrica* 47, no. 2 (1979), 313–327.

30 Gerry, Stoker and Alice Moseley, *Motivation, behaviour and the microfoundations of public services* (London: 2020 Public Services Trust, 2010).

31 Gary S. Becker, *A treatise on the family* (Cambridge, MA: Harvard University Press, 1981, enlarged edition 1991).

32 Shelly Lundberg and Robert A. Pollack, “Noncooperative bargaining models of marriage,” *American Economic Review Papers and Proceedings* 84, no. 2 (1994), 132-137; Shelly Lundberg and Robert A. Pollack, “Bargaining and distribution in marriage,” *Journal of Economic Perspectives* 10, no. 4 (1996), 139-158.

make a big difference to our reasons for saving and our abilities to do so. Reviewing the literature on why and how individuals save, Kempson and Finney³³ report a hierarchy of savings motivations, from concrete and intermediate goals to precautionary saving and more abstract objectives related to self esteem.³⁴ They boil these down to two main motivations: “*saving for a specific purpose and saving to provide a financial safety net*”.³⁵

These differences in motivation can also affect the ways in which individuals – especially those on lower incomes – actually save. Kempson and Finney report that those on lower incomes are most likely to use formal savings for longer term goals, such as saving for their children’s futures, with more informal methods used to meet specific expenses such as Christmas or an anticipated bill.³⁶

In understanding the inter-relationship between savings motivations and savings behaviour, Kempson and Finney report that people typically divide between:

- **Rainy day savers** who save actively and often regularly with no specific goal in mind. Saving is viewed as an end in itself, increasing overall financial security and reducing vulnerability to economic shocks. For this type of saver, saving is a self-reinforcing habit that is frequently developed early in life and maintained subsequently. Based on qualitative evidence, the typical rainy day saver was a

33 Elaine Kempson and Andrea Finney, *Saving in lower income households: a review of the evidence* (Bristol: Personal Finance Research Centre, University of Bristol, 2009).

34 Ibid., quoting Canova, Rattazzi and Webley, “The hierarchical structure of saving motives”. Canova et al found 15 salient motivations for saving that operate hierarchically. They classify these 15 distinct motivations under three headings – security, self-esteem and self-gratification, with the psychological motivations (self-esteem and self-gratifications) sitting higher up the hierarchy. In contrast to models that imply that savings is all about delaying gratification, they report evidence of the hedonic aspects of saving – the pleasure that people derive from the very fact of saving.

35 Ibid., 3.

36 Ibid., 4.

women, owner-occupier, in relatively stable white collar employment.

- **Instrumental savers** who ‘save to spend’, saving to purchase particular items. Again, this type of behaviour is ingrained from childhood and is often a repeating cycle. Some instrumental savers exit the cycle once a spending goal has been achieved and stop saving altogether. Others convert from instrumental savers into rainy day savers, a change that is often triggered by a life event such as marriage or a child, or with advancing age. Compared with rainy day savers, the typical profile of an instrumental saver was younger and more likely to be in less stable and lower paid employment.
- **Non-savers** or, more accurately, those who neither save nor have savings, and **passive savers** (those who have acquired savings without ever being savers – perhaps through a bequest or tax rebate). Non-savers are typically younger, without family responsibilities, have shorter time horizons and are more likely than savers to borrow. Passive savers had similar attitudes to non-savers, and frequently spent the savings they had chanced upon, rather than adding to them.³⁷

OVERCOMING PSYCHOLOGICAL BARRIERS – INTERNAL CONTROLS

Given the natural human tendencies towards short termism,³⁸ some individuals adopt corrective strategies, imposing internal controls and external rules to direct their behaviour. An essential characteristic of money is its fungibility – one £10 note is interchangeable with another. Money in a savings account might be less accessible (liquid) than money in a current account, but once accessed it can be spent in all the same ways.

³⁷ Ibid., 6-8, quoting Clair Whyley and Elaine Kempson, *Understanding small savers* (Peterborough: AMP, 2000).

³⁸ Stoker and Moseley, *Motivation, behaviour and the microfoundations of public services*.

Despite this, Shefrin and Thaler report how people adopt mental accounting strategies to treat different ‘types’ of money in different ways. They find that “some mental accounts, those that are considered ‘wealth,’ are less tempting than those that are considered ‘income’”.³⁹ Labeling one £10 note ‘wealth’ makes you less likely to spend it than labeling it ‘income’. This brings a behavioural dimension to life cycle consumption theory, with mental accounting being used to impose a level of self control.

The evaluation of the Savings Gateway pilots reported how the policy helped participants to develop a savings ‘habit’ which made it easier for them to realise good intentions to save over the longer term. Setting savings targets – for saving each month, but also for the total amount saved – was also reported as valuable strategy for maintaining savings behaviour.⁴⁰

Having targets strengthened savings motivation while participants were succeeding in hitting them. However, some participants reported how failure to hit their regular savings targets had a demotivating effect.⁴¹ This demonstrates how attempting to achieve the self discipline required to save through internal ‘rules’ can be effective, is also psychologically costly.

OVERCOMING PSYCHOLOGICAL BARRIERS – EXTERNAL ASSISTANCE

It is much easier to have the motivation to save and to translate this motivation into action where the external environment – institutional constructs and systemic messages – reinforce these choices and behaviours. The informational and other costs involved

39 Hersh M. Shefrin and Richard H. Thaler, “Mental accounting, saving, and self-control” in *Choice over time*, ed. George Loewenstein, and Jon Elster (New York: Russell Sage, 1992), 287-330.

40 Paul Harvey, Nick Pettigrew, Richard Madden, Carl Emmerson, Gemma Tetlow and Matthew Wakefield, *Final evaluation of the saving gateway 2 pilot: main report* (London: HM Treasury and Department for Education and Skills, 2007), 46.

41 *Ibid.*, 55.

in rational decision making can be reduced by institutional rules of thumb, such as a recommended proportion of earnings to be saved towards a pension. A recent study by the IFS has shown the power of systemic messages. Simply calling a cash transfer a 'Winter Fuel Payment' results in a relatively high proportion of the money being spent on heating bills.⁴² These 'rules' can be used to shape behaviour as the "process of completely rational choice is too costly".⁴³

The mental distinctions that individuals draw between different 'kinds' of money may be reinforced by dividing money into different physical accounts, imposing some level of external control. This form of external control may be strengthened by mechanisms such as contractual savings plans. In line with Whytey and Kempson's passive savers, Sherraden, McBride and Beverly also note how much asset development,

*"...does not occur as a result of individual decisions to save in a savings account. Instead, these savings are the result of contractual agreement. When middle-class people buy a home, they simultaneously build home equity...Automatic monthly deductions from a bank account require little individual effort..."*⁴⁴

In this way, "a structure for saving significantly reduces the psychological cost of saving".⁴⁵

42 Beatty, Blow, Crossley and O'Dea, "Cash by any other name? Evidence on labeling from the UK winter fuel payment".

43 Mark Schreiner and Michael Wayne Sherraden, *Can the poor save? Saving and asset building in individual development accounts* (New Brunswick, NJ: Transaction Publishers, 2007), 32, quoted in Sherraden, McBride and Beverly, *Striving to save*.

44 Sherraden, McBride and Beverly, *Striving to save*: 30.

45 Ibid., 30, referencing Richard H. Thaler and Hersh M. Shefrin, "An Economic Theory of Self-Control," *Journal of Political Economy* 89, no. 2 (1981), 392-406.

Auto-enrollment policies such as NEST (see Box 4.2) achieve a similar goal. By defaulting people into savings schemes and requiring an active decision to opt out, they reverse the dynamics. Apathy becomes a virtue – the psychological costs of saving are now negative.

Box 4.2: National Employment Savings Trust (NEST)

The paucity of pension saving in the UK is an intractable problem. Government appeals to rational self-interest, tax incentives and employer co-payment schemes have proved insufficient as solutions. So from October 2012 the Government will introduce a new pension scheme based upon the auto-enrolment of employees who do not have access to a company scheme, and will enter the market itself, with the National Employment Savings Trust (NEST).

Pensions auto-enrolment will change the default setting of pensions, with every employee automatically entering a 'qualifying workplace pension scheme'. This will shift the savings context from one where the onus is on people to find a pension and sign up to it, to a situation where the onus is on individuals who don't want a pension to opt out. By making a virtue of inertia, the Government hopes that people will stay in the scheme, and continue to save.

Between October 2012 and 2017, depending on the size of company, all UK employers will be required to contribute a minimum of 3% of each employee's eligible earnings into a pension, assuming the employee does not opt out. Employees will need to pay a personal contribution of 4% with a further 1% tax relief being added to make the minimum contribution 8%.

The same is true once workers have enrolled into any other type of company pension or savings schemes. This process can be helped by policies or procedures that create 'moments of decision' – for example, as part of an annual job review.

Box 4.3: Save More Tomorrow

It is easier to have good intentions about future behaviour than it is to put them into practice. It is this truth that lies behind the idea of Save More Tomorrow (SMT). 'Buy now, pay later' deals encourage us to enjoy the benefits of consumer a new sofa today, while putting off the pain of paying for it until tomorrow. SMT is based on the same principle, but used to encourage savings, not consumption. It allows participants to 'consume' any the good feelings a person might get from a positive decision to invest in their future selves, but delays the 'pain' of actually saving to a more propitious time.

Through SMT participants pre-commit to a future savings plan, but don't actually start saving until they get a pay rise. At that point the whole - or a pre-agreed portion - of the pay rise automatically goes into the savings plan. The savings contributions continue to rise with each pay increase until contributions hit a pre-set level. Employees are free to opt out at any time, each increase happens automatically without requiring further consent.

By placing increased savings contributions at some point in the future where they appear more attractive, the SMT model exploits myopic beliefs about our lives in the future, while overcoming problems of procrastination. By taking the money away from participants before they have got used to spending their higher income, it reduces the problem of loss aversion. By requiring people to actively opt out of the scheme once enrolled it exploits the tendency towards inertia which means people are unlikely to opt out.

The impact of SMT programmes in the United States have been dramatic, when tested at a company employee savings increased from an average of 3.5 per cent to 13.6 in just 3.5 years and is now being adopted by companies across the United States, making a considerable impact on pensions savings.

Source: Richard H. Thaler and Shlomo Benartzi, "Save more tomorrow: using behavioral economics to increase employee saving", *Journal of political economy* 112: 1, part 2 (2004), 164-187.

By reducing the costs of making the decision to save and the costs of translating those decisions into action, institutional structures and systemic signals can have a powerful impact on asset accumulation. But they are not – and should not be – determinative. Individuals can – and should – still make choices for themselves:

“People still have agency because institutions do not fully determine individual behaviour. However, institutions make certain choices more desirable, more predictable and more likely to facilitate opportunity. In this way, institutions structure choices by providing resources for the purposeful action of self interested actors.”⁴⁶

People who are auto-enrolled into a NEST scheme can opt out. But staying in a scheme – or sticking to an earlier commitment – have now become the paths of least resistance.

WHAT KINDS OF POLICIES HAVE PROVED EFFECTIVE?

Summarising the literature, Sherraden and McBride report the seven institutional constructs and systemic signals seen as most significant in shaping shape savings behaviour and asset accumulation:⁴⁷

- **Access:** saving is more likely among those who have access to financial institutions and suitable financial products compared with those who do not.
- **Security:** the belief that ‘savings are safe’ and will not lose value as a result of macro-economic instability or because of the failings of individual financial institutions.

⁴⁶ Ibid., 3, referencing Jack Knight, *Institutions and social conflict* (Cambridge, MA: Cambridge University Press, 1992).

⁴⁷ Ibid., 31-39.

- **Incentives:** “subsidies, financial returns and non-financial rewards for saving” frequently generate a positive savings response, not least by “focusing attention and by prolonging deliberation”⁴⁸ as long as they are well designed and tailored to the target group.
- **Information:** the availability of clear and accurate financial information may encourage better decision making about spending and saving, but the extent to which it will do so also depends on individuals’ abilities to use this information effectively. This is influenced by education and socialisation, particularly the development of abilities to delay gratification and be self controlled, and well as early experiences of money management such as having a bank account. In general, they conclude that the role of information in encouraging savings is under-researched.
- **Facilitation:** mechanisms such as automatic enrollment or automatic payroll deductions help people to save by “reducing the willpower required to save...reducing the cost of choosing future gain over current pleasure”.⁴⁹ However, apathy means that people frequently stick with a default option, even where this is not the best for their needs and circumstances.
- **Expectations:** setting norms or expectations about an appropriate level of savings can give individuals a target to aim for and so strengthen their motivation to save. For example, the cap on the amount of savings that will be matched within a matched savings policy can come to be viewed as a savings target by participants. ISA or CTF limits on annual contributions can have the same effect.
- **Restrictions:** limits on the access or use of savings can support individuals’ resolve and help to protect savings. But a balance must be struck. Putting savings beyond immediate

48 Ibid., 32 quoting Amos Tversky and Daniel Kahneman, “Rational choice and the framing of decisions” *The Journal of Business* 5, no. 4, 1986)

49 Ibid., 36.

reach is attractive to some savers because it reduces the need to exercise self control, but can be a disincentive to others.

Overall, they argue that institutions really matter to savings behaviour, and especially for households with lower incomes. But, to be effective, they need to be tailored to the particular needs of different groups.

Often, the requirements for lower income households for savings products will differ substantially than for those with higher incomes. For example, tax relief provides a much lower incentive to those paying lower rates of tax. They conclude that “lower income households would save more if they had access to well-designed savings programs, that is, programs that take into account barriers to saving and asset accumulation faced by these families.”⁵⁰

CONCLUSION

This chapter has pointed to the rational ‘ideals’ that economic theory has used as shorthand to understand savings behaviour. This rational approach in which individuals and households seek to smooth their consumption over their lifetimes has proved a valuable and enduring lens through which to understand human behaviour, certainly at the aggregate level. But the chapter has also pointed to the limits of this approach in helping policy makers. It is clear that there is frequently a gap between rational ideals and the decisions we actually make, plus another gap between our intentions and our actions.

It has discussed some of the strategies that people use to overcome natural tendencies towards short-term thinking and myopia, and how we fight against procrastination and our chronic

50 Ibid., 38.

failures to get around to doing things that we know would be in our best interests. In these struggles, the institutional context in which we are operating has a big impact – both in supporting or undermining our efforts.

The institutional context can support us by reinforcing more virtuous or longer-term decisions that we make to defer consumption. Alternatively, it can support us by obviating the need for virtue and self-control, and even using our weaknesses to our advantage. Auto-enrollment is a powerful force for increasing savings because it exploits tendencies to procrastination. It also notes the extent to which a lot of asset accumulation owes little to explicit ‘savings’ acts, and more to contractual commitments or debt repayment, such as in the case of mortgages used to buy a home.

The chapter has highlighted the institutional characteristics which the literature suggests are important in encouraging savings and asset accumulation, but noted that the policies they imply may be quite different for encouraging savings amongst lower compared with higher income households.

These are important insights for policy makers. As explained in Chapter 3, the coalition’s policy is framed around three components – improving the advice, products and information available. All of these components should help households to plan better for their financial futures and realise those plans. In the terms of the framework set out above, they will help households to balance current and future needs more effectively, in line with rational life cycle models. But, given the findings from the literature set out in this chapter, the approach has obvious limits. There is clearly much more that policy can do to address the psychological and institutional drivers of financial decisions and behaviour, as well as rational drivers.



Much of the literature reviewed here is based on US evidence. The next chapters detail the findings from our analysis of the Child Trust Fund administrative data and the Wealth and Assets Survey, and considers the extent to which our findings accord with the broader literature.

CHAPTER 5: THE CHILD TRUST FUND

The two policies that most defined the Labour government's attempts to increase savings among low income households were the Child Trust Fund and the Savings Gateway. The Savings Gateway was piloted extensively, but its planned national roll out was abandoned by the incoming Coalition Government. By contrast, the policy cycle of the Child Trust Fund was more complete – waxing before it waned. Introduced in 2003, the policy was ended in the summer of 2010, to be replaced by Junior ISAs.

The Child Trust Fund was the most ambitious example of a range of new policies in English speaking countries collectively described as 'asset based welfare',⁵¹ and largely inspired by the seminal 1991 work of Michael Sherraden, *Assets and the Poor*.⁵² The policies tended to emphasise the positive behavioural consequences for lower income households of holding assets, alongside the redistributive benefits and claims for greater efficiency compared with traditional income maintenance welfare policies.

In many ways, the Child Trust Fund was an unusual policy. It required the Government to divert resources from immediate needs towards objectives that were somewhat speculative and definitely long term. As with Chairman Mao's view of the French Revolution, it is still very early to be assessing the full impact of a policy that will take at least 18 years to mature. However, there are lessons to be learned for policy-makers from observing the outcomes from the Child Trust Fund to date. Using HMRC

51 Michael Mendelson, *Asset-based social welfare programs: a critical analysis of current initiatives* (Paris: OECD, 2007), 14.

52 Sherraden, *Assets and the poor*.

administrative data,⁵³ this chapter considers the effectiveness of the CTF in meeting its objectives.

AIMS OF THE CHILD TRUST FUND

After a series of HM Treasury reports developing the Government's strategy,⁵⁴ the CTF was introduced in 2002. As part of its overall active welfare strategy, the stated aims of the policy were to increase:

- **“Security:** *in future all children will have the backing of a stock of financial assets at the start of their adult lives, helping to cushion the impact of unforeseen circumstances;*
- **Opportunity:** *funds can be used to take advantage of opportunities throughout adult life, enabling individuals to play a more confident and continuous role in their communities;*
- **Responsibility:** *development of the saving habit will promote independence and financial education will help individuals to make better financial choices throughout life.”⁵⁵*

The focus on children from lower income households also suggests that the CTF aimed to achieve these policy goals differentially, having a greater impact on the lives of poorer children and so reducing inequalities.

DESIGN OF THE CHILD TRUST FUND

The policy provided every child eligible for child benefit born on or after 1 September 2002 with a voucher worth £250. Around a third of children in lower income households received an additional

53 HM Revenue and Customs, “Child Trust Fund statistics,” <http://www.hmrc.gov.uk/ctf/stats.htm>.

54 HM Treasury, *Helping people to save* (London: HM Treasury 2000); HM Treasury, *Saving and assets for all* (London: HM Treasury, 2001); HM Treasury, *Delivering savings and assets* (London: HM Treasury, 2001).

55 HM Treasury, *Detailed proposals for the child trust fund* (London: HM Treasury, 2003), 1.

£250.⁵⁶ Parents could choose one of three options to invest this initial endowment:

- in a straightforward savings account;
- in a stakeholder account – managed funds invested in shares;
or
- in shares, with the fund controlled by the parents.

If parents did not make an investment choice within 12 months, HM Revenue and Customs would open a stakeholder account on behalf of the child. Each year, around a quarter of accounts were opened in this way.

Parents, family and friends could add up to £1,200 per year to a CTF account fund, with the Government adding £250 to each fund when the child reached 7 years old (£500 for children in lower income households). The money in the fund belonged to the child, who could manage the account from age 16 but could not spend the money until aged 18. At that point, the fund would cease to be a CTF and could be applied for any purpose. Any increases in the value of the CTF during its lifetime would be exempt from tax, as with ISAs.

WHAT HAPPENED TO THE £250 AND £500 VOUCHERS?

By 2009, almost 5 million CTF accounts had been opened, reflecting the cohort of children born since 1 September 2002. Of these, around three quarters (76%) were opened by parents making a positive choice about where to invest CTF vouchers, with one quarter being assigned by HMRC (Revenue Allocated Accounts or RAAs – all of which were stakeholder accounts). Table 5.1 below shows the breakdown of the CTF accounts opened by 2009.

⁵⁶ Paid to children in households eligible for the full amount of Child Tax Credit.

Table 5.1: Breakdown of CTF accounts opened in 2009

	Stakeholder			Non-Stakeholder			All accounts
	Parent opened	Revenue assigned	All stakeholder	Shares	Cash only	All non-stakeholder	
All accounts							
Number (1,000s)	2466	1135	3600	314	842	1157	4757
Share of all accounts	52%	24%	76	7	18	24	100
£500 voucher							
Number (1,000s)	721	540	1261	82	251	333	1594
Share of all accounts	15%	11%	27%	2%	5%	7%	34%
£250 voucher							
Number (1,000s)	1745	595	2340	232	591	823	3163
Share of all accounts	37%	13%	49%	5%	12%	17%	66%

Source: HMRC

Children in lower income households receiving the £500 voucher were almost twice as likely to have their accounts opened by HMRC (34%), compared with children from higher income households (18%).⁵⁷ However, where parents did make an assignment, the investment decisions made by higher and lower income households were virtually identical. Excluding HMRC allocated accounts, 68% of parents in both higher and lower income groups chose stakeholder accounts, and the differences

57 Comparing geographically, accounts were most likely to be HMRC assigned in Northern Ireland (31%), Scotland (29%), and in the North East (28%) and North West (27%) regions. They were least likely to be HMRC assigned in the East, South East and South West regions (all 19%). The UK average was 24%.

in other investment decisions were negligible.⁵⁸ These patterns remained broadly similar throughout the lifetime of the policy, and were similar geographically.⁵⁹

Overall, stakeholder accounts made up around three quarters of all CTF accounts (76%), with 2.5 million of these accounts opened by parents, and 1.1 million opened by HMRC. Almost a fifth (18%) of accounts were savings accounts opened by parents, with only 7% invested in a share portfolio controlled by the parents.⁶⁰

DID PARENTS MAKE ADDITIONAL CONTRIBUTIONS TO THE CHILD TRUST FUND?

Overall, parents, family and friends had made additional contributions to 22% of CTFs, averaging £289 a year. These contributions were more frequent in higher income households (27%) and higher on average (£313 per year) than in lower income households (12%, averaging £181 per year). They were most frequent (32%) and on average highest (£366 per year) in parent controlled share accounts, particularly for higher income families (37%, averaging £398 per year).

Additional contributions were least likely in HMRC allocated accounts (just 2%), and within that group even less likely among lower income households (1% compared with 3% for higher income households). Among parent assigned CTFs, additional contributions were least likely for savings accounts (21% of CTFs, compared with

58 24% of lower income households chose savings accounts compared with 23% of higher income households, and 9% of higher income households choose parental controlled share portfolios compared with 8% of lower income households.

59 Excluding HMRC allocated accounts, parents made broadly similar investment decisions across the UK. Of those who made positive investment decisions, parents were mostly to chose a stakeholder account in London (71%) and least likely in the East region (65%), with a UK average of 68%. Parents in the North East region (12%) and Scotland (11%) were most likely to choose to manage a share portfolio themselves, and least likely to in Northern Ireland (6%), London (7%) and the East Region (7%).

60 HM Revenue and Customs, *Child Trust Funds Statistics Detailed Distributional Analysis November 2010*, <http://www.hmrc.gov.uk/ctf/dda-2010.pdf>.

30% for parent opened stakeholder accounts and 32% for parent controlled share accounts), but the level of contributions were lowest on average for parent assigned stakeholder accounts (£273 per year, compared with £319 for savings accounts, and £366 for parent controlled share accounts).⁶¹

Comparing geographically, parents, family and friends were most likely to make additional contributions in the South East (26%), London (24%) and East (24%) regions, and least likely to do so in Northern Ireland (17%), the North East, North West, and Yorkshire and Humber regions and Wales (all 20%). Of those CTFs receiving additional contributions, average annual contributions were highest in London (£381 a year), South East (£317) and East (£296) regions, and lowest in the North East (£236), Wales (£246) and North West (£248).

WHAT HAS HAPPENED TO CHILD TRUST FUND VALUES OVER TIME?

By getting a £500 voucher, children from lower income households were given an initial £250 head start in the value of their CTFs. However, households with higher incomes were more likely to be able to make more subsequent contributions, and many did. So what happened to the absolute and relative values of CTFs over time?

Table 5.2 below shows average value of CTF accounts from all years to 2009, as well as the increase in value in cash and percentage terms.⁶²

61 Comparing geographically, parents, family and friends were most likely to make additional contributions in the South East (26%), London (24%) and East (24%) regions, and least likely to do so in Northern Ireland (17%), the North East, North West, and Yorkshire and Humber regions and Wales (all 20%). Of those CTFs receiving additional contributions, average annual contributions were highest in London (£381 a year), South East (£317) and East (£296) regions, and lowest in the North East (£236), Wales (£246) and North West (£248).

62 Note that this is the average value of all accounts opened to 2009, so includes accounts that had just been opened as well as those that had been opened in 2003.

Table 5.2: Average value and increase in value of CTF accounts from all years to 2009

	Stakeholder			Non-Stakeholder			All accounts
	Parent opened	Revenue assigned	All stakeholder	Shares	Cash only	All non-stakeholder	
All accounts							
Average market value	£740	£448	£648	£939	£689	£756	£675
Average (less voucher)	£417	£79	£311	£624	£364	£435	£341
Growth	229%	121%	192%	298%	212%	265%	202%
£500 voucher							
Number (1,000s)	721	540	1261	82	251	333	1594
Average market value	£730	£576	£664	£707	£706	£709	£673
Growth	146%	115%	133%	141%	142%	142%	135%
£250 voucher							
Number (1,000s)	1175	595	2340	232	591	823	3163
Average market value	£745	£331	£640	£1022	£680	£776	£675
Growth	298%	132%	256%	409%	272%	311%	270%

Source: HMRC

Chart 5.1 below compares the 2009 value of CTF accounts that had an initial value of £500 with those that had an initial value of £250. On average, accounts of both types have grown in value – from interest and dividends as well as additional parental contributions. But it is clear that the initial £250 advantage of

children from poorer households has been completed eroded by 2009. CTF accounts (from all years) opened with a £500 voucher were worth £675, compared with £673 for CTF accounts (from all years) opened with a £250 voucher.

Chart 5.1: Initial and average values of CTF accounts, 2009

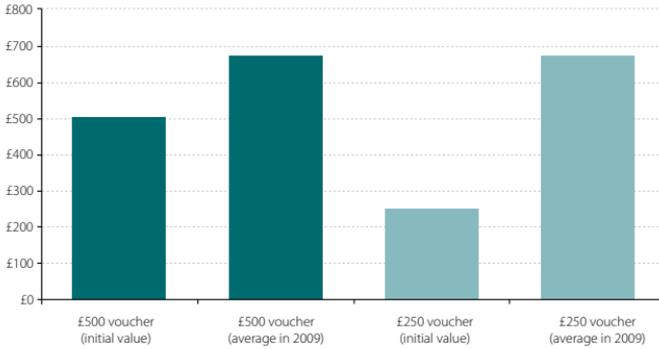
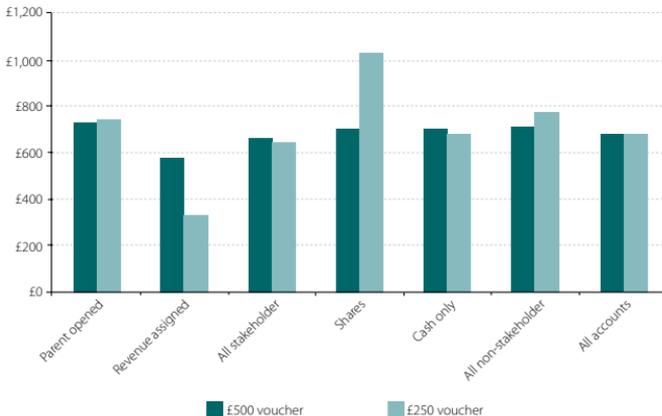


Chart 5.2 below shows the 2009 values of all CTF accounts, broken down by the size of the initial voucher and the type of account opened. It shows how, by 2009 and for most types of accounts, the average value of CTF accounts were similar regardless of the size of the initial voucher used to open the account.

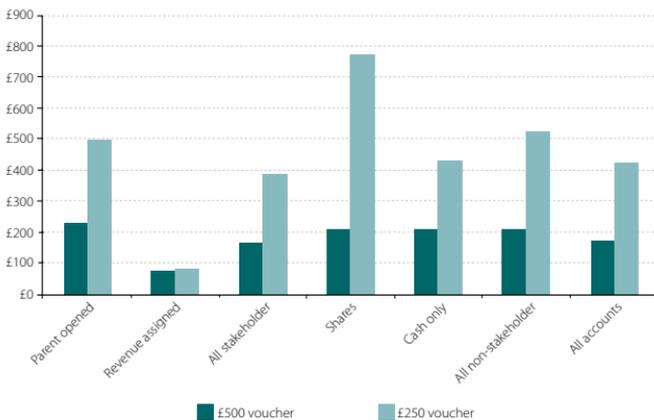
Chart 5.2: Values of all CTF accounts, 2009



There are two notable exceptions: revenue allocated accounts, and share accounts. Revenue allocated accounts have the lowest average values of all types of accounts. With very low rates of parental contributions to these accounts by both higher and lower income households, growth has been limited to dividend payments, and the initial £250 difference in the value of accounts has persisted. It seems that parents who were passive about how the initial voucher was invested remained indifferent subsequently. By contrast, share accounts managed by higher income households have increased in value the most, as parents who have made the most active investment choice have also made the largest additional contributions.

Chart 5.3 below shows this picture more clearly, revealing the much faster increase in the average value of CTF accounts for children from higher income households. If these trends continue in the future, it is clear that the value of CTF accounts for children from higher income households will substantially exceed the value of CTF accounts for children from lower income households.

Chart 5.3: Average change in CTF value to 2009 from initial value



HOW FAR HAS THE CHILD TRUST FUND ACHIEVED ITS OBJECTIVES?

Increasing security and extending opportunity?

A key justification for the CTF was evidence of the positive impact that asset ownership – even at relatively low levels – could have on aspiration and behaviour. By giving each and every child a voucher of at least £250, the CTF sought to extend these positive impacts of asset ownership to entire cohorts of children. Giving the vouchers at birth meant that these positive impacts could accrue over 18 years, just as the value of the initial endowment was likely to grow.⁶³ The larger the amount in the CTF, the larger the likely benefit to a child upon reaching adulthood. However, the main argument for the policy was that the benefits of the CTF are categorical – they arise primarily as a result of having a store of assets, not because of the size of that store. To the extent that this is true, the CTF clearly achieves this objective in a way that the replacement – Junior ISAs – is unlikely to do.

But does the amount matter? Giving a higher £500 voucher to children from lower income households suggests that the Government thought that it did. By targeting this additional £250 according to household income, the policy was – in input terms – straightforwardly redistributive, seeking to give more to those who might otherwise have had less security and opportunity at age 18.⁶⁴

This is to focus on the static benefits of redistribution. One of the key arguments in favour of the CTF is the dynamic benefits: from the impact that having even a small pot of savings might have on a child's financial literacy and sense of possibility; from the changes in savings behaviour among parents and from their additional

63 An initial £250 endowment growing for 18 years at a representative 7% real rate of return would be worth £789.70 at maturation. An initial £500 endowment would be worth £1,579.41.

64 It was also redistributive geographically. The concentration of £500 vouchers was highest in poorer regions, and lowest in richer parts of the country. For example, eligibility for the higher £500 voucher was highest in the North East (43%) and North West regions (40%), and lowest in the South East (23%), East (26%), and South West (28%) regions.

contributions; and from the increase in value of investments over time.

Encouraging responsibility and savings habits?

As set out above, parents, family and friends made additional contributions to 22% of CTFs, averaging £289 a year. Higher income households made more frequent and larger additional contributions, although it is difficult to isolate the impact of higher income alone without statistical controls.

How much of this is savings that would not have happened without the policy is hard to tell, although there seems to be a strong relationship between the level of initial parental involvement and subsequent contributions. Parents who made a positive choice about where to invest the initial CTF voucher were much more likely to contribute than parents who passively allowed an HMRC allocation. Of the parents making a positive choice, those who chose to actively manage a share portfolio for their children were the most likely to contribute subsequently.

This suggests that the policy did little to change the prior behaviour of parents, revealed by their initial activity or passivity. Parents who were passive initially did not become savers, and parents who were active initially were most likely to contribute further. The policy may have made it easier for parents who wanted to save for their children's future to actually do so. This could be evidence showing how institutional arrangements – such as the availability of the CTF – can help to make potential savers into actual savers. However, this would depend on the extent to which savings in CTF were additional to other savings that these parents would have made for their children, rather than a substitute. It is unclear from the CFT administrative data whether this saving was additional, or simply a re-channeling to a more popular savings vehicle. The imminent interim evaluation of the CTF is expected to clarify this.

Reducing inequalities?

As a matter of simple maths, if everyone has some amount of assets, asset inequality will be proportionately less than if some had no assets at all. This is true even if there are wide disparities in the total amounts. If the benefits of having assets are mostly categorical, then differences in the actual values of matured CTFs are of little concern. But if differences in the amount accrued do make a substantive difference to a child's opportunity and security, then the evidence to date that the policy reduced inequalities is less positive.

The early £250 advantage of children from lower income households seems to erode quite quickly as a result of the larger additional contributions made by parents in higher income households. To the extent that these additional parental contributions were induced by the policy, the overall effect will have been to increase absolute inequalities. It seems that the positive dynamic impacts of the policy are more likely to have accrued to households who were already more motivated to save for their children (and may have done so anyway). Within this group, any benefits are more likely to have accrued to households with higher incomes.

CONCLUSION

This chapter has looked at the success to date of the CTF in meeting its objectives, based on HMRC administrative data. It has noted the tension for policy makers in the design of a policy between three good objectives:

- Increasing the number of children with savings, based on categorical advantages of having savings;
- Increasing the amount of savings children have access to, based on the greater opportunities for those with more savings; and
- Decreasing the level of asset inequality between children of the same age.

By advocating a policy that ensured every child would have access to a store of savings, Labour ensured that any categorical benefits from having savings could be enjoyed by all.

But it is disappointing that around a quarter of parents made additional contributions. One factor in the reluctance of parents to contribute may lie in the structure of the policy. The state contributions was paid as a lump sum, rather than being conditional on parental contributions. As a result, there were few marginal incentives for parents to save more. If the goal of a policy is to increase the level of savings overall, this is a clear lesson for policy makers from the experience of the CTF.

Finally, those who did save were already among the most motivated and frequently the richest. As a result, the £250 head start that children from lower income households enjoyed was quite quickly eroded. Arithmetically, relative asset inequality might have fallen. But if current trends continue there is a risk that – as a result of the policy – absolute differences in the store of assets between the poorest and richest children might actually grow.

The next three chapters outline the findings from our analysis of the Wealth and Assets Survey 2006/08. Chapter 6 focuses on the characteristics associated with accumulations of wealth; Chapter 7 looks in more detail at the relationships between assets and attitudes; and Chapter 8 focuses on liabilities and advice.

CHAPTER 6: ASSETS, SAVINGS AND RATIONAL BEHAVIOUR

Chapter 5 looked at the emerging lessons for policy makers from the Child Trust Fund administrative data. The next three chapters report the results of new analysis of the Wealth and Assets Survey 2006/08 (WAS). The purpose of the analysis was to understand the financial dynamics in households revealed by this new source of data, and the implications for policy.

The analysis reported in this chapter unpicks:

- The objective and subjective factors associated with more or less asset accumulation;
- Where and how households save;
- The types of assets households have; and
- The role of institutions in encouraging asset accumulation.

Chapter 7 reveals the huge significance of attitudes in understanding differences in asset accumulation between households, and unpicks the factors associated with these different attitudes. Chapter 8 focuses on differences in debts and debt repayment between households, as well as access to advice.

THE WEALTH AND ASSETS SURVEY 2006/08 AND THIS ANALYSIS

The WAS is the first wave of the largest domestic survey of household finances. The survey was designed specifically to address weaknesses identified by the research and policy community in data relating to household assets. It covers the period July 2006 to June 2008, and includes a sample of 30,595 private households. Grossed to the population, this represents 24,580,000 households.⁶⁵

65 The 2006/08 WAS survey sampled private households in Great Britain, this means that people in residential institutions, such as retirement homes, nursing homes, prisons, barracks or university halls of residence, and also homeless people are excluded from the scope of the analysis presented here.

Initial findings from the survey published by the Office of National Statistics (ONS) took an important step towards understanding the financial well-being, savings behaviour and distribution of wealth among British households and individuals.⁶⁶ The analysis reported here goes beyond the ONS research in two ways, both of which are important in informing an effective policy framework.

First, it delves beyond the beyond descriptive statistics that characterised the ONS work and tries to pick apart the underlying correlates of wealth accumulation. The ONS used cross tabulations to consider the relationships between two or sometimes three variables in the survey at a time. In this study, we use multi-variate regression analysis to isolate the independent statistical relationship between each characteristic and outcomes of interest, such as wealth or particular attitudes.

Second, it addresses the link between earned income and wealth. The quality of the total household income data in the WAS not robust in several important respects.⁶⁷ Household income is comprised of three elements – earned income, unearned income and benefits income (including tax credits). The WAS is particularly weak in relation to benefits income, an important component of income for lower income households. As a result, the ONS in its main analysis elected not to focus on the relationship between income and wealth, leaving a gap in

66 Daffin, ed., *Wealth in Great Britain: main results from the wealth and assets survey 2006/08*. This included analysis of total household wealth and its component parts – property wealth (net), financial wealth (net), physical wealth and private pension wealth. It also included breakdowns of household wealth by age, education, employment status and socio-economic classification of the household head, and by region and household type.

67 See ONS, (2010) *Income Annex, Wealth in Great Britain report 2006/2008*, ONS, http://www.statistics.gov.uk/downloads/theme_economy/wealth-assets-2006-2008/Income_annex_final.pdf. The WAS Consortium is developing a method of improving estimates of income in the Wealth and Assets Survey (WAS) allowing the production of produce robust estimates from Wave 3 onwards.

its findings.⁶⁸ This was problematic given our particular interest in the financial dynamics of low income households. We have tried to fill this gap.

The measure of income utilized in the analysis that follows exploits the most reliable component of income data in the WAS – earned income. By focusing on earned income the analysis abstracts from both unearned and benefit income. Whilst this is not ideal, the risks can be overstated. In the first place, unearned income is not a major component of income for lower income households below retirement age. To avoid potential distortions resulting from the omission of unearned income after retirement, the analysis has been limited to those of working age where necessary.

The impact of ignoring benefits income requires slightly more justification. Benefits are mostly paid on the basis of current needs – to supplement low earned (and unearned) income, and to offset the burden of additional needs arising from disability or childcare costs, for example. As a result, they are not part of the component of income out of which much saving is likely to come. Our interest is in the determinants of a household's propensity to save, therefore the appropriate measure of income is income above and beyond these needs.

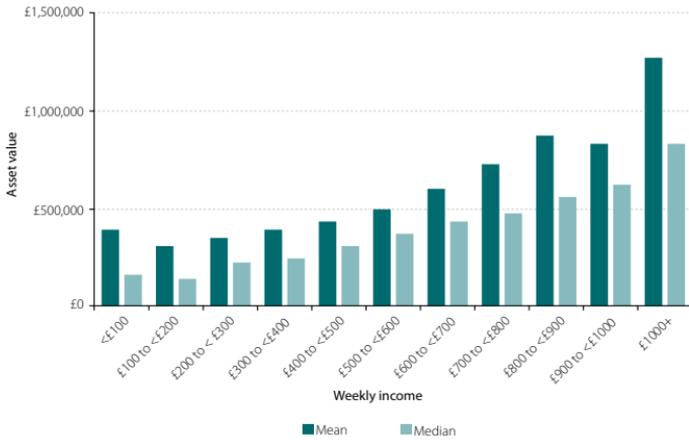
For example, a family receiving benefit income for a disabled child may appear to have a higher income than an equivalent family with a child with no disability. But these benefits are designed to cover the increased financial needs of the household resulting from having a child with a disability. We should not expect the higher income paid in benefits to translate into higher savings – it is paid to meet higher needs. Viewed this way, earned income might be used as a crude proxy for income above and beyond needs.

68 The subsequent Income Annex (ibid) did include breakdowns of household wealth by income, although readers were "urged to treat the results presented in [the] appendix with caution." Ibid, 2.

THE POSITIVE RELATIONSHIP BETWEEN INCOME AND WEALTH

The idea that households with higher incomes have more accumulated assets makes intuitive sense. Chart 6.1 below shows the simple positive relationship between weekly (earned) income and accumulated wealth. For households with earned income above £100, wealth rises with income, and at an increasing rate. This suggests that as household income rises the marginal propensity to save also rises, as we would expect. The big difference between the mean and the median at every level of income again shows the extent to which wealth is concentrated at the top of the distribution.

Chart 6.1: Distribution of household wealth including pension wealth: by income per week, 2006-08



Source: *Wealth and Assets Survey 2006/08*

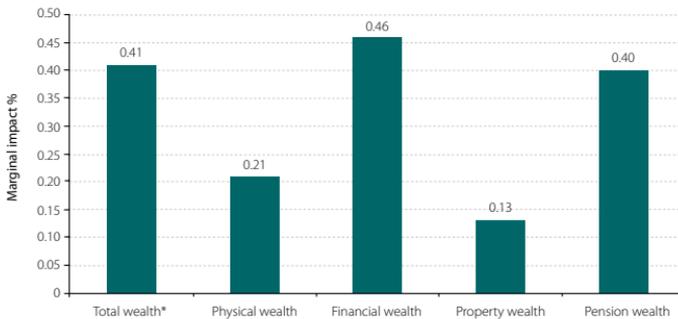
Earned income is income from employment and self-employment, equalized to account for household composition. It excludes income from pensions, benefits and other sources such as interest and dividends. Results exclude those without earned income, due to inaccuracy at this level of disaggregation.

Chart 6.1 above is a simple cross tabulation of income against wealth. In reality a whole range of other personal circumstances and characteristics are also likely to have an impact, both on the level of weekly income and on the level of accumulated assets.

Chart 6.2 below shows results of analysis where statistical controls are included to take account of other relevant variables – like age, education and household status⁶⁹ – in considering the responsiveness of household wealth to changes in annual household equivalized earned income. It shows that the positive relationship between income and wealth still holds, even when the impact of other factors is accounted for. A 1% increase in annual household equivalized earned income is associated with an increase in total household wealth of over 0.4%.

Chart 6.2 also shows how this positive relationship varies for different components of household wealth. All else equal, the relationship is stronger for financial wealth (0.46%) and pension wealth (0.40%), but weaker for physical wealth (0.21%) and property wealth (0.13%). Interestingly, these last two components of household wealth that are less responsive to changes in household income are those that also include an element of concurrent consumption.

Chart 6.2: Impact of household equivalized income on wealth (including pension wealth), 2006-08



Results significant at the 95% level. Controls for gender, age, education, number of children, employment, region, religion, marital status, race, & attitudes. Analysis at household level if household head is of working age

**Includes pension wealth*

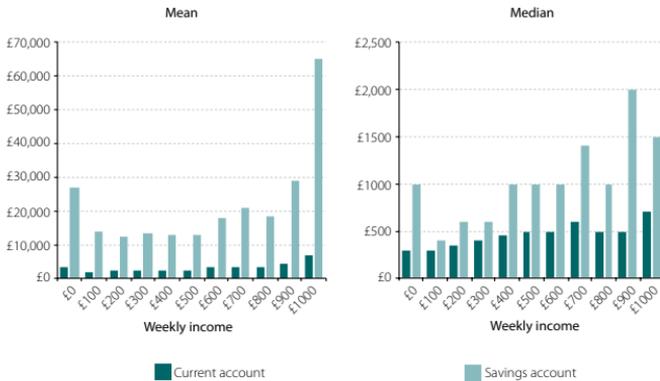
Source: Wealth and Assets Survey 2006/08

69 The regression included controls for sex, age, education, number of children, employment status, region, religion, marital status, race, and attitudes.

HOUSEHOLDS WITH HIGHER INCOMES

Chart 6.3 below shows how households at different levels of weekly (earned) income split their financial wealth between current and savings accounts. It shows how the proportion of financial wealth held in more efficient (savings) accounts increases with the level of earned income. Ignoring households with no earned income, households hold a similar level of savings in current and savings accounts until income reaches £600/week, when levels in savings accounts being to increase sharply.

Chart 6.3: Amount held in savings and current accounts by weekly income, mean and median

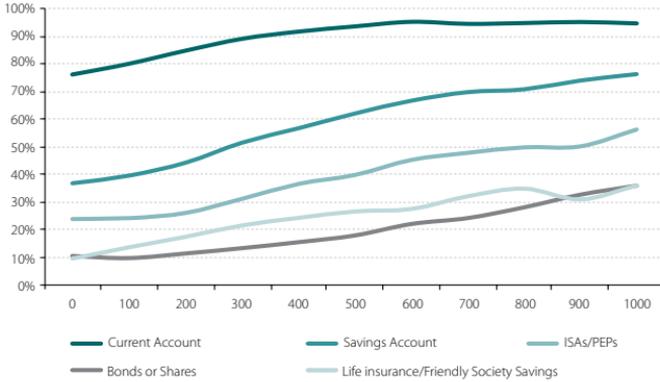


Source: *Wealth and Assets Survey 2006/08*
 Working age population

This finding is amplified by Chart 6.4. It shows that – at every level of household income – most households have savings in relatively inefficient current accounts. However, the proportion of households with a savings account, ISAs/PEPs and Bonds or Shares (relatively more efficient forms of savings) is significantly higher at higher levels of income. Only a quarter of those with weekly earnings of less than £100 have savings in ISAs or PEPs,

compared with more than half of those with weekly earnings above £1000.

Chart 6.4: Proportion of population with different types of savings account, by weekly household equivalized income

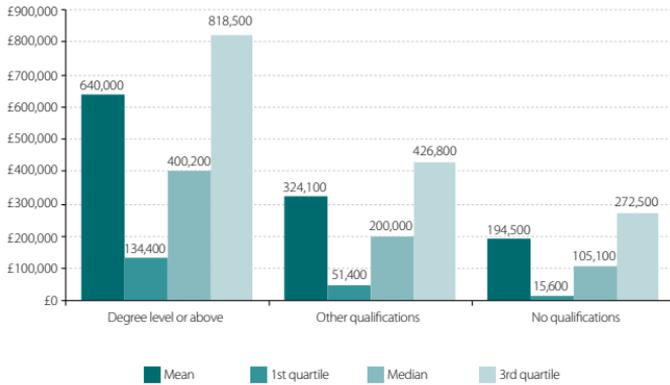


Source: *Wealth and Assets Survey 2006/08*

HOUSEHOLD WEALTH AND EDUCATION LEVELS

Chart 6.5 below illustrates how household wealth varies with educational attainment. Higher amounts of household wealth are correlated with higher qualifications. Households headed by someone with a degree or above have nearly £650,000 in total wealth (including pension wealth) on average compared with under £200,000 for those with no qualifications. Of those households with a degree or above, even those saving the least (the bottom quartile) save more than the median household whose head has no qualifications. In all categories of education, mean savings are well above median savings. This suggests a rightward skew in the distribution – with a lot of wealth concentrated at the top – something that was shown clearly in Chapter 2.

Chart 6.5: Distribution of household wealth by education of household head, 2006-8

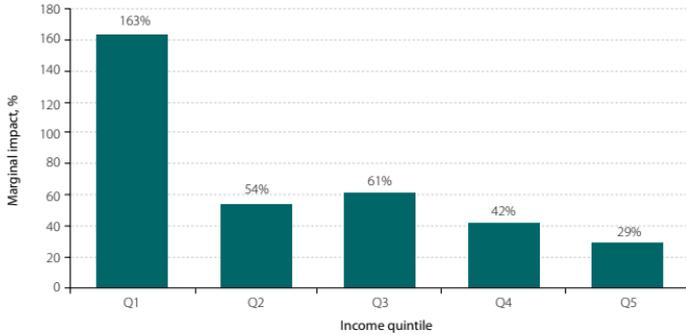


Source: *Wealth and Assets Survey 2006/08*

Once again, this simple relationship between qualifications and household wealth could be driven by any number of individual characteristics that make a household head both more likely to have good qualifications and more likely to accumulate assets. When these other factors are controlled for, however, the analysis shows that a household whose head is educated to degree level or above will have accumulated more than double the total wealth of a household whose head has no degree level education.

Interestingly, this relationship between education levels and wealth is strongest for the 20% of households with the lowest accumulated wealth (163%), and is much weaker for other wealth quintiles. This is shown in Chart 6.6 below. All else equal, the impact on total wealth of holding a degree declines rapidly as wealth rises. For households in the top wealth quintile, the head of household having a degree is associated with only 29% greater wealth compared with other households in the same wealth quintile. At the top end of the distribution, there are clearly many other factors driving wealth accumulation which may substitute for the importance of education.

Chart 6.6: Impact of education of household head on total household wealth (excluding pension)



Source: *Wealth and Assets Survey 2006/08*

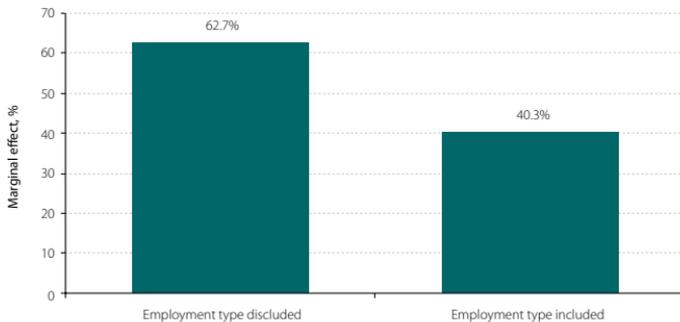
Controls for gender, age, household income, employment status, region, religion, race, region, and attitudes.

Based upon households with working age head

Coefficients transformed for interpretation using $\% \text{ impact} = 100(\exp(\text{coef} - \text{var}/2)) - 1$

Being educated to degree level or above appears to have a particular impact on the amount of savings for retirement. In Chart 6.7 below the left hand bar shows how, controlling for a wide range of characteristics including income, a degree is associated with 63% more retirement saving.

Chart 6.7: Impact of degree level education on pension saving



Source: *Wealth and Assets Survey 2006/08*

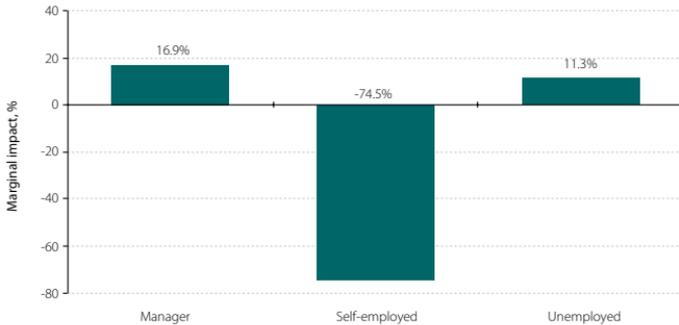
Controls for age, sex, household income, employment status, attitudes, number of children, marital status, disability, region, religion and race.

Having a degree opens up a range of employment opportunities that are less available to those with fewer qualifications, and higher level jobs are also more likely to include occupational pensions. This could be a reason for higher pensions savings among those with degrees, rather than the fact of the degree. Chart 6.7 above shows results of analysis that takes employment type (managerial, manual, intermediate occupations) into account. Even when employment type is controlled for, having a degree is still associated with having 40% more savings for retirement.

INSTITUTIONAL FACTORS APPEAR TO MAKE A DIFFERENCE

Having a degree may be associated with higher retirement savings independently of employment type, but employment status and occupation still matter. Chart 6.8 below shows that, holding all else constant, being in a managerial role is associated with 17% higher retirement savings, whereas being self-employed is associated with 75% lower retirement savings.

Chart 6.8: Impact of employment type on pension saving



Source: *Wealth and Assets Survey 2006/08*

Controls for age, sex, household income, employment status, attitudes, number of children, marital status, disability, region, religion and race.

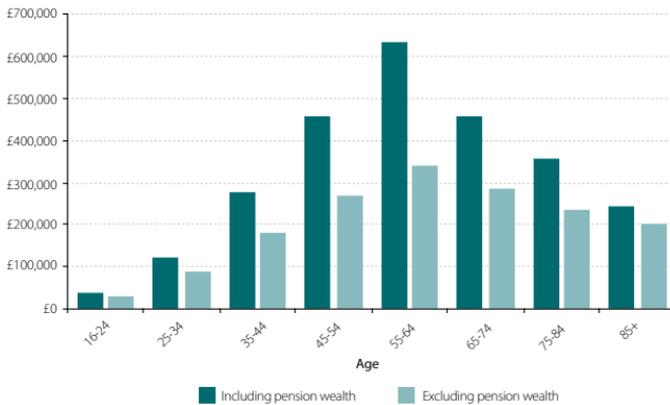
If higher levels of retirement savings among those in managerial roles reflect the greater availability of occupational pensions, this would point to the importance of institutional context – in

structuring the choices that individuals face, and the impact this has on their actual savings behaviour. The absence of these institutional factors may also be a reason for the much lower level of retirement savings among the self-employed. This may also have other explanations, such as a rational preference among those self-employed for more liquid assets to use for business exigencies.

LIFECYCLE PATTERNS

As Chart 6.9 below shows, total household wealth (shown including and excluding pension wealth) tends to increase with the age of the household head. This trend continues until the household head reaches their late 50s and early 60s, before starting to fall with age. This pattern is particularly pronounced when pension wealth is included.

Chart 6.9: Distribution of household wealth by age of household head, 2006-8, mean



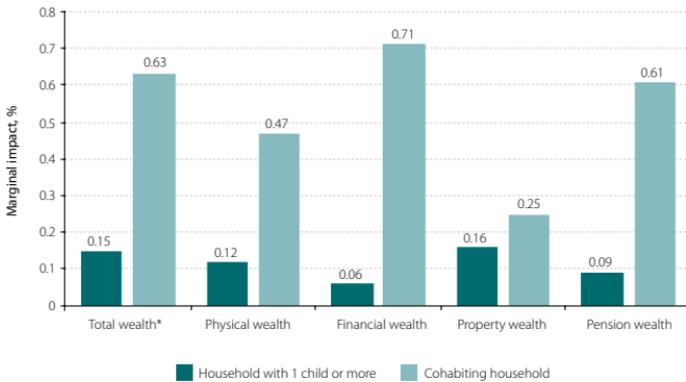
Source: *Wealth and Assets Survey 2006/08*

This finding is intuitive, and consistent with neoclassical economic theory. Older individuals have had a longer period in which to add to their saved wealth. Pension wealth is generated precisely to fund consumption in retirement. This pattern is exactly as would be anticipated by the life cycle hypothesis.

Chart 6.10 below shows how changes in household wealth accumulation are associated with lifecycle events such as household formation with a partner and being a parent. Holding other characteristics constant, having children is associated with higher wealth accumulation – with an increase in wealth of 0.15% for each additional child. This impact is most pronounced for property wealth and physical wealth, both of which have an element of concurrent consumption. It is more negligible for pension and financial wealth.

Chart 6.10 also shows the marginal impact of lifecycle events on wealth accumulation, relative to a single childless household. Holding all other characteristics constant, cohabitation is associated with having substantially higher wealth.⁷⁰ By contrast with the results for having children, this association is strongest for financial and pension wealth, and weaker for physical and housing wealth.

Chart 6.10: Impact of life cycle events on wealth, 2006-08



Results significant at the 99% level with exception of net financial wealth, which is significant only at the 95% level for 'Child in Household'. Controls for gender, age, household income, employment status, region, religion, race, region, and attitudes. Working age population. Relative to single household, no children.

**includes pension wealth*

Source: Wealth and Assets Survey 2006/08

70 A cohabiting household is defined as one with 2 people living together as: married, cohabiting, civil partner, or same sex couple.

SUMMARY

This chapter has demonstrated the relationships between objective households (and for pensions, individual) characteristics, and accumulations of household wealth. Having identified the general relationships between wealth and characteristics such as age of the household head, education level, occupation and earned income, it has also isolated the marginal impact of each of these characteristics.

As well as many findings that might have been predicted by standard life cycle models, two particularly interesting findings emerged. First, institutional context seemed to make a difference. Household heads in occupations that were more likely to offer occupational pensions were more likely to have higher pensions savings. This occupational impact was distinct from other factors associated with higher accumulated wealth such as income or education.

Second, the impact of certain characteristics on wealth accumulation differed sharply according to the type of wealth being considered. In particular, there was a distinction between the characteristics associated with higher financial and pension wealth and those associated with higher housing and physical wealth. This is significant. Housing and physical wealth contain an element of contemporaneous consumption. Indeed, physical wealth might be deemed as indistinguishable from consumption. By contrast, financial and pension wealth contain an element of deferred consumption. Not all financial wealth requires actual savings – households might gain financial wealth as a result of inheritance or other windfall – but maintaining a stock of financial wealth does require a deferring of consumption.

As well as capturing rich data on objective characteristics, the WAS also investigated more subjective factors influencing the financial dynamics of households – such as the attitudes to

financial risk of adults in the household. In the above analysis of objective characteristics, controls for attitudes captured by the survey were also included. It is the impact of these attitudes on wealth accumulations that is the focus of the next chapter.

CHAPTER 7: ASSETS AND ATTITUDES

Chapter 6 showed how objective characteristics – age, income, education status, occupation – are helpful in understanding general patterns of wealth accumulation. But the WAS also asked questions concerning certain attitudes of households. This chapter explores the importance of these subjective characteristics in understanding differences in asset accumulation between two otherwise similar households.

ANALYSING ATTITUDES AND THE DIFFERENCE THEY MAKE

Applying the framework developed in Chapter 3, objective characteristics provide a set of reasons why a household may make rational decisions to save or otherwise accumulated assets, and why other households might not.

The subjective characteristics help us to understand why – given the same set of objective characteristics and circumstances – some households are more successful at accumulating assets than others. And the evidence from this section shows that these internal drivers are quite significant.

The framework from Chapter 3 also explained how the institutional context within which financial decisions are taken can strengthen the logic of rational arguments for saving as well as the psychological resolve needed to turn ideas into actions. Chapter 5 showed how institutional factors seemed to make a difference to asset accumulation. The evidence in this chapter may help to explain why.

The analysis focused on three categories of attitudes:

- A 'spender' versus 'saver' orientation. In their analysis the ONS had grouped respondents together according to answers to three

questions in the survey.⁷¹ The answers to these questions tended to be highly correlated, and so the ONS created a five point scale from those with a strong spending orientation to those with a strong orientation away from spending. The analysis in this paper used the same basis of categorisation, labeling those with a spending orientation as ‘spenders’ and those with the opposite orientation as ‘savers’.

- ‘Tolerance for risk’ versus ‘risk aversion’. Respondents’ risk preferences were determined by whether they would prefer to receive a guaranteed £1,000 or take a one in five chance of winning £10,000.
- ‘Patient’ versus ‘impatient’. Respondents’ time preferences, or discount rates, were determined by whether they would prefer to receive £1,000 today or £1,100 in a year’s time.

The ONS analysis considered the incidence of each of these attitudes, and also their relationship to other characteristics, such as age and sex.

- For ‘spending orientation’ it found that 10% had a spending orientation (3% strong, and 7% moderate); 24% were neutral; and 65% were not orientated towards spending (26% moderately, and 40% strongly).⁷² Younger respondents were more likely to have a spending orientation than older respondents. This was particularly true of women, who were more likely to have a spending orientation than men in every age group as well as overall (9% for men, 11% for women).
- For time preferences, the ONS analysis found that 80% of respondents would prefer £1,000 today compared with only 20% who would choose £1,100 in a year.
- For risk preferences, the ONS found that 78% of people would prefer a guaranteed £1,000, compared with 22% who would take a one in five chance of winning £10,000.⁷³

71 Daffin, ed., *Wealth in Great Britain: main results from the wealth and assets survey 2006/08*, 86. The three questions concerned level of agreement or disagreement to the following statements: “I tend to buy things when I can’t really afford them”; “I am more of a saver than a spender”; and “I tend to buy things on credit and pay them off later”

72 Ibid.

73 Ibid, 87.

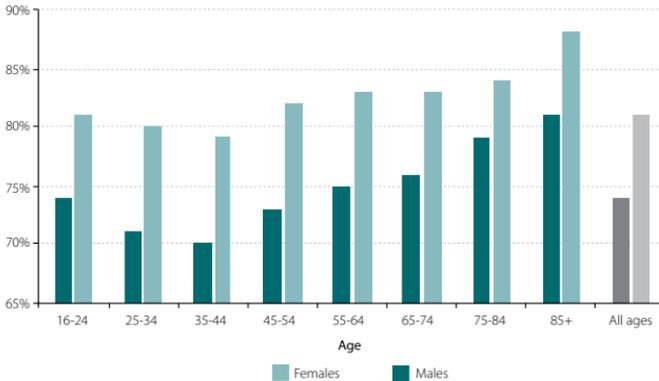
Overall, there was a strong majority in favour of both certain and immediate payments (63%) and only 5% of respondents chose to take a one in five chance to win £10,000 and wait a year for £1,100.⁷⁴

Going beyond the ONS work, the analysis in this paper considers the relationships between attitudes, income and wealth. These associations are first considered descriptively, before focusing on how particular attitudes are related to differences in wealth accumulation, holding other characteristics constant.

ATTITUDES, AGE AND SEX

The simple relationships between attitudes, age and sex are described in Charts 7.1 to below. They show how – at all ages – women are more likely to be risk averse and impatient and, in addition, are more likely to have a spending orientation. In general, risk aversion increases with age for both men and women (Chart 7.1). Impatience falls for men in middle age, but rises for both men and women in higher age groups (Chart 7.2). Spending orientation tends to fall with age for both among women and among men – though from a lower base (Chart 7.3).

Chart 7.1: Risk aversion: by age and sex, 2006-08, percentage



74 Ibid, 88.

Chart 7.2: Impatience: by age and sex, 2006-08, percentage

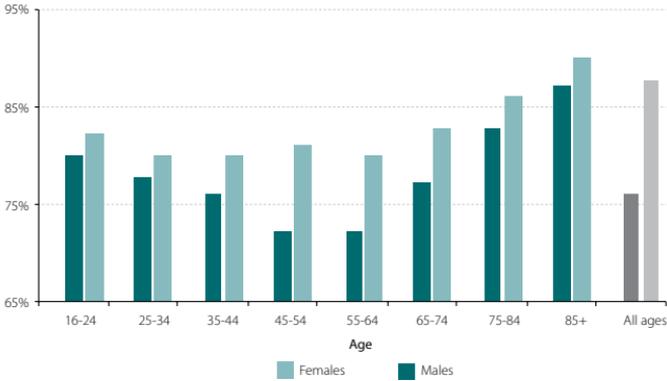
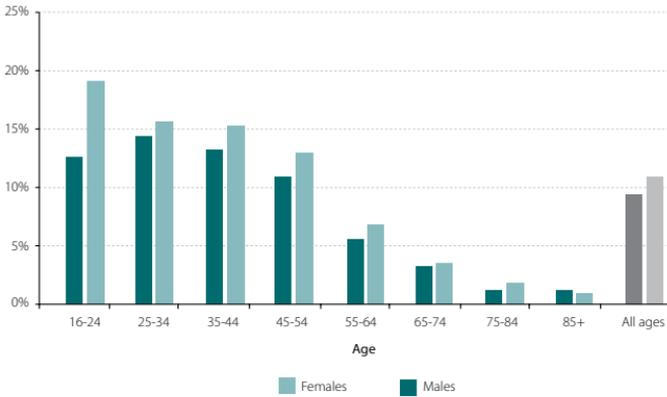


Chart 7.3: Spender orientation by age and sex, 2006-08



ATTITUDES AND INCOME

Charts 7.4 to 7.6 below show the simple relationships between attitudes and income, again dividing respondents by sex. They show how spending orientation creates an inverted ‘U’ shape, initially rising as weekly earned income rises, before falling again at higher incomes. This pattern is evident among men and women, although more pronounced among women (Chart 7.4).

The level of impatience tends to fall as weekly earned income rises for both men and women (Chart 7.5), as does the level of risk aversion (Chart 7.6).

Chart 7.4: Spender orientation: by income and sex, 2006-08

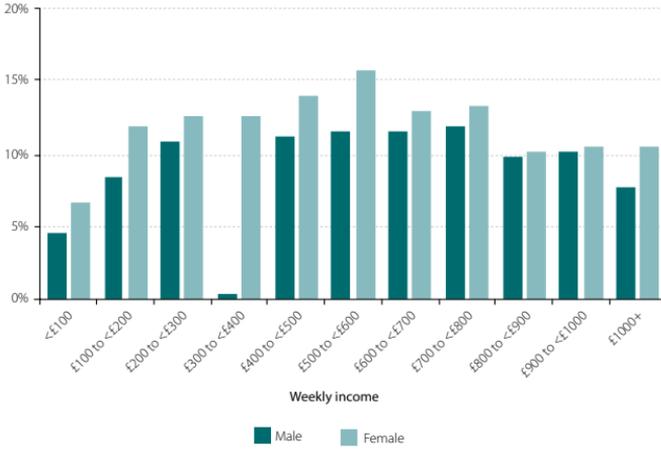
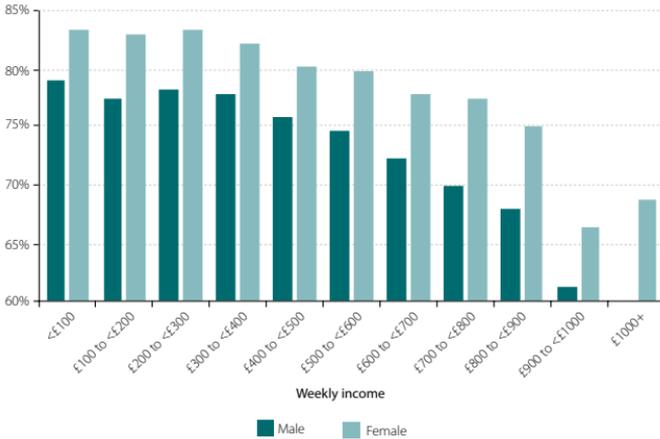
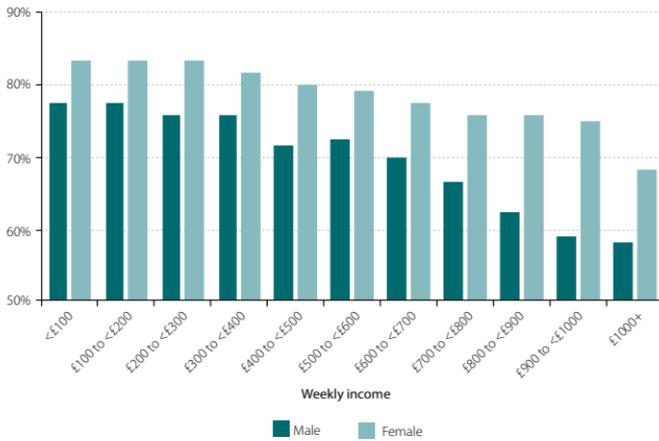


Chart 7.5: Impatience: by income and sex, 2006-08, percentage



Source: *Wealth and Assets Survey 2006/08*

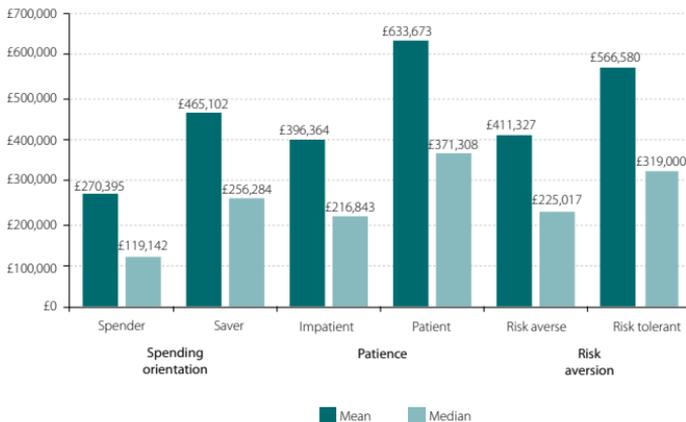
Chart 7.6: Risk aversion: by income and sex, 2006-08, percentage



ATTITUDES AND HOUSEHOLD WEALTH

Finally, Chart 7.7 below shows the simple relationships between attitudes and household wealth. It shows that wealth is greater among those who are savers not spenders, those who are patient and those with a greater tolerance for risk. The mean and median are shown. The large difference between these measures of average wealth show the extent to which the wealth is concentrated in the top half of the distribution, a truth that holds whatever the attitudes of respondents.

Chart 7.7: Average wealth by attitude of household head, 2006-08



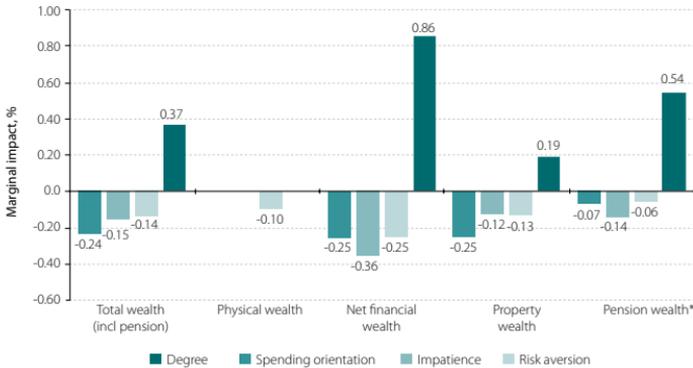
Source: *Wealth and Assets Survey 2006/08*

The above graphs have shown the simple relationships between subjective attitudes and more objective characteristics such as age, sex and income. Obviously, many of these factors overlap with each other. Income is correlated with age. Attitudes may change through the passing years. The analysis below seeks to isolate the relationship between particular characteristics and attitudes by examining these relationship while holding other characteristics constant.

Chart 7.8 below shows the impact of attitudes on wealth accumulation. It shows how, holding constant everything else, a spending orientation is associated with significantly lower household wealth for all types of wealth except physical wealth. Total household wealth is around 24% lower, with this effect particularly pronounced for net financial wealth and property wealth.

Impatience is associated with lower wealth of all types, except physical wealth. This effect is particularly pronounced in net financial wealth, which is 36% lower for an impatient person compared with an, otherwise similar, patient person. Risk aversion is associated with lower levels of wealth in every category, including physical wealth. This negative association is most pronounced for net financial wealth, at 25%.

Chart 7.8: Impact of attitudes of household head on wealth



Results significant at the 99% level with exception of pension wealth, which is significant only at the 90% level for spending orientation and risk aversion. Controls for gender, age, household income, number of children, employment, region, religion, marital status, race, region. Results above derived using the formula: $\text{impact} = \exp(\text{coefficient}) - 1$, to generate correct interpretation of dummy variable on logged dependent variable. *Working age population

Of the other characteristics included in the regression, education to degree level has a strong positive association with wealth accumulation in all categories except physical wealth. Overall, and holding everything else constant, a degree is associated with 37% higher wealth, including 86% more financial wealth and 54% more pension wealth.

The descriptive statistics above have shown how attitudes relevant to wealth accumulation vary by gender, age and income. At all ages, women are more likely to be risk averse and impatient, plus more likely to have a spending orientation. Age tends to increase aversion to risk, and decrease the likelihood of a spending orientation. The likelihood of a spending orientation rises as income rises, before falling. Impatience and risk aversion both fall as income rises. The descriptive statistics also point to a relationship between attitudes and household wealth, with wealth being greater among savers, the patient, and those with a greater tolerance for risk.

Results from the regression analysis show the relationship of attitudes to total household wealth and its component parts. Holding everything else constant, a spending orientation, impatience, and risk aversion are all associated with much lower household wealth, although physical wealth is an exception. Of the other characteristics included in the regression, education to degree level has a strong positive association with wealth accumulation in all categories except physical wealth.

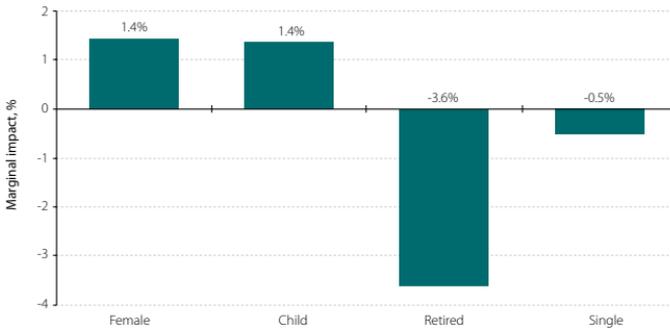
WHAT DETERMINES ATTITUDES?

The above analysis has focused on the impact of attitudes on wealth accumulation. With the relationships between attitudes and wealth outcomes being so systematic and strong, what is lying behind these attitudes? How amenable might they be to change through public policy?

ATTITUDES AND THE LIFE COURSE

First, the determinants of a spending or savings orientation are considered. Descriptive statistics in Chart 6.9 above show a predictable relationship between age and accumulated wealth, with wealth rising with age until retirement when it begins to fall. But holding constant other characteristics, age had very little systematic impact on the likelihood of having a spending orientation.⁷⁵ Furthermore, additional household equivalized income has no significant effect on the likelihood of having a spending orientation. However, as is illustrated in Charts 7.9 and 7.10 below, a spending orientation is related to several characteristics, some of which are innate and others more amenable to change through public policy. Chart 7.9 shows the relationship between elements of the life course and a spending orientation. Being a female and having a child are both associated with having a spending orientation, whereas being retired and single reduce the likelihood.

Chart 7.9: Determinants of spending orientation: life cycle events, marginal probit



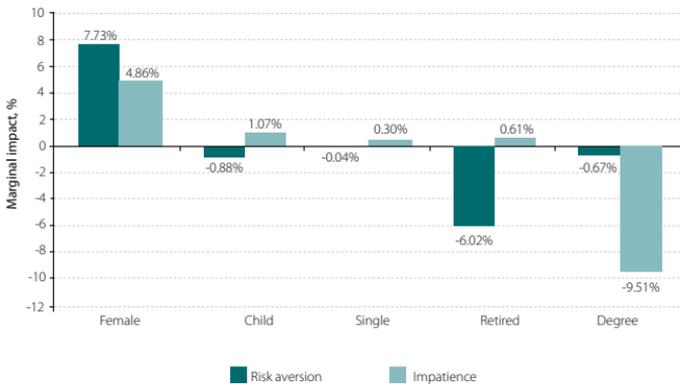
Source: *Wealth and Assets Survey 2006/08*

Controls for age, household income, employment status, region, religion, race, region, and attitudes. Based upon working age population

75 Controlling for household income, region, sex, level of education, employment status, attitudes, race and religion an increase in age of 1 year decreases the likelihood that an individual will have a spending orientation by only 0.002%, significant at the 99% level.

These life events are also associated with other attitudes relevant to wealth accumulation, as shown in Chart 7.10. Being risk averse and impatient are both negatively associated with wealth accumulation. Holding other factors constant, risk aversion is more likely among women, and less likely among those with a child, retired or having a degree. Conversely whilst women are also more often associated with impatience, unlike risk aversion, those with a child are also more often impatient as are those who are single and those who are retired. Impatience is less often associated with those holding degrees.

Chart 7.10: Determinants of risk and time preferences, marginal probit



Source: Wealth and Assets Survey 2006/08
 Controls for age, household income, employment status, region, religion and race.
 Coefficients transformed for interpretation using $\%impact = 100(\exp(\text{coef} - (\text{var}/2)) - 1)$

ATTITUDES AND INCOME

Chart 6.2 showed the strong positive relationship between earned household income and all types of wealth accumulation, holding constant all other factors (including attitudes). Chart 7.8 showed the relationship between attitudes and wealth accumulation, again holding constant all other factors (including earned income). But does the level of income affect the relationship between attitudes and wealth?

This was tested in two ways. First, a regression including an interaction between savings orientation and income did not find evidence that having a savings orientation had a greater impact on wealth accumulation at higher levels of income. However, if there were a 'threshold' level of income at which people change from being 'latent savers' (with the inclination but not the means to save) to 'actual savers' (with the inclination and the means to save), this may not be picked up with the simple interaction. As a result a second test divided households into quintiles according to their annual equivalized income levels,⁷⁶ before running the regression analysis separately on each income quintile.⁷⁷

The results are reported in Chart 7.11 below. This again shows the strong association between certain attitudes and household wealth. Having a savings orientation is strongly associated with greater household wealth at every level of income, whereas impatience and risk aversion show a strong negative association at all income levels. There is no immediately observable systematic difference across income quintiles in the relationship between having a savings orientation and accumulated wealth. The effect of a saving orientation on those in the higher income quintiles tends to be larger. Those in the 3rd and 5th income quintiles with a saving orientation have on average 38 and 32% higher total wealth than those without. This compares with differentials of 20 and 17% in the 1st and 2nd income quintiles.

By contrast, while there remains a strong negative association between impatience and risk aversion and accumulated wealth across all income quintiles, this relationship weakens appreciably as earned income rises. This is particularly true of impatience, which is associated with 29% lower wealth for households in the lowest quintile, falling consistently as incomes rise to 12% for households in the highest quintile.

76 Those households without any earned income (likely to be living from benefit income, which is not adequately captured in the WAS data and therefore excluded from the analysis) are included in the lowest income quintile.

77 This is equivalent to an interactive approach with a discrete multinomial variable.

Chart 7.11: Impact of attitudes of household head on total household wealth (excluding pension wealth)



Source: Wealth and Assets Survey 2006/08

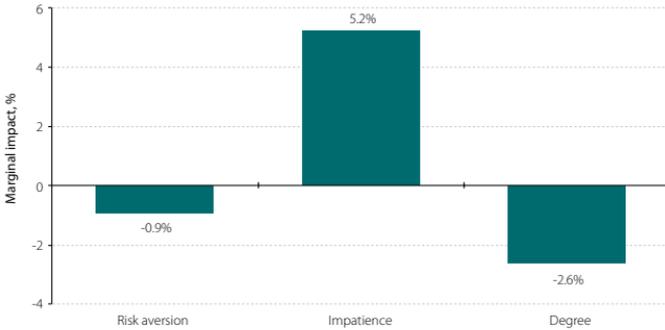
Controls for gender, age, household income, employment status, region, religion, race, region, and attitudes.

Based upon households with working age head

Coefficients transformed for interpretation using $\% \text{ impact} = 100(\exp(\text{coef} - (\text{var}/2)) - 1)$

ATTITUDES AND OTHER ATTITUDES

Chart 7.12: Determinants of spending orientation: attitudes and education, marginal probit



Source: Wealth and Assets Survey 2006/08

Controls for sex, age, household income, employment status, region, religion, race, and region. Based upon working age population

Attitudes are themselves interrelated. Risk aversion is associated with a 0.9% lower probability of having a spending orientation. Impatience is associated with a 5.2% higher probability of having

a spending orientation, and holding a degree level education is associated with a 2.6% lower probability of having a spending orientation. This suggests some potential for increasing the time horizon of individuals in order to encourage saving behaviour and a role for educating individuals in the value of seeking to smooth consumption over the life-cycle.

SUMMARY

The results in this chapter demonstrated clear associations between householder attitudes and household wealth:

- The descriptive statistics showed that wealth was greater among savers, the patient, and those with a greater tolerance for risk.
- Results from the regression analysis showed the relationship of attitudes to total household wealth and its component parts:
- Holding everything else constant, a spending orientation, impatience, and risk aversion are all associated with much lower household wealth, although physical wealth is an exception.
- Of the other characteristics included in the regression, education to degree level has a strong positive association with wealth accumulation in all categories except physical wealth.

It also reported how attitudes relevant to wealth accumulation vary by gender, age and income:

- At all ages, women are more likely to be risk averse and impatient, plus more likely to have a spending orientation.
- Age tends to increase aversion to risk, and decrease the likelihood of a spending orientation.
- The likelihood of a spending orientation rises as income rises, before falling. Impatience and risk aversion both fall as income rises.

What determines attitudes is partly driven by innate characteristics, and partly by characteristics more amenable to the influence of policy:

- All else equal, being a female and having a child are both associated with having a spending orientation, whereas being retired and single reduce the likelihood.
- Being risk averse and impatient are both negatively associated with wealth accumulation.
- Holding other factors constant, risk aversion is more likely among women, and less likely among those with a child, retired or having a degree.
- Impatience is also more likely among women, but also among those with a child, those who are single and those who are retired. It is less likely among those with degrees.

Holding other factors constant, the level of household income does not seem to affect the relationship between attitudes and wealth in any systematic way. Having a savings orientation is strongly associated with greater household wealth at every level of income, whereas impatience and risk aversion show a strong negative association at all income levels (although this does weaken as incomes rise).

Attitudes are themselves interrelated. Risk aversion is negatively associated with a spending orientation, as is having a degree. By contrast, impatience is positively associated with a spending orientation.

CHAPTER 8: LIABILITIES AND ADVICE

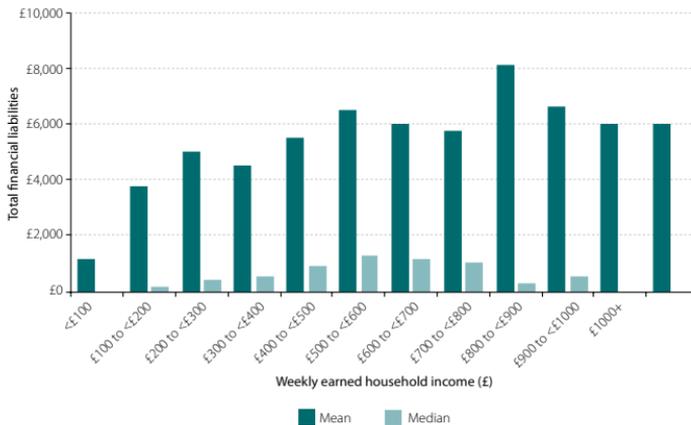
Chapters 6 and 7 have sought to unpick the reasons for differences in household assets. This section focuses on household liabilities, and whether and where households turn to for financial advice.

LIABILITIES

Chart 6.1 above showed how total household wealth tended to increase as earned income increased. Within each band of income the mean level of assets substantially exceeded the median. This showed that, at every level of income, wealth was unequally distributed.

Chart 8.1 below shows how household liabilities are distributed, again broken down by weekly earned income. Here, debts form an inverted 'U' shape. As incomes rise, household assets also rise and, to a certain point of income, so do household liabilities. This suggests that access to borrowing increases as incomes rise, or attitudes to debt change as households feel more able to make regular repayments. The big difference observed between the mean and median shows that – at every level of income – a relatively small number of households are accounting for a very large share of total debt.

Chart 8.1: Distribution of total household financial liabilities: by weekly income

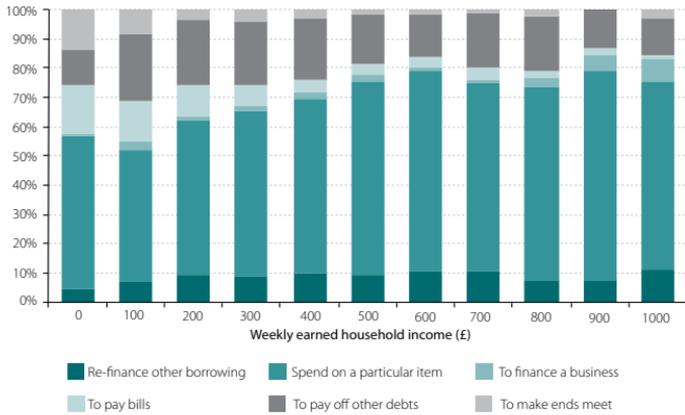


Source: *Wealth and Assets Survey 2006/08*

The long-term wealth implications of borrowing can vary dramatically depending on what borrowed resources are used for. If borrowing is used to finance an income-generating activity such as capital investments or business financing, borrowing may increase long term wealth accumulation, unlike borrowing to pay bills or for day to day spending.

Chart 8.2 below shows the motivation for loans broken down by weekly earned household income. It shows how households with lower levels of earned income are more likely to borrow to make ends meet and to pay bills, whereas those with higher levels of earned income are more likely to borrow to finance a business. Across all income bands, borrowing is most likely to finance the purchase of a particular item of consumption.

Chart 8.2: Motivation for loans by weekly income

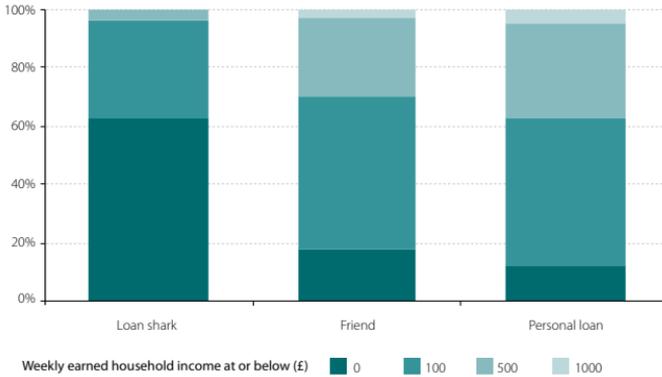


Source: *Wealth and Assets Survey 2006/08*

Where do these loans come from? Chart 8.3 below breaks down selected sources of loans by the income levels of those that utilize them. Costly forms of borrowing, such as loans from loan sharks, are overwhelming the preserve of households with no or very low levels of earned income. Personal loans are unlikely

among households depending only on income from benefits, as are loans from friends.⁷⁸

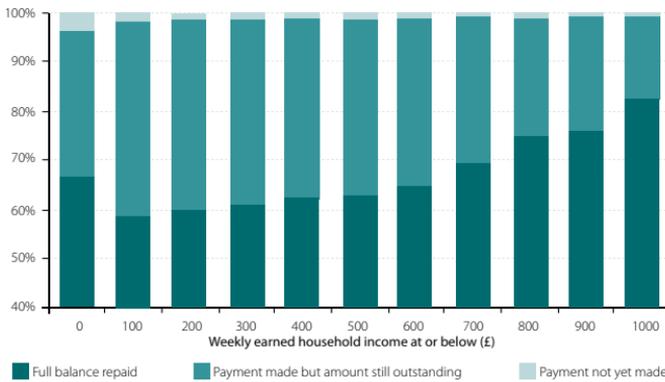
Chart 8.3: Source of loans, by weekly household income



Source: *Wealth and Assets Survey 2006/08*

Credit cards can be an efficient way to borrow for very short term debts, but interest rates are relatively high if balances are not repaid in full. Chart 8.4 below shows that most households at all levels of income do clear their credit card balances before interest payments are incurred. However, this likelihood rises sharply as incomes rise.

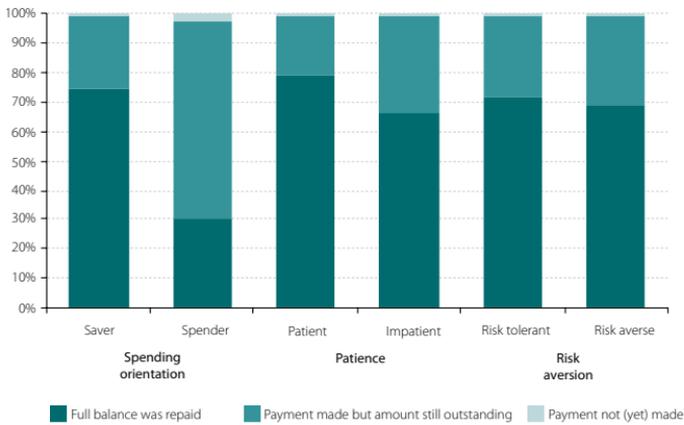
Chart 8.4: Credit card repayment by weekly household income



⁷⁸ There were only 23 observations of individuals borrowing from pawn-shops, thus this is not included in the table. Nevertheless, of those that do borrow from pawn shops 14 out of 23 earn less than £100 per week.

Attitudes are also relevant to the likelihood that credit card balances will be repaid in full. Chart 8.5 below shows how being a spender rather than a saver makes a 45 percentage point difference to the likelihood that balances will be cleared: nearly 30% of those with a moderate or strong spending orientation paid their credit card balance in full, compared with 75% for those with a savings orientation.

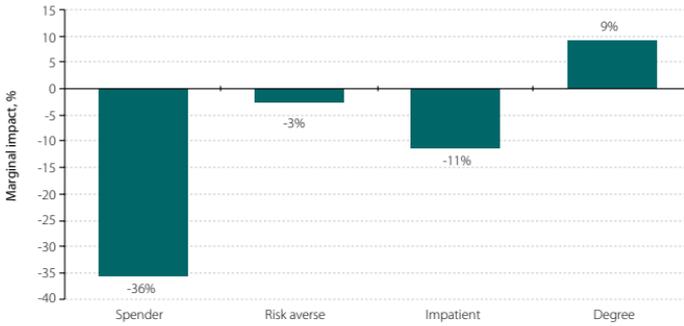
Chart 8.5: Credit card repayment: by attitude



Source: *Wealth and Assets Survey 2006/08*

Being a spender may also be associated with many other characteristics that also reduce the likelihood of repaying a credit card balance. Chart 8.6 below reports the results of a probit regression, which holds constant other factors (such as sex, age, household income, employment status, region, religion and race) to isolate individual characteristics. It shows that, all else equal, a spending attitude reduces the likelihood of repaying a credit card balance by 36%. Similarly, being impatient is associated with an 11% lower likelihood of repayment, whereas having a degree is associated with a 9% greater likelihood.

Chart 8.6: Impact of attitudes on likelihood to repay credit card in full, marginal probit estimates



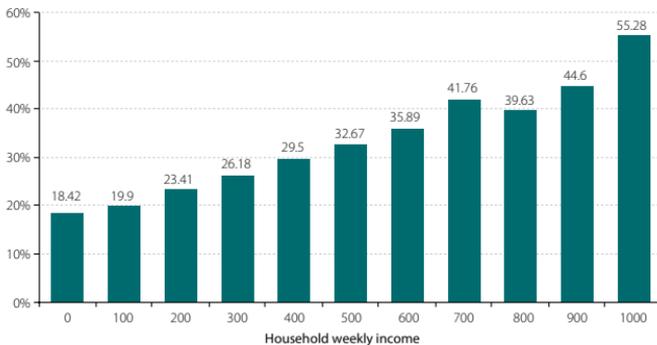
Source: *Wealth and Assets Survey 2006/08*

Controls for gender, age, household income, employment status, region, religion, race and region.

FINANCIAL ADVICE

Financial advice can help households to budget more effectively, manage debts and take a more deliberate approach to saving. Chart 8.7 below shows how the likelihood of taking financial advice rises as earned income rises. Over half of households with earned weekly incomes above £1000 had taken financial advice, compared with less than a fifth of households with earned weekly incomes below £100.

Chart 8.7: Proportion of income bracket who sought professional financial advice

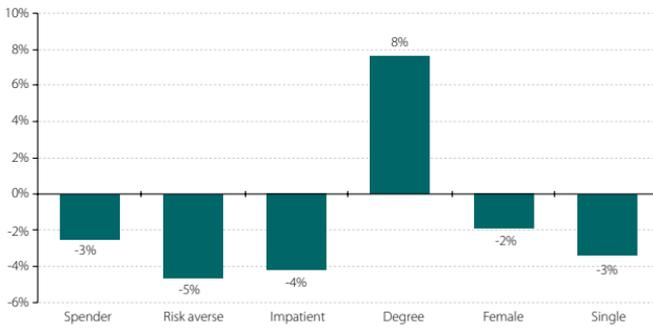


Source: *Wealth and Assets Survey 2006/08*

Equalized weekly household income.

Holding constant other characteristics,⁷⁹ Chart 8.8 below shows how being a spender, impatient and risk averse are all associated with a reduced likelihood of seeking professional financial advice. By contrast, those educated to degree level are 8% more likely to seek professional advice.

Chart 8.8: Impact of attitudes and education on probability seek professional advice, marginal probit estimates



Source: *Wealth and Assets Survey 2006/08*

Controls for gender, age, household income, employment status, region, religion, race and region. See Appendix 5

SUMMARY

To a certain point of income, as household incomes rise so do household liabilities, after a point, however, they begin to fall. As might be expected, households with lower levels of earned income are more likely to borrow to make ends meet and to pay bills, whereas those with higher levels of earned income are more likely to borrow to finance a business.

Costly forms of borrowing, such as loans from loan sharks, are overwhelming the preserve of households with no or very low levels of earned income, though the incidence of such borrowing types revealed in the data were limited. Personal loans are unlikely

79 Including age, household income, employment status, region, religion, race, and region.

among those households depending only on income from benefits, as are loans from friends. Most households, at all levels of income, do clear their credit card balances before interest payments are incurred, but the likelihood that they fail to do so rises sharply as incomes fall. Full credit card repayment is much more common among savers than spenders, the more patient, and those with degrees.

The likelihood of taking financial advice rises as earned income rises. Holding constant other characteristics (including income), being a spender, impatient and risk averse are all associated with a reduced likelihood of seeking professional financial advice, whereas those with degrees are more likely to seek advice.

Chapter 4 reported the findings from our analysis of the Child Trust Fund administrative data. Chapters 6, 7 and 8 explained the findings from our analysis of the WAS revealing the underlying correlates of wealth accumulation, including income and attitudes, as well as analysis of household liabilities and access to advice. Taking these findings together, the next chapter considers the implications for policy.

CHAPTER 9: A WHOLE NEW APPROACH TO SAVINGS POLICY

With the Coalition Government still developing its approach to savings policy, this paper has sought to open up the debate – about the goals of the policy and the means of achieving them.

We have set the Coalition’s approach in its political and (recent) historical context, noting the points of continuity and difference with the previous Labour government. We have outlined the scale of the challenge for policy, whichever approach is adopted. We have reviewed the relevant literature and analysed Child Trust Fund administrative data, extracting lessons for policy makers from both. And we have provided a fresh analysis of the Wealth and Assets Survey 2006/08 unpicking the underlying correlates of wealth, including the relationship with household income and the relevance of attitudes.

Together this has provided plenty for policy makers to chew on. Five themes have emerged as especially important.

1. There are tensions between different, legitimate goals of savings policy: clear priorities are needed.

There are five legitimate goals for savings policy: increasing the savings ratio; reducing asset inequalities; increasing financial resilience; ensuring sufficiency of retirement savings; and enabling opportunities and changing peoples’ outlook through asset holding. Within these goals there are clear tensions, particularly between aggregate savings objectives and distributional goals, and between the types of strategies best suited to achieving them. These relationships are summarised in Box 9.1 below.

These interrelationships and tensions between policy objectives and approaches put a premium on governments being clear about their priorities, and allowing those priorities to shape policy design.

2. It is important to do traditional savings policy better, and there is plenty of scope for improvement.

Overall, our findings offer strong support for traditional approaches to savings policy that encourage a 'savings habit', where these are most appropriate given the policy priorities.

This is because those individuals who are already saving are likely to have attitudes that are strongly correlated with savings habits. These are people who have already found ways of linking the strong rational incentives that everyone has to save with the wherewithal to actually save. Policies that build on these attitudes and propensities are likely to be successful. If the policy priority is to increase the level of savings overall or to improve the savings ratio (rather than to get non-savers saving), then those with a pre-existing savings propensity should be the first to be helped and encouraged to save more. But this is the low hanging fruit of savings policy, and expenditure here is often beset by deadweight costs.

Our findings also suggest that there is much more that can be done to improve this approach to policy, by offering more institutional supports and stronger systemic messages. Savings decisions are complicated and easy to put off. Anything that can precipitate savings decisions, or make staying in a savings programme the default option reduce the psychological costs.

3. There are limits to the effectiveness of a 'savings habit' approach.

Changing attitudes might be a desirable aim of policy but, in practice, it is difficult. As a result, a 'savings habit' strategy that succeeds in encouraging existing savers to save more, might not succeed in encouraging saving among those not already inclined to save.

This is an important insight. A 'savings habit' strategy may well help in raising the level of savings overall, a valuable goal. But it is

likely to fail in other goals for policy, such as increasing the share of households with savings, or reducing asset inequality.

4. There are good – mostly complementary – alternatives: focus on ‘savings activities’

The good news is that having a savings habit is not necessary to accumulate assets. Much policy research, thinking and activity in this area is devoted to encouraging more of us to become savers. While this is obviously a noble goal to which we might aspire, one of the key findings from our analysis of the WAS is that much asset accumulation is not the result of savings habits. ‘Saving friendly’ attitudes had a weaker relationship with types of asset accumulation that had an element of consumption. Meeting contractual payments on a mortgage to ‘consume’ housing today requires much less self motivation and financial discipline than choosing to put aside today’s income for the future.

Accepting that people don’t have to become habitual savers, in the traditional sense, to build a pot of savings or other assets opens up many other possibilities for savings policy if policy makers are creative. The absence of a savings habit need not be a barrier to asset accumulation if the policy environment is right.

And unlike in many areas of policy, there is little conflict between a dominant ‘savings habit’ strategy, and other approaches for many goals of savings policy. Indeed, many of the insights that point towards ‘savings activities’ strategies could also be used to increase the effectiveness of the dominant ‘savings habit’ strategies.

5. The role of government is nuanced

Many of the findings in the paper are things that government can act on directly. These range from the design of specific policies or tax incentives to the signals that government sends in the way it makes cash transfers. But other things depend on cooperation

from a much broader range of actors. Here the role of government will not be to do itself, but to catalyse, persuade, guide, reward and regulate so others will do.

Box 9.1 Which approach for which goal?

Where are the goals of savings policy interrelated? Where are they in tension? Which strategy should be used for which goal?

In general, if the priority is to increase overall savings (to improve the savings ratio or to reduce the number of people with insufficient savings for retirement) the primary focus should be on increasing the amount of savings among those who are already savers. 'Savings habit' strategies are most appropriate. By contrast, if the objective is to increase the numbers of households with savings, then 'saving activities' strategies should be chosen. Finally, 'savings habit' strategies might be actively harmful to efforts to reduce asset inequality, so pursuing them must depend on the priority given to this goal relative to others.

Policy goal		'Savings habit strategy'	'Savings activities strategy'
Increase savings ratio	Increase aggregate savings relative to consumption	✓1st	✓2nd
Reduce asset inequalities	Reduce ratio of assets between top and bottom	X	✓
Increase financial resilience	More households with a store of liquid assets	Neutral	✓
Ensure sufficiency of retirement savings	More people saving more for retirement	✓ (Higher savings)	✓ (More savers)
Enable opportunity and change outlook through asset holding	Unlock categorical benefits of having some savings	✓*	✓

* This was the primary objective of the Child Trust Fund

BRINGING IT ALL TOGETHER: THE NEW APPROACH

Chapter 1 argued for a whole new approach to savings policy, based on the findings of the paper. This comprises three elements: continuing to encourage the development of savings habits, developing a new policy strategy to encourage savings activities, and making existing government actions part of the solution.

1. Encouraging savings habits – cultivate attitudes associated with asset accumulation, and help people in converting positive intentions into savings habits and behaviours.

The evidence from the WAS analysis demonstrated how important attitudes are to savings decisions and behaviour. Income makes a difference, education makes a difference, age and life cycle events all make a difference. But even when all this is taken into account, attitudes still make a huge difference. Thinking longer term, being willing to take financial risks, and prioritising saving over spending were all independently associated with likelihood of greater asset accumulation, whatever else was happening to a household. The CTF analysis confirmed similar patterns of behaviour – with a close relationship between initial decisions to invest the CTF voucher, and subsequent likelihood of saving into the Fund.

For policy makers, this suggests two things:

First, cultivate attitudes associated with asset accumulation.

Policies that change or strengthen attitudes to saving are likely to be successful in raising the overall levels of asset accumulation and increasing the numbers of households with savings. For example:

- **Ensure accurate and simple information is more available;**
- Build financial capabilities through **offering proactive and regular advice** about budgeting, saving and longer term financial planning;

- Encourage banks to provide smart budgeting or **'jam jar' accounts** making it easier for customers to manage their accounts, understand their expenditure and increase savings by increasing transparency and control. The features of a 'jam jar' account include the provision to customers of detailed breakdowns of expenditure, with the ability to subdivide account balance into separate 'jam jars' corresponding to patterns of spending (see Box 9.2: Jam Jar Banking)

Second, help people convert positive savings intentions into actual savings habits by:

- **Stimulating a diverse range of financial products**, making it more likely that prospective savers will find a product that matches their needs;
- **Precipitating decisions** with Savings Smartcards, helping to overcome tendencies towards procrastination (See box 9.4);
- **Capitalising on points of change**. Box 4.3 in Chapter 4 highlighted the 'Save More Tomorrow' concept in which employees pre-commit to putting future pay rises into a pension or savings plan. Pre-committing and limiting the commitment to the increase in pay both allow individuals to increase their savings at lower psychological costs: pre-committing helps overcome tendencies towards procrastination; limiting the commitment to future pay increases avoids problems of loss aversion.

These suggestions are very much in line with the Coalition's emerging policy framework, and build on many good examples of similar activities. Some would depend on government directly but, for many of the examples, the challenge for government is to get others to take the lead.

Box 9.2 Jam Jar Banking

Accounts that help you budget

In years gone by, households would often budget by dividing income into different jars: one for the rent money, another for food, another to pay the bills. By putting money into a jar, it is clearly ear-marked and therefore semi-secure: it takes an act of will to spend it, and it is securely separated from an account handling direct debits and other bills. Now, modern banking technology is catching up with our grandmothers' condiment containers. 'Jam jar' accounts bring this time-honoured approach into the modern world.

'Jam jar' accounts have a number of features that help customers to manage their accounts, understand their expenditure and increase savings by increasing transparency and control:

- A detailed breakdown of spending so customers can see where their money is spent.
- The ability to subdivide the account balance into separate 'jam jars' corresponding to these spending areas.
- Intelligent information about the accounts, with real time updates on levels, low balance alerts and automated transfers of funds from the main account to the jam jars.
- Automated re-allocation of funds between jam jars to support budgeting, reduce bank charges and increase savings. For example, if a bill payment account is running too low, funds will be automatically transferred from the consumption account. And if the consumption account has money left over at the end of the month, it will automatically go into savings.
- Customer access to trained money managers, who provide budgeting advice and referrals to specialist consumer services where necessary.
- Fixed consumer fees that cover the cost of the account, without additional penalty fees, that penalise those who manage their money poorly; a monthly fee of £4.45 would be attractive to low-income savers and cost-neutral for banks.^a

There are small number of specialist financial companies that offer products with jam jar elements, used by around 150,000 people, many of

whom take up the products after referral by debt recovery agents. These products are niche, too expensive and with little profile or recognition among consumers.^b The Fairbanking Foundation is offering a kitemark for accounts that offer jam jar elements, but so far only four accounts have received it.^c Government could help to broker a deal among all major UK banks to offer such an account, which would help to reduce fee levels, increase their profile, and boost take-up.

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- a John Springford, *A confidence crisis? Restoring trust in financial services*. (London: Social Market Foundation, 2011), 49.
 b Social Finance, *A new approach to banking: Extending the use of jam jar accounts in the UK* (London: Social Finance, 2010), 5.
 c Fairbanking Foundation, 'Four UK banking products gain first Fairbanking accreditations', press release,

2. Generating opportunities for savings activities – make it easier for people to accumulate assets without ever becoming a habitual 'saver' in the traditional sense.

The central argument of this paper is that saving could be much easier than it is: if only policy focused on creating opportunities for savings **activities**. Instead of pursuing the more orthodox approach of encouraging virtuous 'savings habits', such an approach would seek to make a virtue of impulses to consume or procrastinate. For the most part, they would be complementary to policies encouraging savings habits, extending the impact of savings policy by acting on different groups of individuals and households with differing attitudes to saving.

There is a lot that policy makers can do or encourage to increase the amount and distribution of accumulated assets, even if they cannot persuade all of us to see ourselves as savers. For example:

- **Exploiting passivity:** as with the Turner reforms to pensions, establishing opt-ins to NEST accounts as the default position turns a common weakness – procrastination – into a strength (See Box 4.2 in Chapter 4). Similar opt-ins could be encouraged for other types of savings products, perhaps through incentives for inclusion in

employment contracts, rather than through legislation. Employees would always need to be able to opt out if they chose to do so.

- **Link Save More Tomorrow to NEST:** one of the objections to the passive NEST approach is that the 8% minimum contributions (3% from the employer, 4% from the employee, 1% from the government) will become a maximum, and this won't be sufficient to provide an adequate income in retirement. Linking Save More Tomorrow principles to NEST, so that employees could pre-commit to putting future pay rises into pension accounts, could overcome this problem (See Box 9.3).
- **Making saving a 'crime of opportunity':** instead of requiring deliberate planning, saving should become a crime of opportunity, with multiple opportunities to save small amounts of money. Key to this would be establishing a generic platform technology upon for which multiple applications could be developed. The model here is the Oyster card, adapted to become a Savings Smartcard. This would operate like any prepayment card, but would be linked to a savings account. The Savings Smartcard could be used to pay small amounts of money into the savings account, but not withdraw it (See Box 9.4). Once the Savings Smartcard technology was established, multiple opportunities for additional saving could be created.
- **Bill round ups:** drawing on Lloyds TSB's 'Save The Change' scheme, supermarkets would offer to round up customers' shopping bills to the nearest £5 or £10, and then use the Savings Smartcard to transfer the difference into their savings account. Money 'saved' through multi-buy offers or discounts could also be banked in this way. By facing many opportunities to save small amounts in fun ways, individuals can slowly increase the funds in their savings account without minimal impact on their current spending patterns (See Box 9.4).
- **Make saving a form of 'consumption'** – just as repaying a mortgage allows households to accumulate assets while 'consuming' housing, so the idea of making savings more like consumption could be extended. The 'No Lose Lottery' (see Box 9.5) is one such idea. Portion of the purchase price would go into the saver's account, with

a smaller amount going towards the prize fund. By comparison with the National Lottery, this would be something like the money that goes to 'Good Causes' going instead into the player's savings account.

- **Give citizens assets in things they already 'own':** one of the main justifications for the Child Trust Fund was the potential of asset ownership to influence behaviour. This principle could be extended to shares in public assets transferred from public ownership. The Social Market Foundation has promoted this idea in recent years, for example in relation to mutual ownership of the Strategic Roads Network.⁸⁰

Box 9.3: Increasing the NEST egg

Link the Save More Tomorrow Approach to National Employment Savings Trust (NEST)

Box 4.2 in Chapter 4 explained the changes to pensions being introduced from 2012 requiring every employee to be automatically enrolled in a 'qualifying workplace pension scheme'. If an employee doesn't qualify for or have access to a company pension scheme then they will be automatically enrolled in NEST, a simple, low-cost pension scheme being introduced by the Government. Auto enrolment should generate higher saving contributions as employees are far less likely to opt-out than they would have been to opt-in. Employers are required to contribute a minimum of 3% of each employee's eligible earnings into a pension, assuming the employee does not opt-out. Employees will need to pay a personal contribution of 4% with a further 1% tax relief being added to make the minimum contribution 8%.

Box 4.3 also in Chapter 4 explained the idea of 'Save More Tomorrow', in which employees pre-commit to increase contributions to a savings scheme with each pay rise. Employees are free to opt-out at any time.

One of the concerns with NEST is that the 8% minimum figure for minimum contributions will become a maximum implicitly endorsed by the government through the signal it is sending. This is unlikely to be enough to provide an adequate income in retirement.

80 Ian Mulheirn and David Furness, *Roads to recovery: reducing congestion through shared ownership* (London: Social Market Foundation, 2009).

The solution may be to link the 'Save More Tomorrow' approach to NEST. Instead of contributions remaining at a relatively low level of 8%, they would rise with each pay increase. In the US, the NEST model has demonstrated immense potential to increase pensions contributions, far in excess of traditional opt-out models. But unlike the NEST scheme where saving contributions are maintained at a low pre-set level, SMT automatically increases contributions as wages are increased to in order to align pension contributions with desirable lifecycle saving rates.

The Government should introduce the SMT mechanism within the existing NEST scheme, enabling employees to sign up to the SMT mechanism when being enrolled in NEST, using people's tendency towards inertia to create a more dynamic savings regime.

Box 9.4 Savings Smartcard

A new generic platform to channel small amounts of money from multiple savings activities into savings accounts

A Savings Smartcard - based on the model of Transport for London's Oyster Card - would be a new generic platform technology, enabling the development of multiple new opportunities to save in many different ways. The Savings Smartcard would be used to pay small amounts of money into a savings account, but not withdraw it. It could be the platform for the No Lose Lottery (see Box 9.5) and many other creative ideas, including the following.

Research from Sainsbury's Finance suggests that 50% of individuals would be interested in making deposits into their savings accounts whilst paying for their shopping at the supermarket. Sainsbury's SaveBack scheme allows customers to do just that, putting money aside for future purchases in the supermarket. But unlike this, and other, existing examples, the Savings Smartcard would not be tied to any particular store. The card would be linked to an individual's savings account, or where none exists, to a default account.

The smartcard could be used as a basis for further schemes to encourage saving. Borrowing from Lloyds TSB's 'Save The Change' scheme,^c supermarkets could offer to round up customers' shopping bills and transfer the difference into their savings account via the individual's

smartcard. In addition, stores could allow customers to put aside the money they have 'saved' through multi-buy offers. By saving small amounts over time, individuals can slowly increase the funds in their savings account without experiencing a large change in their current spending patterns. Forcing individuals to make these decisions when they purchase their shopping increases the chances of them opting into the scheme on impulse, thereby adding to their savings funds.

a http://www.sainsburysbank.co.uk/savings/sav_es_saveback.shtml.

b Sainsbury Finance, press release, 2010, http://sainsburysbank.thepressdesk.co.uk/pages/136/2010+Press+releases.stm?article_id=692.

c http://www.lloydstsb.com/savings/save_the_change.asp.

Box 9.5 No Lose Lottery

A lottery where you must pay a 'savings tax' to yourself, as the price of competing for a big cash prize

The rush of excitement and apprehension experienced when entering the National Lottery, combined with the chance to 'get rich quick', encourages over 32 million Britons to buy a lottery ticket each week.^a Nevertheless, with 14 million-to-one odds^b and an 'expected return' of £0.45 on a £1 bet,^c critics portray it as a waste of money.

Several lottery schemes to encourage saving are already in place, such as 'Save to Win' developed by Michigan's Credit Unions and NS&I Premium Bonds. However, as people are not able to see the winning numbers being revealed, these schemes do not build up a sense of thrill and anticipation amongst the participants, reducing the incentive to save.

Under the 'No Lose Lottery', the expected return of £0.45, which is largely concentrated on a few big winners, would be replaced with a much better bet: more would be returned with certainty (or nearer certainty) and less would be gambled towards big prizes. No money would leave the No Lose Lottery for good causes (currently 28%). The certain return (say £0.50) would be saved directly into the players savings account using a Savings Smartcard (See Box 9.4), with the difference going into the prize fund, and the costs of marketing and running the lottery.

While allowing individuals to experience the excitement of entering the National Lottery, it creates a 'win win' situation by building up people's

savings resources at the same time. Given that 67% of low-income earners buy a lottery ticket at least once a month,^d this initiative will contribute towards the funds in the accounts of those least likely to save.

a <http://elottery-syndicates.com/uk-lottery-tickets/>.

b www.uklotteryinformation.com/winning-information3.htm.

c Ian Blow and Laura Crawford, "A nonparametric method for valuing new goods," *Institute for Fiscal Studies*, (2009), 18.

d Paul Bickley, "Is the National Lottery helping Britain's poor?," *Theos*, (2009).

3. Making government consistently part of the solution – using government itself to encourage asset accumulation.

Whether the actions of government are positive or negative for a particular policy objective, they are rarely neutral. *How* money is paid by governments, and *who* it is paid to can have real consequences for the goals of savings policy. Aligning policy more consistently towards these objectives would make a real difference. For example:

- **Pay a portion of tax credits as a lump sum:** Most government transfers are paid weekly or monthly as income. This creates a bias towards immediate consumption. At the lowest levels of household income, this might reflect necessity in meeting basic, day to day needs. However, not all basic needs involve day-to-day expenditure, which can be lumpy. Hence some government transfers could be withheld and paid as lump sums. The US equivalent to tax credits are typically paid as a lump sum, and the same approach could be used for some portion of tax credits (See Box 9.6).
- **Use existing resources more effectively:** The size of the deficit and the resulting fiscal constraints put a premium on extracting the most value from every £1 of taxes spent or foregone. At present, policies such as pensions tax relief provide relative large benefits to a relatively small group of people: 55% of pensions tax relief goes to around 10% of taxpayers. Better alignment of this expenditure to the goals of spending policy might see it used to offer smaller savings incentives to a much wider group. (See Box 9.7)

- **Understand and use the differential power of particular incentives for different income groups.** Tax relief offers the largest incentives to those paying tax at the highest rates, and offers no incentives to households not paying tax. Matched savings products can work in much the same way as tax relief, but the level of incentive can be adjusted with much greater precision, and offer incentives even to those who don't pay tax.

Box 9.6: Make more income transfers assets

Paying a portion of tax credits as a lump sum

Chapter 4 reviewed the literature concerning the strategies individuals use to try to impose some discipline on their finances. For example, by using distinct 'mental accounts' for money from different sources, individuals think about and spend the money in different ways. This is despite the essential fungibility of money from any source – money is money. How government pays money to individuals can prove a powerful signal for how the money should be spent.

Most government transfers are paid as income. Some are paid as lump sums and given a label. Chapter 4 highlighted a recent IFS study which has shown how calling a cash transfer a 'Winter Fuel Allowance' results in a relatively high proportion of the money being spent on heating bills.^a

In the UK, tax credits are paid monthly as income. By contrast, the US equivalent – the Earned Income Tax Credit – is typically paid as a lump sum at the end of the year. In the UK, tax credit payments are viewed as an essential part of monthly income. In the US, EITC claimants have an overwhelming preference for lump sum payment.^b US claimants might save the money, use it to clear accumulated debts, or to purchase larger household items. It is viewed very differently from income, and used differently as a consequence.

Average annual EITC awards are much smaller than average UK tax credit awards, which make up a much larger share of household income. As a result, switching entire tax credit awards from payment as income to lump sum payments would not be feasible or desirable. However, it is worth considering the benefits of switching a small proportion

of tax credit awards to lump sum payments, as a complement to the remaining share that would continue to be paid as income.

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- a Beatty, Blow, Crossley, and O'Dea, "Cash by Any Other Name? Evidence on Labelling from the UK Winter Fuel Payment".
 - b Steve Holt, *Beyond lump sum: periodic payment of the earned income tax credit* (Washington DC: The Brookings Institution, 2009). Claimants of the EITC can elect to receive the money as a lump sum or as a regular payment. Overwhelmingly they chose the lump sum (less than 1% chose 'advance' options), partly because it is much easier to do.

Box 9.7: Matched Pensions Savings

The current pension tax relief system is not progressive. Pension contributions receive tax relief at the contributor's marginal rate of tax. This effectively means that for each pound saved by a higher rate taxpayer, £1.57 goes into their pension pot, while for basic rate taxpayers, the figure is just £1.25. Indeed, in 2004, 55% of pensions tax relief went to those paying the higher tax rate, making up just 10% of UK taxpayers.^a Despite the scheme's aim to incentivise contributions, it has failed to prevent a major savings deficit occurring in Britain.

The abolition of the current system and the introduction of a matched pension saving scheme could solve these problems. As with the Savings Gateway pilots,^b matching requires that for every £1 transferred into a pension pot, the state adds a additional amount on top – perhaps 50p for each pound contributed – up to an annual limit. This would be more progressive since the matching amount would be uniform regardless of income, rather than rising with it. Such a scheme could easily be made cost neutral to the taxpayer.

Unlike tax relief, a matching scheme would be easily understood by the public, helping them to recognise and exploit the benefits of the policy. It is couched in a positive tone of the state providing funds, rather than the negative language in tax relief of not taking money away. This psychological element would further encourage individuals to save, with estimates suggesting that the boost could be as much as £1.5 billion.^c

a Chris Curry and Alison O'Connell "Tax Relief and Incentives for Pension Saving," *Age Concern England*, (2007), 11.

b PricewaterhouseCoopers, "Bridging the savings gap: An evolution of voluntary and compulsory approaches to pension reform" *API*, (2005), 46.

c *Ibid.*, 21.



CONCLUSION

This paper has argued for a whole new approach to savings policy. Traditional approaches to savings policy – trying to make us into a nation of habitual savers – should be continued and improved. But such approaches can involve big deadweight costs. In addition, they don't tend to help large groups in society whose attitudes to saving don't fit the policy. Saving could be made much easier if traditional approaches were supplemented with strategies with a new focus on boosting actual savings *activities*. This is a way of saving for people who don't much like to save.

The call is for creativity from policy makers. A number of ideas have been put forward. There is scope for many more, particularly if the idea of the Savings Smartcard was adopted, providing a robust platform for many new savings applications.

Saving would also be easier if government thought more deliberately about the role it can play in a new culture of saving. This includes the signals it sends through the way it pays money to citizens, and in its priorities for expenditure.

The challenges for savings policy are significant. The recent financial crisis has exposed our vulnerability – collectively and for many households. Strengthening our individual and collective financial resilience must be an urgent priority. A radical rethink of savings policy is needed. This report is the beginning of that task.

TECHNICAL NOTE

Whilst the analysis of the Wealth in Great Britain 2006/08 report, presents breakdowns by age, education, employment status, socio-economic classification of the household head, over the component parts of total wealth– property wealth (net), financial wealth (net), physical wealth and private pension wealth – it does not include breakdowns by income. This decision was taken due to a concern that the income data could not be given the appropriate level of quality assurance.

Total household income in the WAS data consists of three components: earned income (from employment), income from benefits, and other income (such as income from investments). The primary concern among the producers of the Wealth in Great Britain 2006/08 report lay in misgivings regarding the quality of the benefits data. A significant number of respondents declined to answer the questions in the benefits section, leading to potential selectivity issues⁸¹ and this problem was exacerbated by the lack of proxy respondents asked for information about benefits with the result that there was insufficient information collected to attempt to impute the missing data.⁸²

The analysis that contained in this report therefore focuses on earned income at the household level.⁸³ Clearly a focus on earned income, abstracting from benefit income, is sub-optimal when looking at the savings attitudes and behaviour of the poor. However, given that those on benefits are likely to be in the lower part of the income distribution,

81 Selectivity issues can arise if the sample is non-random across the population. In particular if there exists a systematic correlation between inclusion in the sample (here the sample of those who chose to answer the questions on benefits) and some other relevant characteristic, then selection bias can be the result.

82 Furthermore, when compared to the Living Costs and Food Survey and the WAS Wave 1 was found to significantly underestimate total household income and income deciles showed the underestimation to be systematically greater for low income households.

83 The WAS data on earned income follows a similar distribution to the Annual Survey of Hours and Earnings, and whilst earned income in the WAS data were slightly higher (ASHE measures earned income on a job basis while WAS measures it at a household level), the pattern is consistent across all decile groups. ASHE does not include self-employed income, so the distributions were compared excluding income from self-employment.

and are likely to remain in the lower part of the income distribution when benefits are not included in income, it is our feeling that the distribution of earned income can still offer a good deal of insight. To mitigate the potential bias arising from a focus on earned income those over the age of 65, who are likely to be getting a sizeable proportion of their income from unearned pension income are, where necessary, excluded from the analysis. Furthermore, in regression analysis, the unemployed, retired, and disabled were controlled for separately.

Household income refers throughout to equivalized household income and has been calculated according to the McClements Equivalence Scale. Equivalised household income is income measured over the whole household adjusted for household size and composition using the McClements equivalence scale. Details of this scale can be found in the table below.

McClements Equivalence Scale	
Cohabiting head of household	0.61
Partner/spouse	0.39
1st additional adult (in addition to spouse)	0.42
Subsequent (in addition to spouse + other additional)	0.36
OR	
Cohabiting head of household	0.61
1st additional adult	0.46
2nd additional adult	0.42
Subsequent adults	0.36
AND	
Child Aged	
16-18	0.36
13-15	0.27
11-12	0.25
8-10	0.23
5-7	0.21
2-4	0.18
Under 2	0.09

The values for each household member are added together to give the total equivalence number for that household. For example, a household has a married couple with 2 children (aged 6 and 9) plus one adult lodger. The household's equivalence number is $1.0 + 0.21 + 0.23 + 0.42 = 1.86$. The household's income is £20,000, and so its equivalised income is £10,753 ($= £20,000/1.86$).

Detailed analytical results have been excluded for reasons of brevity, but are available on request from the Social Market Foundation.



Saving is difficult. It goes against the immediacy of our impulses and the messages of our culture. But what is difficult for us as individuals is a problem for us all as a society. The financial crisis showed how vulnerable we are, both as individuals and as a society, to shocks. Too few of us are saving at all. More than one fifth of households have more debts than savings. Even fewer of us are saving enough for our longer-term needs.

Traditional approaches to savings policy try to make us into a nation of habitual savers. But changing our behaviour is difficult. Based on new empirical analysis of the Wealth and Assets Survey 2006/08 and data from the Child Trust Fund, this paper argues for a whole new approach to savings policy. Many people would save if it was easier to do. With ideas from a No Lose Lottery to a Savings Smartcard, this report calls for creativity from policy makers, banks and businesses, to develop savings policy for people who don't much like to save. Given the scale of the challenge, a radical rethink of savings policy is needed. This report is the beginning of that task.

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