Fiscal Policy

Should lower-income families pass through the Gateway to Saving?

The Government has proposed the ***Saving Gateway*** *to encourage higher rates of saving and asset ownership among lower-income households.* ***Matthew Wakefield*** *(A Research Economist at the Institute for Fiscal Studies) examines the proposal*

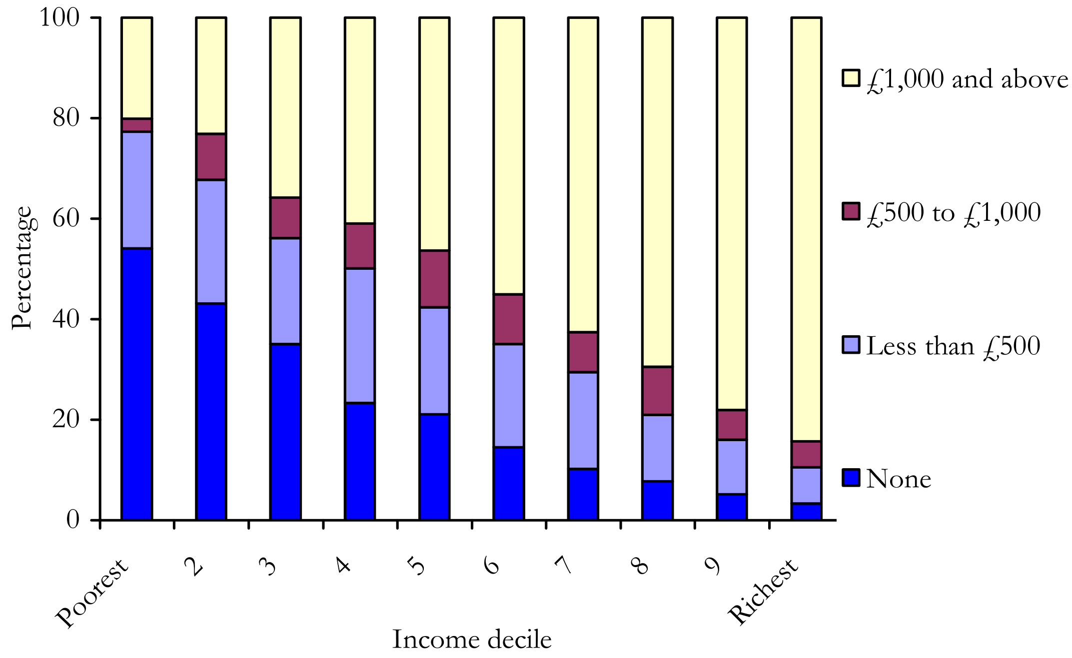
The Government has stated a desire to 'increase rates of saving and asset ownership … among lower-income households'. But does economic reasoning suggest that there are grounds to be concerned about the saving behaviour of lower-income households? I will argue that although there might be some people towards the bottom of the income distribution who could benefit from being encouraged to save more, there is a danger that if the Government's proposed policy is not carefully targeted then it might not achieve its aims. To set the debate in context, let us begin by considering evidence on the saving behaviour of lower-income households.

Evidence on saving behaviour

For individuals living in households with a head aged less than sixty, Figure 1 displays data on the amount of financial wealth held at different points in the British income distribution. Each bar represents a tenth of the population, ranging from the tenth with the lowest incomes (hereafter, the poorest tenth) in the leftmost block, up to the tenth with the highest incomes (the richest tenth) in the right-hand column. The proportion of individuals living in families with larger amounts of wealth increases as one moves up the income distribution. This pattern is consistent with, but does not necessarily imply, a population of individuals making sensible savings decisions.

The Government's focus is on the bottom part of the income distribution. Considering therefore the poorest 30% of the population, we see that approximately two-thirds of individuals live in households with less than £500 of financial wealth. Although these figures are the most recent available on amounts of financial wealth held by British families, they date from 1995. More up to date figures on numbers of families holding any financial asset confirm the pattern: 1999-2000 data suggest that in the poorest tenth of the population almost one quarter of families did not have a basic current account or any other financial assets; in the richest tenth less than half a percent had no financial assets.

Figure 1: Estimates of household financial wealth, by income decile, 1995: individuals in households with a head of household aged under 60 only



Notes: Wealth is all money held by household members in interest-bearing accounts and financial investments.
Source: Emmerson, C., and M. Wakefield, 2001.

The document from which these data are taken considers many of the issues discussed here and is available at http://www.ifs.org.uk/pensions/abw.pdf. See also Chapter 7 of the IFS Green Budget (January 2002), which may be found at http://www.ifs.org.uk/gb2002/chap7.pdf Links to these pages can be found on the *Economic Review* website.

The Saving Gateway

To encourage increased saving by those towards the bottom of the income distribution the Government has proposed the Saving Gateway, a matched savings account that would be available to lower-income households. Matching involves the Government contributing some amount (probably a pound) on top of every pound (below some limit) that an individual pays into the account. This will provide a strong financial incentive for eligible individuals to put money into a Saving Gateway account. Financial information and education will be provided alongside accounts.

Why would the Government choose to spend money to provide matched savings, rather than to provide more direct forms of support to lower-income families? The argument used to justify this seems to be that there are benefits of saving and of having a stock of assets that will not be realised by these families unless they are strongly encouraged to save. We have seen that quite a high proportion of lower-income families have low financial wealth. It would be too simplistic to argue that individuals in these families should be saving more: they might have good reasons for not saving.

Motives for saving

Economic theory suggests that people will wish to 'smooth' their consumption by saving during periods when they have high income and running down their savings during periods when income is lower. Over a lifetime this typically involves saving during one's working life in order to provide for one's retirement: this is the lifecycle motive for saving. In the shorter term it suggests that individuals might wish to have a 'buffer stock' of savings from which they can fund consumption during periods of unforeseen low-income (and also to fund unforeseen large expenditures): this is the 'precautionary' or 'rainy day' motive for saving. Much of the rhetoric around the Saving Gateway suggests that it is primarily intended to encourage rainy day saving; if it encourages people to develop a habit of saving then it might lead to lifecycle saving as well.

For some groups of people with lower-incomes, these motives will often not apply. First, lower-income pensioners are past that stage in their lifecycle when they have reason to save to provide for their retirement. Second, the majority of students have low current income and expect much higher income once they start work. Rather than saving, they would probably wish to borrow against this future income. Third, many amongst the unemployed are unlikely to want to save. Unexpected unemployment is the type of low-income 'rainy day' contingency during which any buffer stock of savings would be run down rather than built up.

Students, pensioners and the unemployed

Further analysing the data used in Figure 1, we find that half of people in the bottom third of the income distribution either have over £500 of financial wealth, or are students, unemployed or pensioners. Assuming that those with assets do not need encouraging to save more, and remembering that we have argued that students, the unemployed and pensioners probably would not want to save, this implies that up to half of a potential target population would not stand to gain from the Saving Gateway in the ways that the Government hopes. This would not be a serious problem if the people that the Government would not wish to target would simply opt out of the Saving Gateway. This would almost certainly not happen. Those with existing stocks of liquid financial assets could save in the accounts simply by transferring these assets to receive the high return guaranteed by matching. The state would have to bear the financial cost of matching, without creating any new savings or savers.

Borrowing to save?

Those without a ready stock of assets who also find it difficult to afford to save from their income, might be able to reap the finance benefits of matching if they can profitably 'borrow-to-save'. Matching represents a large, guaranteed return on an individual's savings. Many people will be able to borrow money at an interest cost that is lower than this guaranteed return, (by borrowing on a credit card, for example). For such people it would be profitable to borrow to put funds into a Saving Gateway account and then to pay off the debt using the funds in the account when it closes. If people could borrow informally from family or friends, then it might be possible to gain the entire matching return by 'borrowing-to-save'. A concern that unscrupulous moneylenders might lend to people to extract these returns has led some commentators to dub the policy "loanshark lolly". Even if the returns were not appropriated by loansharks, 'borrowing-to-save' would not leave people with a large stock of assets when they closed their Saving Gateway because some of the money would be used to pay off the debt.

Such borrowing could also make the Saving Gateway ineffective in achieving the Government's aim of teaching a saving habit if the discipline to consume less than your income is an important part of this habit. Like transferring existing assets, borrowing-to-save could generate matching costs for the Government without the hoped-for benefits of the Saving Gateway being realised.

Who should save more?

Among people in the 'other' half of the bottom third of the income distribution – those who do not have over £500 of financial wealth and are not students, unemployed or pensioners – there might well be some who would be well advised to save more. People might save less of their income than would be wise because they have poor information about financial institutions, or about the benefits of having a stock of savings or the benefits of going through the forward looking process of planning to put money away to spend in the future. Alternatively it might simply be that they have never got into the habit of spending less than their current income or of using a bank or building society to save with. The benefits of Saving Gateway to such people would be larger if what they learn from having an account continues to affect their saving behaviour even after their account has closed.

The need for targeting

We have seen that whilst some lower-income individuals might benefit from being encouraged to reconsider their savings decisions, there might be some people who would respond to the Saving Gateway in ways that impose costs of matching on the Government without yielding the benefits that they hope to achieve. If the policy can be targeted towards those who stand to benefit then these 'deadweight' costs might be avoided. Evaluation of the pilot (or trial) versions of the policy could help us to see whether the Saving Gateway can be a cost effective way to 'increase rates of saving and asset ownership' among lower-income households.